ICFR: INSIGHTS, ISSUES, AND PRACTICES

A LESSEE'S GUIDE TO IMPLEMENTING
Internal Control over Financial Reporting
for contracts accounted for under

Accounting Standards Codification (ASC) 842, Leases

NOVEMBER 2018

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Committee on Corporate Reporting

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IMPLEMENTING INTERNAL CONTROL OVER FINANCIAL REPORTING FOR CONTRACTS ACCOUNTED FOR UNDER *Accounting Standards Codification (ASC) 842, Leases*

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ICFR: Insights, Issues, and Practices highlights noteworthy circumstances that may affect how management establishes good ICFR and performs an attestation around the effectiveness of internal controls specific to Leases to comply with Section 404(a) of the Sarbanes-Oxley Act of 2002 ("SOX"). Management should determine whether and how to respond to these ICFR Insights, Issues, and Practices under the existing requirements of the rules of its regulators and relevant laws. Management should determine whether and how to establish policies and processes (inclusive of internal controls) based on specific facts and circumstances. The statements contained herein are non-authoritative; they do not establish rules or reflect any auditor or regulator determination or judgment about the application of ICFR for Leases.

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Introduction

This document has been prepared by Financial Executives International's (FEI) Committee on Corporate Reporting (CCR). The objective of this publication is to provide useful, relevant information that will help companies streamline and focus internal control efforts related to the new leasing standard.

As a result of Accounting Standards Codification (ASC) 842, Leases ("*Leases*" or "the new standard"), preparers may face the inherent challenges associated with determining right-of-use (ROU) assets, lease liabilities, and related disclosures and may also experience significant efforts in designing controls and developing documentation to maintain an effective system of internal controls. This document contains insights from financial statement preparers compiled to help other preparers in their respective application of internal controls over the new leasing standard. At a high level, the document includes insights, best practices, and recommendations in the following areas:

- Considerations around how to scale the implementation of internal controls associated with *Leases* based on the significance of the impact of the new standard to a company's financial statements;
- Suggestions on how to determine the appropriate design of internal controls based on the company's materiality assessment;
- Specific examples of key risks and controls that may be applicable to areas such as data collection, lease identification, lease classification, preparation of disclosures, etc.;
- Special considerations for multinational companies that must also consider the impact of the new International Financial Reporting Standards (IFRS) leasing standard on local statutory reporting requirements; and
- Recommendations for companies to consider when implementing a systems solution to comply with the new requirements of the new standards.

This document is not authoritative literature. The insights provided are intended to be thought provoking; therefore, they do not represent an "all-inclusive" or "one-size-fits-all" approach. It is expected that preparers will be able to leverage the considerations and examples in this document, but they will ultimately need to calibrate the information to the respective risks, judgments, and complexities involved in adopting *Leases* based on the facts and circumstances surrounding the entity.

PART I: Purpose and background of this document

Purpose

The application of internal control has been a persistent issue for financial statement preparers and their auditors for many years. Part of the challenge lies in translating high-level internal control theory and principles into practice. This is particularly true when evaluating the adoption of new accounting pronouncements, and many preparers experienced this challenge during the implementation of the new revenue recognition standard. In addition to getting the right controls in place for ongoing accounting (day 2), adopting companies also need to consider controls around transition (day 1 adoption), which inevitably leads to pragmatic considerations related to time, resources, and costs for a one-time adoption event.

It is our view that the application of internal control principles to the new leasing standard would be more efficient and effective if companies adopting this new standard shared insights and examples of key internal control areas addressed during the implementation process. We believe many companies will have similar issues and questions. It is our hope that companies will want to participate in this process and share their own perspectives on techniques and approaches that appropriately balance the costs and benefits of particular controls related to leasing. Users of this document who wish to provide their perspective and/or who seek future engagement on the topic, are encouraged to contact the following: techacct@financialexecutives.org.

From these efforts and similar ones focused on the new standard on the accounting for loan losses[1], we hope to gain and disseminate insights that will be valuable when evaluating and addressing issues that exist with the application of internal controls more generally, particularly upon the adoption of a new accounting standard.

Background

The Financial Accounting Standards Board (FASB) issued the final accounting standard for leases, *Leases*, in February 2016. The new standard requires lessees to record leases on their balance sheets, eliminates the specific guidance for real estate, and requires additional financial statement disclosures. Of these changes, lessees will experience the most significant impact. The accounting for lessors retains many aspects of the lessor accounting model under ASC 840. As a result, ICFR efforts to adopt this standard primarily focus on lessees.

For lessees, the new standard will result in the recognition of ROU assets and lease liabilities and the compilation of a series of disclosures. There is complexity in the details of applying the guidance to recognize leases on the balance sheet, and corresponding changes to the related design and implementation of ICFR are expected. For example, processes such as the identification of leases (including embedded leases), evaluation of lease contracts, classification, measurement and recognition of ROU assets and lease liabilities, evaluation of related estimates, and preparation of disclosures may need to be reevaluated to determine necessary changes or additions to existing control activities. This standard is particularly challenging for preparers because the range of lease transactions requires differing levels of judgment and precision to prepare financial statements that comply with the standard. In addition to these considerations, companies implementing a system solution to comply with the requirements of the new standard will also have to assess the related system risks and design and implement related internal controls.

[1] Refer to the separate *ICFR: Insights, Issues and, Practices* document prepared by FEI's CCR to address the application of internal control for the FASB's new current expected credit loss (CECL) standard.

As preparers, we understand and appreciate the importance of a good system of internal controls over financial reporting. We recognize that every public company is subject to a legal requirement to maintain accurate books and records and that internal control is the foundation for achieving that state. This requirement was a central element of the Foreign Corrupt Practices Act (FCPA) of 1977, which also served as the impetus for the development and formalization of the internal control practices used today by public companies. SOX requires the evaluation of the effectiveness of an issuer's ICFR as of the end of each fiscal year. The SEC has identified Committee of Sponsoring Organizations of the Treadway Commission's (COSO) internal control–integrated framework ("COSO framework") as an example of a suitable framework. It is our experience that preparers would welcome additional relevant, useful information to assist their understanding and application of the COSO framework and that such help would be welcomed in the form of insights and practices gleaned from the experiences of other preparers. We believe this type of sharing will help companies achieve a reasoned, focused application of internal control across industries and across a wide spectrum of companies.

The focus of this document is on internal controls around the accounting applied by lessees that would often be identified as in scope controls for documentation and testing in an ICFR assessment. This document also considers the technical aspects of the new standard in certain areas in which management's judgments intersect with the internal control structure for leases. This document is not meant to establish minimum standards for compliance. Rather, it is intended to highlight certain significant assumptions, inputs, estimates, and computations necessary to implement the standard. It is our intent to provide a document that assists companies in their analysis of the factors significant to them.

This document does not provide an end-to-end internal control solution for adoption and ongoing compliance. Every company has unique attributes, and what is applicable to one company may not be applicable to another. We therefore expect that the relevance and utility of the insights and practices in this document will vary depending on the size and complexity of the organization, the significance of leasing activity, the existing control environment, and the nature of the company's business as well as any accounting elections and practical expedients that have been adopted in connection with the new standard. Accordingly, for the purposes of a company's annual ICFR assessment, this document considers the perspectives of preparers for whom the financial statement impact of leases is as follows:

a. material (material impact) in the aggregate;
b. where leasing is a significant activity, but not material to the financial statements taken as a whole (significant impact); or
c. where leasing is insignificant (insignificant impact) in the aggregate.

While this document is oriented based on the quantitative impact of *Leases*, a holistic assessment is required, including the complexity of the leasing portfolio, to make an informed risk assessment for the annual ICFR assessment.

Part III of this document differentiates risk and control activities based on the three categories of impact listed above to demonstrate possible differences in an annual ICFR approach. Identifying when the financial statement impact is material and when it is insignificant is intuitive. More challenging are situations in which the adoption of *Leases* results in a significant recognition of ROU assets and lease liabilities but that is not material relative to the total balance sheet and, more broadly, the financial statements taken as a whole. This "significant impact"[2] category requires careful judgment to determine the appropriate level of annual ICFR effort to document and test compliance with *Leases* given that the overall outcome does not represent a material risk to the financial statements. We believe many companies will fall under this category.

It is our hope and belief that the information provided in this document will help lessees of all sizes successfully implement and maintain controls over leasing activities on an ongoing basis. In addition, we hope the information in this document will facilitate a dialogue between preparers and their auditors around the issues encountered in the application of internal control and promote efficiencies in this area by applying consistent guidance.

[2] From our perspective, an example of a situation we would consider as having a significant impact (but not as having a material impact or as being insignificant) is when the total lease assets and total lease liabilities, respectively exceed by a marginal amount, a quantitative materiality threshold calculated using an income statement-based measure such as pre-tax income. However, when the total lease assets and total lease liabilities are compared to the balance sheet as a whole, they represent an immaterial percentage of total assets and liabilities, respectively, such that the removal of the balances would not materially misstate the balance sheet.

PART II: Materiality considerations for implementing and maintaining effective internal control over *Leases*

During the implementation of internal controls associated with the FASB's revenue recognition standard, which became effective in 2018, many companies faced the challenge of determining how to evaluate whether the internal controls are sufficiently robust to achieve accurate books and records and effective internal control over financial reporting. For the revenue recognition standard, companies generally had an objective to comply with the standard and fully cascade the impacts of the revenue recognition standard to division scorecards and management bonus computations. Therefore, companies had an operational interest in implementing the revenue recognition standard with a high degree of precision. In contrast, companies generally view the balance sheet recognition of ROU assets and lease liabilities as a corporate effort having little to no impact on operational scorecards. Accordingly, the risk assessment and materiality considerations of *Leases* may be justifiably lower than the recent revenue recognition implementation.

We also observed that many companies that were not significantly impacted by the revenue recognition standard invested significant efforts into demonstrating the lack of material impact. For some companies, the cost of implementing the standard approximated or exceeded the total impact recorded to the Profit and Loss Statement (P&L). In essence, companies were frequently burdened by a lack of consensus as to what level of evidence was sufficient to address the risk of insufficient application of the new standard. In simple terms, how do you know when enough is enough?

We believe the approach for evaluating new and/or changes to existing risks, processes, and controls required to support *Leases* can be appropriately scaled based on the significance of the impact of the new standard on the respective company's financial statements and the related risk of the lease activity.[3] Such an approach requires a continued focus on the maintenance of accurate books and records throughout the transition period ("implementation") and on an ongoing basis after the effective date of the standard ("day 2" accounting).

As companies redirect accounting and internal control experts to the implementation plan for the new *Leases* standard, familiar judgments re-emerge, such as:

- What is the likelihood a material misstatement would occur absent internal controls?
- Which elements of the process present the highest risk that a misstatement could occur?
- What evidence can be collected to demonstrate that the design of controls is sufficiently robust to support accurate books and records and effective internal controls over financial reporting by addressing the likely sources of potential misstatement?
- Is it possible to perform an analysis to reasonably demonstrate that certain de minimis lease transactions do not present a risk of material misstatement such that specific control activities would not be needed in response to the risk?

A thoughtful, deliberate approach to scoping the design of internal controls around *Leases* grounded in a well-reasoned risk and materiality assessment and involving proactive dialogue with the auditor regarding management's decisions on the design and implementation of control activities should enable consistent expectations between management and the auditor on how to address a control deficiency should one be identified during the ICFR assessment.

[3] *When approaching the adoption of Leases, it is important to remember that companies have a starting point in the ICFR process, which is the system of controls put in place to comply with the accounting and disclosure requirements of ASC 840.*

As we noted previously, the most significant impact of *Leases* will be the recognition of ROU assets, lease liabilities, and the related disclosures. This significant change from ASC 840 will likely impact the risk assessment of a company's lease process. Under ASC 840, if a lease was incorrectly designated (e.g., a capital lease designated as an operating lease), the balance sheet could be significantly impacted. Under *Leases*, this valuation risk is minimized because every identified lease will be recorded on the balance sheet and the magnitude of such an error would not be as significant. Conversely, because all operating leases will be presented on the balance sheet, processes to identify all operating leases under *Leases* may need to be more robust than they were under ASC 840. This is reflective of a very low risk of material misstatement under ASC 840 since the rent expense would likely still have been recognized on a straight-line basis whether it was an operating lease or a service contract. Accordingly, in transitioning to *Leases*, companies may have to reassess whether their existing controls are sufficient to identify all significant lease transactions, including embedded leases, which may warrant additional processes and controls as of the initial adoption date to strengthen the completeness of the inventory of leases.

Further, the implementation of *Leases* will generally not impact key performance indicators such as net earnings, net sales, or operating cash flows, although there may be an impact on debt covenants in certain circumstances. Therefore, because the impact of *Leases* is primarily to the balance sheet, a company might assess a lower risk assessment for the internal control design and establish its tolerance for precision in financial reporting at a higher level compared to other new accounting standards (e.g., the new revenue recognition standard) since the quantitative impact of an error would be limited mainly to the balance sheet and related disclosures. In this situation, even quantitatively significant errors may not be material to a company's financial statements given qualitative considerations. Accordingly, a key question to ask in the initial design of the annual ICFR assessment of controls for *Leases* is how large an error must be to be considered material.

Materiality used to develop ICFR procedures is typically derived by taking a percentage of pretax income. This materiality factor is the basis for determining the reporting level of misstatements in communication to senior management and the audit committee, including misstatements with an impact limited to the balance sheet. As companies assess the materiality of *Leases* to their business and design their controls to implement *Leases*, this should be considered.

We organized this document to address different control considerations companies may evaluate during the implementation period and for day 2 accounting based on the risk assessment and materiality of the accounting change. For example, if the balance sheet impact from the recognition of the ROU assets and lease liabilities is not expected to be material for a company, we believe the annual ICFR effort can be adjusted to reflect the corresponding risk to the financial statements; thus, this document describes what we believe are the appropriate considerations for such a scenario. Conversely, for certain companies, the magnitude and complexity of its lease inventory may yield a material impact; thus, we believe additional incremental effort is required to consider the annual SOX testing strategy of internal controls when addressing that scenario. Part III of this document attempts to provide risk descriptions and internal control activities for leases that are scaled based on the materiality and risk assessment of the standard's impact on the company's approach to documenting and assessing the effectiveness of ICFR.

How can a preparer conduct an initial assessment of the estimated materiality impact of *Leases*?

At the outset, a landscape assessment of current lease transactions will help frame the internal control design. The quantitative sources of information may include the following:

- The inventory of leases identified under the soon-to-be-superseded guidance in ASC 840 (including traditional leases and embedded leases) and lease commitments in the contractual commitments disclosure;
- Lease transaction activity recognized in dedicated accounts in the company's general ledger; and
- Inventories of lease contracts centralized by a department, such as purchasing or legal; by division/location; or by a third-party service provider that manages leased real estate or equipment as part of its services to the company.

The qualitative sources of information may include the following:

- Inquiry results to collect lease contracts by department or division/location;
- Inquiry results to collect service contracts that may meet the definition of a lease; and
- Real estate inventories or site walkthroughs at large locations to understand the nature of operations and identify lease contracts.

The indicated ROU asset and lease liability from the currently identified lease transactions under ASC 840 can be compared against key balance sheet items, liquidity metrics, and debt covenants to frame the initial impact of *Leases*. An assessment of potential embedded leases as well as other facts and circumstances should be included in this assessment. If the initial impact of *Leases* does not have a material impact to the balance sheet and key liquidity metrics, we believe a preparer may design a "right-sized" documentation and testing plan for SOX-relevant internal controls that address the core elements and disclosures of *Leases*. If a company performs an initial assessment of its lease activity and concludes that the impact is not material, the company would document the basis for its conclusion following its accounting policy control process and periodically reassess this conclusion to determine whether facts and circumstances indicate that the company's leasing activity may no longer be immaterial. The reassessment of this conclusion would generally occur on an annual basis or more frequently if a triggering event indicates a significant change in facts and circumstances.

It is also strongly advised that companies have early dialogues with their independent auditors on the initial thinking for the internal control design for the new standard. This early information sharing reduces the risk of a late surprise when the independent auditor assesses the design and operating effectiveness of internal controls for *Leases*.

Can the design of internal controls be different based on the type of lease?

The consideration of materiality and risk in the design and implementation of internal controls for the new standard is not a one-size-fits-all solution. Companies should consider whether its leases are subject to different processes, controls, and systems, and thus, may be subject to different risks. Some companies have designed internal controls for the new standard with differentiated materiality thresholds based on the class or location of lease transactions.

Many lease populations consist of a) lower-volume/higher-dollar value arrangements for real estate and property and b) higher-volume/lower-dollar value arrangements for equipment. Therefore, as a risk assessment on leases is performed, thoughtful consideration can be given to the appropriate time, effort, and resources to be allocated in the design and implementation based on the differing needs and risks of these divergent populations.

Lease portfolios can be differentiated in multiple ways; a common example involves differentiating between real estate leases and equipment leases. Some companies have a centralized process to manage real estate and property leases. In those instances, a company might implement a robust control under which each individual real estate and property lease arrangement is individually reviewed by the accounting policy leader or a similarly placed contract review team well-versed in the new standard, which allows a high degree of confidence in compliance with the requirements of *Leases*.

Conversely, other companies delegate approvals of equipment leases to their operating divisions or other organization units, such as procurement, and they do not have centralized processes to manage equipment leases. In some of those cases, companies have concluded that a comprehensive approach to equipment leases is not justified because even though the number of individual arrangements is greater than the number of real estate leases, the overall financial impact and risk is judged to be de minimis, leading to a conclusion that the level of internal control design and implementation may not require the same level of precision for lease identification, recognition, and measurement. Under this approach, the control design may include an assessment of the expected error rate of this approach to demonstrate that the risk of financial misstatement is immaterial.[4] This approach requires a solid understanding of a company's lease populations, existing controls, and potential financial statement implications of the *Leases* standard.

[4] *This scenario is for illustrative purposes only; the lack of a centralized process to review equipment leases (or any other type) does not automatically imply that the respective lease population is always immaterial or that there is a correlation to the level of precision required in the application of internal control. Ultimately, the determination of internal control design, documentation, and testing will rely on the specific facts and circumstances of the entity.*

What accounting policies are companies applying in the design of internal controls for *Leases*?

Our experience with the new revenue recognition standard reinforced that a successful approach to internal control design involves a well-reasoned materiality assessment and the consideration of risks that may arise from excluding certain transactions from the assessment. Such an approach may involve the development of an accounting policy that establishes a reasonable threshold to be used to scope out certain transactions from the assessment. The determination of a leasing policy threshold entails a careful assessment of quantitative and qualitative factors impacting the financial statements and related disclosures. Valid challenges arise when developing a leasing policy threshold; however, the benefits of a threshold that clearly eliminates minor lease transactions—individually and in the aggregate—from the compliance effort, thereby balancing the cost–benefit ratio of accurate books and records with the cost of compliance, are compelling. Such accounting thresholds allow companies to focus more on matters that are most significant. Upfront dialogue with the company's auditors during the development of such an accounting policy is essential so the implementation effort can be focused on material and complex lease arrangements. Companies should leverage their experience with similar thresholds and conventions, which have existed for many years in many areas of accounting.

Some companies have considered an accounting policy threshold for a minimum lease recognition threshold using the materiality threshold for fixed-asset capitalization as a reasonable proxy for ROU assets because fixed assets and ROU assets represent tangible, long-term assets. However, the threshold for fixed-asset capitalization is typically driven by tax compliance requirements at a much lower level than necessary to achieve accurate books and records and effective internal control over financial reporting. In addition, the impact of a capitalization threshold for leases needs to consider the impact of a threshold on the asset and liability sections of the balance sheet. Instead of the fixed-asset capitalization policy, some companies leverage thresholds from other processes, such as:

- The dollar amounts applied for certain senior-level management sign-off authority level for new contract commitments (cumulative spending commitment and/or contract duration) and/or accounting/controllership review of contracts;
- The dollar amounts applied for capital spending authorizations; or
- The dollar amounts applied for management sign-off of non-routine journal entries.

In addition, depending on whether the lessee elects to combine lease and non-lease components, a leasing policy threshold may apply a higher threshold for embedded leases than traditional leases because only a component of the overall embedded lease arrangement would be treated as a lease.

Beyond a leasing policy threshold for the recognition of an individual lease, companies may adopt a leasing policy to recognize portfolios of similar leased assets with broad judgments applied to a group of leases in the aggregate instead of evaluating each lease separately.

If an accounting policy threshold or portfolio approach is ultimately applied, it is important that the accounting policy be established via an effective control activity. This control activity is generally documented as follows:

> *Management, with the appropriate authority, establishes an accounting policy to guide the work process to develop and maintain the database of leases. The rationale for the accounting policy threshold or portfolio approach is documented in the Accounting Policy Memo and Implementation Oversight Summary and validated on an annual basis (or more frequently if there is a significant change in facts and circumstances).*

The rationale for the accounting policy threshold or portfolio approach should include a computation that indicates if the potential omission or error is immaterial. Furthermore, this rationale will require an annual reassessment to confirm that the conclusion remains sound as facts and circumstances evolve.

PART III: Risk and control activity considerations for implementing and maintaining good internal control over *Leases*

Once the materiality considerations discussed in Part II are completed, attention would likely turn to the key risks pertinent to the particular company and the identification of appropriate controls to mitigate those risks. This activity is the most critical in determining how much effort for ICFR needs to be exerted to adopt *Leases*.

In designing the right level of controls, common considerations that most companies would want to answer include the following:

- How can companies design and implement internal controls to collect lease information accurately and completely?
- How can companies design and implement internal controls to identify embedded leases?
- How can companies design and implement internal controls to determine the incremental borrowing rate?
- How can companies design and implement financial reporting controls for the disclosure requirements of *Leases*?
- How can companies document their adoption of *Leases*, including the design and implementation of controls?

This paper does not attempt to address every possible consideration in internal control design for the adoption of *Leases*, such as the reclassification of lease terms, cash flow presentation, and ROU asset impairment assessments.

The extent to which a company needs to answer these and other questions to demonstrate effective internal controls will depend on its own risk assessment and materiality considerations. Each of these questions is discussed further below, and examples of risks and control activities are provided.[5] To identify how risks and control activities may differ based on a company's materiality analysis of *Leases*, the risk and control tables included in the subsections below make the following differentiations:

- *Material impact*
  Companies that have determined that *Leases* is material would want to consider performing, documenting, and testing the controls included in the table or adequate substitute controls.
- *Significant impact*
  Where leases are not material but also not entirely insignificant, companies would want to consider performing, documenting, and testing the indicated controls or adequate substitute controls. These companies are in the "significant impact" category described in Part I, where they could find themselves performing more annual SOX documentation and testing of leases controls than is necessary if thoughtful caution is not applied.
- *Insignificant impact*
  Companies minimally impacted by *Leases* may want to consider performing, documenting, and testing the indicated controls.

[5] *The risk and control tables are provided to show example risks and controls. Other risks and control activities relevant to a company may not be included in the tables. Similarly, all these risks may not be present and/or not all the control activities identified may be necessary for a company.*

How can companies design and implement internal controls to collect lease information accurately and completely?

A critical first step to properly account for leases is to identify lease contracts. Companies with a standardized contract process and a centralized repository will likely have an easier time identifying lease contracts than companies without a standardized process or central repository. Companies in the latter position may have to exert significant effort to identify and gather their lease contracts. After ensuring that lease contracts have been identified, companies need to measure those contracts correctly to properly account for them. The proper measurement of a lease contract requires the appropriate determination of the lease term, lease payments, and lease classification. Considerations of initial direct costs, estimated useful life, and residual value are not addressed in this document.

Determination of the lease term

A significant element of lease accounting is the appropriate determination of the lease term (as defined by *Leases*), which will be used for classification and measurement. Lease arrangements include a base lease term and, in many cases, contain renewal provisions. Companies will need to establish an appropriate process and related controls over the determination of whether to include renewal periods in the lease term. The process and controls may be stratified based upon the significance and nature of certain sub-populations. For example, the control design and implementation may be more robust for significant, complex real estate arrangements compared to that for a fleet of cars.

Determination of lease payments

On the surface, the determination of lease payments may seem straightforward. However, it can be complex and impacted by factors including, but not limited to, security deposits, bargain purchase options, purchase options other than bargain purchase options, residual value guarantees, variable components (e.g., payments based on an index), etc. Adequate, effective controls should be implemented to consider all components impacting the lease payments, the payment related to the ROU asset, and obligations are properly identified and assessed when determining the measurement of a lease contract. This determination would further be impacted if a company elected to combine lease and non-lease components in connection with the recognition and measurement of leases.[6]

Determination of lease classification

Leases must be classified as either a finance lease or an operating lease. The determination of lease classification can require significant judgment, but it is critical to appropriately measure a lease contract. While finance and operating leases will both have a related asset and liability on the balance sheet, the impact on the income statement will differ. The rent expense for operating leases is recognized on a straight-line basis, whereas the rent expense for finance leases are recognized using an effective interest method associated with the lease liability. Additional controls can be implemented to conclude that leases are properly classified with reasonable assurance.

To make each of the above determinations during the measurement of lease contracts, numerous contract- and non-contract-sourced data elements are required. The data-gathering process is often highly manual for lease contracts because they are generally not executed in an automated manner. Therefore, data can be manually abstracted from contracts and other sources. The most critical data points to be accumulated to evaluate the proper measurement for lease contracts include the following:

[6] *Payments included in initial direct costs (IDC) are not lease payments, and they should be accounted for in accordance with the provisions of Leases. IDCs are usually not a significant element of equipment leases, and it may be reasonable to develop policies excluding them from less-significant transactions. They may, however, be a more significant element of property leases.*

Lease term

- Lease commencement date
- Lease end date (including end-of-lease options that are reasonably assured/certain[7])

Lease payments

- Lease incentives
- Contractual minimum lease payments
- Lease currency
- Residual value guarantee, including amount of guarantee
- Bargain purchase option likely to be exercised,[6] including amount of option
- Any payments made prior to start of lease term

Other lease classification items

- Economic lives of related assets[6]
- Fair values of underlying assets[6]
- Interest rate (or incremental borrowing rate[6])

For certain lease transactions, it may be overly burdensome to collect data by individual lease relative to the objective of maintaining accurate books and records and effective internal controls. A classic example of this situation involves individually leased printers. If a lessee can demonstrate that the total population of leased printers is not individually material and/or the individual accounting of the individual assets does not lead to a materially different outcome, the company may choose to address these leases as a single pooled asset. For example, consider a hypothetical company with 100 printers with an estimated cumulative asset value of $100,000 and an average remaining lease term of two years. In this situation, the hypothetical company will record one lease transaction at the estimated cumulative value and average remaining lease term to alleviate the record-keeping burden of tracking each leased printer. This scenario is admittedly simplistic, but it identifies defensible opportunities to pragmatically implement *Leases* while complying with the requirements of the standard in all material respects.

[6] Payments included in initial direct costs (IDC) are not lease payments, and they should be accounted for in accordance with the provisions of Leases. IDCs are usually not a significant element of equipment leases, and it may be reasonable to develop policies excluding them from less-significant transactions. They may, however, be a more significant element of property leases.

[7] While the IBR is an element of classification, this area may also be addressed through a reasoned analysis of the impact of changes in rates on classification for groups of transactions.

Examples of risk and control activities for the accurate data collection of these critical terms are as follows:

Note: The term corporate controller organization is used here and elsewhere for illustration purposes to represent organizations in which accounting policies and business processes control decision authority. Companies with differing structures would focus on the elements of their company authorized to enter into leases or similar transactions.

Risk Description	**Control Activity** Scaled based on impact of *Leases* as follows: I – insignificant impact; S – significant impact; and M – material impact	I	S	M
Significant lease transactions are not collected in the lease database.	Management reviews and approves all lease contracts prior to entering the agreement following a delegation of authority threshold design. The corporate controller organization implements a work process to receive all proposed lease contracts and modifications above a certain commitment threshold following the company's delegation of authority.	√	√	√
	The corporate controller organization designs a quarterly certification process such that each division leader affirms that they have complied with the company's contract approval process and disclosed to the corporate controller organization all new and modified contracts above a pre-defined threshold.		√	√
	The corporate controller organization meets with purchasing on a quarterly basis to discuss executed and in-progress contracts that could include a lease transaction.			√
	The corporate controller organization meets with the real estate organization on a quarterly basis to understand all executed and planned lease changes greater than a pre-defined threshold for the company's real estate portfolio.			√
	The corporate controller organization meets with each division leader to assess whether any event has occurred that would trigger a reassessment of the lease term or lease options.			√

Risk Description	Control Activity Scaled based on impact of *Leases* as follows: I – insignificant impact; S – significant impact; and M – material impact	I	S	M
Incorrect data elements are abstracted for leases.	For each contract identified as containing a lease, one person extracts and a second person subsequently validates the required data elements by tying the data to the supporting source documentation.		√	√
	On a monthly or quarterly basis, a controllership monitoring function selects a sample of new lease contracts and performs selected tests to assess the accuracy of abstracted critical data elements.			√
	A controllership monitoring function establishes a policy requirement that all contracts exceeding a pre-defined threshold are centrally reviewed by accounting policy personnel.	√	√	√
	On an annual basis (or more frequently if there is a significant change in facts and circumstances), a controllership monitoring function performs data analytics and higher-level reviews for the population of new lease contracts to validate critical lease data, such as: • Confirming that leases appropriately have $0 balances at the end of the lease terms, excluding certain exceptions such as leases with purchase options that are reasonably certain of exercise • Comparing interest rates for operating leases to incremental borrowing rate schedules published by Treasury • Conducting outlier tests to identify unusually large or unusually small asset values for data input errors Any analytic assessment or fluctuation analysis should be executed with pre-defined thresholds against management's expectations for follow-up and documentation of the ultimate resolution of significant items.			√

How can companies design and implement internal controls to identify embedded leases?

The starting point for lease accounting is the identification of which transactions would be within the scope of *Leases*. This is generally straightforward when working with transactions in which the legal documentation categorizes the transaction as a lease.

The question is more complex when other contractual arrangements include an asset subject to lease accounting. This assessment is often the most challenging element of implementing *Leases*. Whether they are stand-alone or combined with other elements, most service contracts include terms that include the use of an asset by one of the engaged parties. As a result, companies will need to establish reasonable screening methodologies to determine which transactions would be subject to lease accounting. These screens would address the risk of not identifying a lease embedded in a service transaction. If a transaction that contains a lease is not identified, the primary impacts may include the following:

- Not recognizing a ROU asset and lease liability;
- Not reclassifying the lease element from other expense accounts to the relevant lease account; or
- Omitting certain required disclosures.

When assessing the significance of this risk, it is appropriate to consider:

- *The type of lease embedded in the service arrangement*
  While some contracts may contain a finance lease, particularly longer-term arrangements with fixed minimums, it is expected that most would be considered an operating lease under the new standard, and the impact of the omission would be an understatement of assets and liabilities.
- *The payment terms related to the transaction*
  These arrangements range from those with minimum- or floor-payment provisions to those in which payments are wholly variable. If a transaction is wholly variable, the mischaracterization will not impact the balance sheet but will impact the variable rent disclosure. A disclosure-only impact could be subjected to a different level of materiality assessment compared to an item that directly impacts books and records.
- *The allocation of payments within the contract to lease and non-lease components*
  In certain cases, the lease component will always be less than the full amount of the payment.

These factors may be combined with other criteria, such as the contract term and nominal payment value, to reduce the population of contracts that would be reviewed when searching for embedded leases.

These elements can be considered when developing the overall approach to risks and controls. However, it is equally important to consider the practicality of operationalizing the requirements of the new standard. The scope of *Leases* results in a potentially large and broad population of transactions to review. The cost of subjecting certain transactions to *Leases* may outweigh the financial reporting benefit of accounting for the transactions under the new standard. Therefore, a properly designed control structure can accommodate approaches that allow the exclusion of certain transactions from the analysis. Once the contract is determined to contain an embedded lease, the specific accounting and disclosure requirements would then be subject to other controls documented elsewhere in this document.

Examples of the risk and control activities for this element of lease accounting are set forth below:

Risk Description	**Control Activity** Scaled based on impact of *Leases* as follows: I – insignificant impact; S – significant impact and M – material impact	I	S	M
Other contractual arrangement includes an asset that is subject to lease accounting.	Management reviews and approves all significant contracts as defined prior to entering the agreement, including contract modifications, following the company's delegation of authority. *Note: To achieve this goal, it may be appropriate to provide reasonable guidance to groups likely to be involved in these arrangements, e.g., purchasing and legal departments, to identify arrangements that may include a lease for accounting purposes. Implement an escalation process in which potential significant arrangements that may contain an accounting lease are forwarded to the accounting policy leader or contract review team for assessment.*	√	√	√
	Leverage management authorization levels for contractual arrangements and spending to identify significant agreements that exceed a pre-defined threshold. Consider a separate authorization/escalation process for contractual arrangements with a significant take-or-pay or capital guarantee commitment. Incorporate a lease accounting assessment in this authorization control in which significant contractual arrangements are forwarded to the accounting policy leader or contract review team for assessment.		√	√
	Divisions, departments, and/or locations certify on a quarterly basis that they have complied with the company's approval process and submitted new significant contracts to the accounting policy leader or contract review team. A company may institute a certification checklist to document the key processes performed by divisions or locations.	√	√	√
	On at least a quarterly basis, collect data on new service contracts executed during that period. Stratify the contractual commitments considering their nominal value and the term of the arrangement and design a testing plan for new significant transactions that exceed a pre-defined level for further analysis of whether the transaction contains a lease.			√
	On at least an annual basis, reassess whether the screening criteria to determine if the criteria used for identifying transactions to exclude from the review process continues to be appropriate for the enterprise.		√	√

How can companies design and implement internal controls to determine the incremental borrowing rate?

Some companies have spent considerable time reviewing this element of the guidance; thus, we anticipate that robust controls around this estimate will be necessary. However, other factors should be considered prior to a technical assessment of the discount rate. For example, companies can assess the materiality impact of a change in discount rate on the ROU asset and lease liability relative to the financial statements taken as a whole. For companies with significant leasing activity but for which leasing activity is not material or insignificant, the sensitivity impact of a change in discount rate will likely not be material to the financial statements taken as a whole. In such situations, companies generally document a simplified approach to the discount rate determination with economic indicators when the discount rate would be reassessed.[8]

For companies with material leasing activity, a detailed, complete assessment of the discount rate is recommended. Once lease payments and lease terms are determined, the cash flows are discounted at either the incremental borrowing rate (IBR) or the rate implicit in the lease, if readily determinable. In most circumstances, we expect the lessee will use the IBR to discount the cash flows.

The IBR is defined as follows:

> *The rate that, at lease inception, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset. This definition does not proscribe the lessee's use of a secured borrowing rate as its incremental borrowing rate if that rate is determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances.*

This rate will be used for the classification of leases as operating or finance and for the measurement of the ROU asset and lease liability.

We anticipate that approaches for *Leases* will include a methodology to develop and update this rate based on the conditions relevant to an entity's facts and circumstances. The IBR will need to reflect the term of the arrangement considering the appropriate yield curve. The rate used will also need to consider the collateral value of the lease transaction, which may be the leased asset or any form of collateral a creditor would be expected to accept to secure borrowing for a similar term.

The starting point for the IBR once the term is determined will be the rate at which a company may borrow at in the jurisdiction/currency of the lease at inception. Factors to consider include the following:

- *The nature of the lease obligation in the lessee's legal environment*
  Lessor protections in some countries may be limited, especially developing countries. Therefore, the use of an unsecured rate may be appropriate in these countries.
- *The value of the collateral to the lessor*
  Lessors of low-value items often place no value on the collateral because the cost of recovering the asset eliminates the value of the collateral to market participants. In other circumstances, the value of the collateral may be more significant, and it can be an element of the adjustment.
- *The lessee's current creditworthiness*
  For companies with a strong credit rating, their unsecured borrowing rate may be so low that the impact of considering the collateral impact on the borrowing rate may be immaterial.

When an entity's unsecured rates are materially consistent with the risk-free rate in a country, such as the United States, it would be likely that the variance between an unsecured and secured rate is also not materially different. As such, a robust process to establish collateralized rates would likely not be necessary.

[8] *While the IBR is an element of classification, this area may also be addressed through a reasoned analysis of the impact of changes in rates on classification for groups of transactions.*

Although the FASB did not intend for adjustments for collateral to be overly complicated, we expect some companies will have to develop methodologies for their adjustments.[9]

For entities that enter few leases within an accounting period, the process behind this evaluation may be entered on a sporadic basis. Entities that enter many leases in an accounting period and who have the complication of multiple countries to consider will need to develop a process that does the following:

- Extracts an unsecured borrowing rate for common transaction lengths;
- Adjusts rates for differences in the average life of the lease obligation and other borrowings, if applicable; and
- Adjusts the unsecured rate for the impact of the collateral.

It is reasonable for entities to develop IBRs on a periodic basis (e.g., monthly or quarterly) and use them for all transactions within the period. For situations in which a lessee has leases in multiple countries/currencies, management will also want to carefully consider its own intercompany financing arrangements to determine the appropriate IBR to use. In some situations, each jurisdiction may have a different IBR, whereas in other situations, a corporate IBR may be used.

Risk Description	Control Activity Scaled based on impact of *Leases* as follows: I – insignificant impact; S – significant impact and M – material impact	I	S	M
The IBR used to calculate the ROU asset and lease liability is not appropriate.	A competent accountant from the corporate controller organization establishes clear guidance to determine the IBR, which is reviewed by another accountant in the corporate controller organization.	√	√	√
	New lease transactions The discount rate file is reviewed prior to being loaded into the system.			√
	Monthly or quarterly Treasury internally publishes and reviews the company's IBRs and incorporates key inputs, such as: • The company's credit rating; • Current bond yields; • Recent debt offerings; • Intercompany financing arrangements; and • Legal and tax implications that could make transferring funds across borders prohibitive. The discount rate is verified on a test basis for individual leases loaded into the system.			√
	Quarterly Controllership performs a fluctuation analysis of the IBRs by jurisdiction to rates from prior months and explains any significant changes against management's expectations that exceed a pre-defined threshold or lack of significant change when one would otherwise be expected.		√	√
	As needed If an unsecured rate is used in the calculation, perform an analysis that is reviewed by the corporate controller organization to determine whether the variance between the secured and unsecured rates is immaterial.			√

How can companies design and implement financial reporting controls for the accounting for leases?

Many companies find that complexity in internal control design and execution significantly reduces once an effective process is designed to identify leases and collect relevant information for leases. Companies generally apply a mix of automated controls from a lease accounting system or manual controls to perform accounting for leases. This mix is contingent on the following factors:

- The significance of leasing activity to the company and a cost–benefit assessment of an investment in an automated lease accounting system;
- The possible differentiation of the lease portfolio with an automated solution for significant leases or leases in which robust information is readily available and a manual solution for the remaining portfolio of minor leases; and
- The readiness of the lease accounting system to fully and sustainably execute accounting for leases (see Part IV for further perspective on system solutions).

Regardless of whether the accounting controls are manual or automated, the financial reporting risk and control descriptions are common.

Risk Description	**Control Activity** Scaled based on impact of *Leases* as follows: I – insignificant impact; S – significant impact and M – material impact	I	S	M
The determination of whether a lease is classified as an operating or a finance lease is incorrect.	A competent accountant from the corporate controller organization designs the criteria and underlying computations to determine whether a lease should be classified as an operating lease or a finance lease. This methodology is documented in the accounting policy manual and implementation oversight summary and approved by the appropriate corporate controller organization leader.	√	√	√
	The accounting policy manual creates an escalation model for mandatory reviews of certain significant finance leases and significant operating leases that requires a second review of the computation performed. These thresholds may be consistent with existing thresholds for non-routine journal entries.		√	√
	The appropriate corporate controller organization leader reviews the analysis of the determination of operating or finance lease classification per the accounting policy manual criteria.			√
The initial determination of the ROU asset and lease liability is incorrect.	A competent accountant from the corporate controller organization designs computations to determine the initial value of the ROU asset and lease liability. This methodology is documented in the Accounting Policy Manual and Implementation Oversight Summary and approved by the appropriate corporate controller organization leader.	√	√	√
	The accounting policy manual creates an escalation model for the mandatory review of individually significant ROU assets and lease liabilities from an individual lease or pooled leases.		√	√
	The appropriate corporate controller organization leader reviews the initial determination of the ROU asset and lease liability per the accounting policy manual criteria.			√

Risk Description	Control Activity Scaled based on impact of *Leases* as follows: I – insignificant impact; S – significant impact and M – material impact	I	S	M
The initial and ongoing accounting to compute lease costs for operating leases or amortization and interest expenses for finance leases is incorrect.	A competent accountant from the corporate controller organization tests the automated control within the lease system (or the manual calculation if performed outside a system) to determine whether the lease costs and interest expense/amortization expenses for operating leases and finance leases, respectively, are being calculated appropriately with reasonable assurance.	√	√	√
	A competent accountant from the corporate controller organization tests the automated control within the lease system (or the manual calculation if performed outside a system) to evaluate whether variable lease payments are appropriately calculated and lease and non-lease components are appropriately treated based on the company's policy elections.		√	√
	For each contract identified as containing a lease, one person abstracts and a second person subsequently validates the required data elements by tying the data to the supporting source documentation.		√	√
	A controllership monitoring function establishes a policy requirement that all contracts exceeding a pre-defined threshold are centrally reviewed by accounting policy personnel.		√	√
	At least quarterly, a competent accountant from the corporate controller organization reconciles the lease data to the appropriate financial statement accounts by the corporate controller organization or an appropriate designee.			√
	A competent accountant from the corporate controller organization performs and has an appropriate supervisor review a fluctuation analysis to evaluate whether lease costs and interest expense/amortization expenses related to leases are materially correct. This fluctuation analysis should be compared against management's expectations with further evaluation of deviations exceeding pre-defined investigation thresholds. The resolution of any follow-up items should be documented.		√	√
The accounting for a lease modification is incorrect.	Lease modifications meeting specified criteria outlined in the company's policies are reviewed by an appropriate representative of the corporate controller organization to determine the accounting impacts.		√	√

How can companies design and implement financial reporting controls for the disclosure requirements of *Leases*?

The control considerations around presentation and disclosure for implementation when there is a material impact are consistent with those for day 2 accounting.

Companies can generally leverage their existing control processes related to the creation and review of the financial statements for *Leases* implementation. A completed disclosure checklist will support a thorough evaluation of all incremental disclosure requirements. In addition, any supporting schedule that reconciles financial statement and footnote disclosure amounts to source information is important evidence for auditors. Additional disclosures required by *Leases* would likely need controls in place around gathering, extracting, and reviewing relevant disclosure information.

While most of the quantitative disclosures required by *Leases* can be readily supportable through the lease accounting process, some quantitative disclosures may require additional controls because the necessary information is not readily available through a company's standard lease process. Management should evaluate all disclosure requirements to determine that the necessary controls are in place. Entities should also consider that disclosures may be populated from multiple systems (i.e., some disclosures may come from the lease system and others may be populated through the general ledger); as such, new controls may need to be implemented in or around multiple financial reporting systems. Some quantitative disclosure requirements that may require additional controls to be implemented beyond those in a company's standard lease accounting process include the following:

- *Variable lease cost*
  Depending on the lease accounting process, the variable lease cost recorded during a period may not be readily available, requiring manual analysis that can be subject to additional controls.
- *Short-term lease expense*
  Many companies have elected not to record ROU assets for leases with terms less than 12 months. Controls can be implemented to evaluate whether short-term leases are also appropriately identified and the related expenses disclosed.
- *ROU assets obtained in exchange for new finance and operating lease liabilities*
  Companies must separately disclose ROU assets obtained during the period. Depending on their lease accounting processes, some companies may need additional controls and procedures to accurately aggregate and disclose this information.
- *Weighted-average remaining lease term and weighted-average discount rate for finance and operating leases*
  Although a weighted-average calculation may appear to be relatively straightforward, manual data aggregation would require additional controls if the lease population is not accounted for in a singular location. Similarly, special consideration is advised for foreign currency impacts to evaluate whether the calculations are performed accurately.

Risk Description	**Control Activity** Scaled based on impact of *Leases* as follows: I – insignificant impact; S – significant impact and M – material impact	I	S	M
Financial statement disclosures or leases are not accurate and/or complete.	Management reviews and approves the financial statements, including the completed disclosure checklist.	√	√	√
	Management reviews a reconciliation of the financial statement disclosures to supporting schedules.	√	√	√

How can companies document their adoption of *Leases*?

Often, the oversight provided for significant accounting standards is formalized into an entity-level control or captured as part of an existing entity-level control. Example entity-level controls that capture the implementation of *Leases* and evidence that would likely be maintained to support the effectiveness of the entity-level control are outlined below.

Entity Level Control Description	Control Activity Scaled based on impact of *Leases* as follows: I – insignificant impact; S – significant impact and M – material impact	I	S	M
Senior management and the board apply effective oversight of financial reporting via reviews of implementation plans and communications to senior management and the board.	Presentations, agendas, or minutes from project meetings with key decisions and considerations	√	√	√
	Materials provided to the board and management governance committees regarding adoption status and key decisions	√	√	√

Entity Level Control Description	**Control Activity** Scaled based on impact of *Leases* as follows: I – insignificant impact; S – significant impact and M – material impact	I	S	M
Management updates the policy manual to reflect changes in accounting standards. The accounting policy leader or contract review team develops and maintains the entity's accounting policies; analyzes and coordinates the implementation of new accounting standards, establishing pre-implementation controls as necessary for adoption of new accounting standards determined to be significant; and maintains the accounting policy manual. To the extent that a new standard requires the company to modify its accounting policy manual, the organization interprets the new guidance on behalf of the company and develops a policy that conforms with Generally Accepted Accounting Principles (GAAP). Changes to the accounting policy manual are reviewed and approved by the corporate controller organization or its designee, and documentation supporting accounting policy decisions is maintained.	Updated accounting policy and accompanying white papers with supporting accounting conclusions	√	√	√
	Inquiry with the accounting policy leader or contract review team and relevant accounting policy subject matter experts regarding the overall implementation project approach and key stakeholders involved	√	√	√
	Implementation Oversight Documentation memo (see Appendix)	√	√	√
	Presentations, agendas, or minutes from project meetings with key decisions and considerations	√	√	√
	Materials provided to board and management governance committees regarding adoption status and key decisions	√	√	√

Entity Level Control Description	Control Activity Scaled based on impact of *Leases* as follows: I – insignificant impact; S – significant impact and M – material impact	I	S	M
Based on respective roles and responsibilities, management confirms that employees receive appropriate training to enable them to perform their responsibilities accurately and in accordance with new accounting policies and procedures.	Training plan documenting key personnel who require new skills to comply with *Leases*, including corporate accounting, purchasing, division controllers, etc.		√	√
	Presentations and agendas of key training materials		√	√
Management evaluates the IT implications of new accounting standards and appropriately upgrades systems and resources to align to changes to the company's financial reporting and control objectives.	System solutions for *Leases* (see Part IV of this document)		√	√

The launching point for the internal control design and implementation of *Leases* is generally a new accounting standard implementation memo. In our experience, a well-reasoned, documented implementation memo is essential to drive an effective implementation and efficient dialogue with auditors.

Companies generally have strong processes to address the accounting and financial reporting impacts of a new accounting standard. However, these accounting memos often focus on accounting conclusions and do not address internal control considerations. An emerging best practice is to extend the accounting memo to address the assessment of internal control changes. Refer to Appendix A for an outline of our recommended Implementation Oversight Summary for *Leases* as a proposed template to address the end-to-end accounting and internal control considerations.

Furthermore, it is our view that if management has put in place controls providing reasonable assurances that its books and records are accurate by following a rigorous, inclusive process (e.g., a process that involves the right stakeholders, such as senior management and the audit committee), we believe the resulting controls and accompanying documentation are sufficient.

How are companies designing and implementing controls for leases for international subsidiaries subject to the IFRS Leasing standard?

Multinational companies have the added complexity of considering the impact of the IFRS leasing standard on local statutory reporting requirements for its international subsidiaries. IFRS and other national accounting standards require reasonably similar accounting as *Leases*. Many companies strive for a scaled approach to local statutory reporting under IFRS by developing a set of common IFRS accounting policies and procedures to maximize standardization and efficiency in the preparation of local statutory financial statements for their international subsidiaries. The common controls for local statutory reporting include accounting policy updates and appropriate training for applicable individuals. Companies with significant leasing activity in a number of international subsidiaries are considering investments in lease systems that support the requirements of ASC 842 and IFRS 16.

One challenge with local statutory reporting requirements is the determination of a singular leasing policy threshold addressing the materiality considerations of the consolidated financial statements and local statutory financial statements. Another challenge is an assessment of any intercompany leases for cost-allocation arrangements for stand-alone legal entity reporting.

PART IV: System Solutions

Some companies currently use systems to track their leases and comply with the requirements of lease accounting under ASC 840. An increasing number of companies are implementing such systems as operating leases transition from off-balance sheets to full balance sheet recognition. Companies implementing a system solution to comply with the new requirements of *Leases* will have to assess the related system risks and internal controls, including review of system access, segregation of duties, and change management.

The need for and design of a leasing system is inherently driven by the nature, size, and complexity of an entity's lease portfolio. What worked previously under ASC 840 may not work for companies in the future because *Leases* requires more frequent financial reporting with less time available to manually and accurately compile the necessary data. However, some companies with minimal leasing activity may still be able to support manual processes currently used for existing lease accounting and disclosure requirements. Others with a larger number of significant leases have found that investing in a system to implement the accounting standards is necessary to maintain quality internal controls across a large volume of transactions. Still others choose a hybrid approach, selecting a leasing system for a significant portfolio of real estate and property leases and executing a manual process for an insignificant amount of equipment leases.

If a new or revised system solution is integral to the adoption of *Leases*, controls will generally include IT general controls, such as logical access, change management, and segregation of duties; application controls, such as those that maintain data integrity for the lease information captured, the accuracy of lease expense computations, ROU asset amortization, interest expenses, etc.; and as applicable, secure and accurate integration with other systems (e.g. accounts payable) and data transfers from one system to another or from the subledger to the general ledger.

As a company implements the system, it is important that the project team focuses on the accuracy and completeness of the technical accounting computations, key reports/outputs, and broader IT general controls. This includes maintenance of proper documentary evidence showing that any system or IT application has effective controls.

It is important to note that one particular challenge with lease systems under *Leases* is that system providers are designing the systems at the same time as companies are attempting to implement them. This creates a compressed design and implementation timeframe that also increases the risk that IT general controls, application controls, and other system controls may not be effective upon implementation, potentially requiring additional manual work to achieve accurate financial reporting with reasonable assurance. As a result, many companies are designing hybrid approaches that combine manual controls during the initial reporting periods with an intent to transition to IT general and automated controls once the lease accounting solution is fully implemented.

Some vendors offer lease IT software as a service. Under such arrangements, it is important that companies establish their governance needs in the contract, including access to an annual SOC-1 report providing evidence of the vendor's general IT controls as it relates to the software as a service. SOC-1 reports will likely address IT general controls (ITGC) but may not address access controls at the company or controls over data entry and extraction. Typically, SOC-1 reports do not address application controls over data processing (e.g., *Leases* calculations), which may require the entity to perform user-acceptance testing. As with any SOC-1 report, a company should carefully consider the user control considerations specific to the SOC-1 report and evaluate if appropriate controls are identified to conclude whether the company can rely on the SOC-1 testing results and report.

APPENDIX A

The following is an outline of an Implementation Oversight Summary that documents the key management conclusions on the internal control design for *Leases*.

Management oversight performed around the adoption of *Leases*

- A management oversight mechanism established to evaluate whether the *Leases* adoption was thoughtful and whether it included appropriate internal governance practices (e.g., establishment of a *Leases* implementation team consisting of management that meets periodically to discuss issues, key decisions, and progress around adoption)
- Roles and responsibilities established within the organization with respect to *Leases* adoption and implementation (i.e., the parties responsible, accountable, consulted, and informed); exact implementation team membership will vary for *Leases* but will generally include personnel from corporate accounting, purchasing, legal, business division controllers, IT, and internal audit

Key accounting conclusions and accounting policy thresholds reached to comply with *Leases*

- Materiality threshold by type of lease, business division, etc. (should also include details regarding how the material assessment was performed and the key contributing factors)
- Calculation of incremental borrowing rates
- Lease classification considerations
- Application of portfolio approaches and related assumptions
- Practical expedient determinations
- Other key judgments and estimates

Key internal control processes designed to determine the ROU asset and lease liability

- Completeness procedures surrounding the existing lease population
- Controls to identify contracts that qualify for lease accounting
- Input and review of lease data and assumptions, including controls over source data
- Automated control and testing of lease calculations, including any lease system solution

Development of accounting policies and corresponding procedures

- Drafting and review of accounting policies and technical accounting position papers
- Publication of relevant accounting policies
- Training materials on new accounting policies and procedures

Key considerations for internal control framework

- Periodic review of methodology
- Controls in place over the data used in the lease database to evaluate its reasonableness
- Periodic review of assumptions, such as discount rate, other key judgments, estimates, etc.
- Controls over financial reporting and disclosure process

Management interaction with those charged with governance

- Presentations provided to the board of directors' governance committee regarding updates around *Leases* adoption

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