# Guide to auditing the implementation of ASC 842, *Leases*

Revised July 2018

Building a better working world

# Contents


Glossary of key terms .......... 1

1 Introduction .......... 2

- 1.1 Overview .......... 2
- 1.2 Leases audit roadmap for lessees .......... 3
- 1.3 Summary of effective dates and transition .......... 4
- 1.4 Transition practical expedients and other policy elections affecting transition .......... 5
- 1.5 Transition accounting considerations .......... 7
- 1.6 Effect of implementation on our audit approach and planning .......... 8

2 Understand the entity's process and identify risks .......... 12

- 2.1 Understand management's process for implementing ASC 842 .......... 12
  - 2.1.1 Critical assessment of management's timeline .......... 12
- 2.2 Understand entity-level controls .......... 14
  - 2.2.1 Example entity-level controls for each COSO 2013 Framework principle .......... 14
- 2.3 Risk assessment .......... 17
  - 2.3.1 Risks related to the completeness of the population of leases .......... 17
  - 2.3.2 Risks related to the data that is used to apply the transition provisions .......... 17
    - 2.3.2.1 Risks when additional lease contracts are identified during management's assessment of completeness .......... 19
  - 2.3.3 Risks related to applying the ASC 842 transition provisions .......... 20
  - 2.3.4 Additional risks arising from the use of IT in the implementation .......... 21
    - 2.3.4.1 Use of service organizations (added July 2018) .......... 22
  - 2.3.5 Risks related to management's disclosures .......... 22
  - 2.3.6 Identify significant risks, including fraud risks .......... 22

3 Design and execute tests of controls and substantive audit procedures .......... 24

- 3.1 Develop and execute our audit strategy .......... 24
- 3.2 Planning materiality and tolerable error considerations .......... 26
- 3.3 Reminders regarding the timing of our audit procedures over the transition adjustments and workpaper archiving .......... 26
- 3.4 Extent of testing procedures .......... 27
  - 3.4.1 Addressing identified risks of implementation .......... 27
    - 3.4.1.1 Assess the completeness of the population of leases .......... 27
    - 3.4.1.2 Assess the completeness and accuracy of the data that is used to apply the transition provisions .......... 32
      - 3.4.1.2.1 Address risks when additional lease contracts are identified during management's assessment of completeness .......... 34
    - 3.4.1.3 Apply the ASC 842 accounting framework and determine transition adjustments and disclosures .......... 35
      - 3.4.1.3.1 Testing the discount rate in implementation (updated July 2018) .......... 39
    - 3.4.1.4 Evaluate management's disclosures during the transition period (updated July 2018) .......... 42
  - 3.4.2 Define the population of lease contracts and the sampling unit .......... 42

3.4.3 Determine the sample size for testing of lease contracts (updated July 2018) ... 45
3.4.3.1 Dual-purpose testing (updated July 2018) ... 47
3.5 Use of IT in the implementation and related data considerations ... 48
3.5.1 Addressing risks when management uses a service organization (added July 2018) ... 49
3.6 Prospective accounting policies (updated July 2018) ... 50
3.7 Extent of testing if the entity asserts it is not materially affected ... 51

**A Group audit considerations ... 52**
A1 Overview ... 52
A2 Organizational structure of the entity's lease activities ... 52
A3 Management's process to implement ASC 842 ... 53
A4 Significance of the component ... 53
A5 Not significant components ... 54
A6 Extent of work to be performed at in-scope components ... 54
A7 Oversight of component teams (added July 2018) ... 55

**B Lessor auditing considerations ... 56**
B1 Introduction (updated July 2018) ... 56
B1.1 Transition for lessors (updated July 2018) ... 57
B1.2 Effect of the implementation on our audit approach and planning ... 58
B2 Understand management's process for implementing ASC 842 ... 58
B3 Assess risks, plan and execute our audit ... 58
B3.1 Assess the completeness of the population of leases ... 59
B3.2 Address risks when the hindsight practical expedient is elected ... 60
B3.3 Evaluate management's SAB Topic 11.M disclosures ... 61
B4 Considerations related to prospective accounting policies, processes and controls ... 62

**C Use of the GDS Accounting Change COE in auditing the implementation of ASC 842 ... 64**
C1 Overview of the COE ... 64
C2 Integration with the COE ... 65

**D SAB Topic 11.M disclosures ... 69**
D1 Requirements of SAB Topic 11.M and SEC comment trends ... 69
D2 Audit responsibilities — controls and substantive ... 69
D3 Responsibilities related to quarterly disclosures ... 73
D4 Disclosures are incomplete or inadequate ... 73

**E Frequently asked questions ... 74**
E1 FAQs — ICFR considerations ... 74
E2 FAQs — Quarterly review procedures ... 75
E3 FAQs — EQR responsibilities (updated July 2018) ... 76
E4 FAQs — Change in auditor ... 76
E5 FAQs — Engagement management ... 77

**F Example risk and control matrix for lessees ... 80**

# Glossary of key terms

- Commencement date of the lease (commencement date) — The date on which a lessor makes an underlying asset available for use by a lessee.
- Date of initial application — The first day an entity applies the transition provisions of ASC 842 to its financial statements (e.g., 1 January 2017 for a calendar year-end public entity or 1 January 2019 if the FASB finalizes the proposed optional transition method and a calendar year-end public entity elects to apply it).
- Effective date — The date on which the entity adopts ASC 842 (e.g., 1 January 2019 for a calendar year-end public entity that does not early adopt).
- Master Lease Schedule — For lessees, a schedule that captures all of the entity's leases and the data necessary to compute the transition adjustments. The Master Lease Schedule generally will include the following information for each lease, as applicable: (1) lease classification under ASC 840, (2) whether the lease has been modified prior to the effective date, (3) remaining term of the lease and any revisions to the term if the hindsight practical expedient is elected, (4) remaining minimum rental payments, (5) discount rate, (6) existing assets and liabilities (e.g., prepaid or accrued lease payments, unamortized initial direct costs, capital lease asset and obligation) and (7) any other information management may wish to capture.
- Implementation — This is the term used to describe everything management does to prepare for the adoption of ASC 842, including calculating transition adjustments, preparing SAB Topic 11.M disclosures and developing accounting policies, processes and controls to perform the prospective accounting and make the required disclosures.
- Prospective accounting — The accounting for leases that commence, or are remeasured or modified, on or after the effective date of ASC 842.
- Prospective period — The period that begins on the effective date.
- Transition adjustments — The adjustments to the financial statements for the comparative periods presented in the year of adoption (e.g., adjustments to restate the financial statements for 2017 and 2018 for a calendar year-end public entity that adopts the standard on 1 January 2019), including any adjustment to the opening balance of retained earnings to recognize the cumulative effect of adoption as of the date of initial application and the adjustment to recognize the right-of-use asset and lease liability. If the FASB finalizes the proposed optional transition method and an entity elects to apply it, the adjustments would be recorded as of the effective date.
- Transition period — The period from the earliest comparative period presented in the financial statements for the year of adoption through the quarter of adoption.

# 1 Introduction

## 1.1 Overview

This *Guide to auditing the implementation of ASC 842,* Leases, is designed to assist teams in auditing an entity's implementation of the new leases standard, Accounting Standards Codification (ASC) 842, *Leases*. It focuses on auditing an entity's transition adjustments and disclosures and related internal control over financial reporting (ICFR), which we need to address if we are conducting an integrated audit or using a controls reliance strategy. The guide also discusses what we need to do during implementation to understand the policies, processes and controls that entities develop to account for leases under ASC 842 in the prospective period.

When planning for our audit of the implementation, teams need to keep in mind the following points, which are discussed in detail in this guide:

- The biggest change under the new standard is that lessees are required to recognize a right-of-use (ROU) asset and a lease liability for most operating leases. This change creates risks that clients and audit teams need to address, including those related to the completeness of an entity's population of leases, the completeness and accuracy of the lease data it collects and uses during implementation and the application of the ASC 842 transition provisions.

- Management needs to evaluate its existing controls over the accounting for leases under ASC 840, *Leases*, to determine whether they are sufficiently precise to address the risks over the identification of a complete population of leases and the completeness and accuracy of the lease data that will be used to calculate the transition adjustments. Management needs to assess the entity's existing controls early in the process so that controls needed in implementation can be designed and executed timely.

- Although entities won't recognize the transition adjustments until the quarter of adoption, the majority of management's controls and our contemporaneous audit procedures over the implementation need to occur in the year prior to adoption. We should begin performing our audit procedures (including ICFR procedures) as early as possible in the transition period.

- Entities will follow different accounting models to calculate the transition adjustments for leases that existed prior to the effective date and to account for those that commence, or are modified on or after the effective date. As a result, entities will need to develop two sets of policies, processes and controls.

- Entities will need to change their accounting policies, processes and controls and make new disclosures, even if applying the standard doesn't have a significant effect on the financial statements. We need to begin evaluating these prospective accounting policies, processes and controls that an entity develops during the transition period.

- Entities and audit teams should not underestimate the time and resources necessary to implement the new standard. Teams should be mindful that information technology (IT) systems may not be adequate to support the initial and subsequent accounting for leases and the preparation of disclosures required by the new standard, and third-party vendor systems may not be fully functional in time for adoption. As a result, entities may rely on Excel or legacy systems during the implementation and a portion of the prospective period and may then implement a new IT system. If that's the case, we will need to adjust our audit procedures to address the resulting risks.

### Use of this guide

This guide focuses on the risks associated with implementation and procedures we need to perform in audits of lessees, because this is where we expect the most significant accounting changes and where we expect to focus the majority of our efforts during implementation. The accounting for lessors retains many aspects of the lessor accounting model under ASC 840. The risks and procedures we need to consider as we design our audits of lessors' implementation of the new standard are included in Appendix B, *Lessor auditing considerations*.

Most entities are expected to elect the package of practical expedients provided in ASC 842, and this guide was developed based on this assumption.

While the expedients were intended to make the transition easier for entities, the transition provisions will require entities to follow different accounting models for leases that existed prior to the effective date and those that commence, or are modified, after the effective date. The package of practical expedients and other transition expedients are discussed in section 1.4, *Transition practical expedients and other policy elections affecting transition*. Members of the Quality Network are available to assist teams on audits of entities that choose not to apply the package of practical expedients.

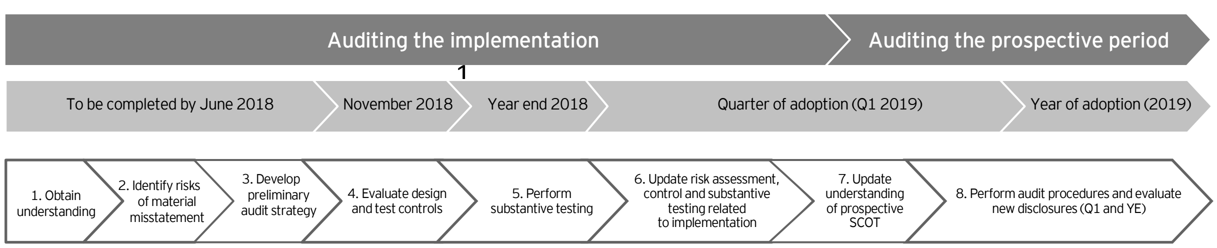
Our companion publication, *Guide to auditing leases under ASC 842*, which we refer to as our prospective guide, is designed to help audit teams address audit considerations for contracts that commence, or are remeasured or modified, after an entity adopts ASC 842.

Auditing an entity's implementation of the new leases standard requires a detailed understanding of the accounting guidance. To help readers understand our audit strategy, this guide describes certain accounting requirements of ASC 842. But reading this guide is not a substitute for reading our Financial reporting developments (FRD) publication, *Lease accounting, Accounting Standards Codification 842,* Leases (ASC 842 FRD) and other EY leases publications, which can be found on the Lease Accounting Discover page.

The nature, timing and extent of our audit procedures will depend on the nature and complexity of the entity's lease activities and contracts, and our assessment of the risks of material misstatement. We tailor our audits to each entity's facts and circumstances, including the nature of the contracts being evaluated.

## 1.2 Leases audit roadmap for lessees

Prior to reading this guide, members of teams on audits of lessees need to review the *Leases audit roadmap for lessees*. This guide follows the eight steps in the roadmap depicted below:




The roadmap provides the expected timeline for a calendar year-end public company that does not early adopt and activities for auditing the implementation and first year of adoption. It also directs users to learning and enablement resources.

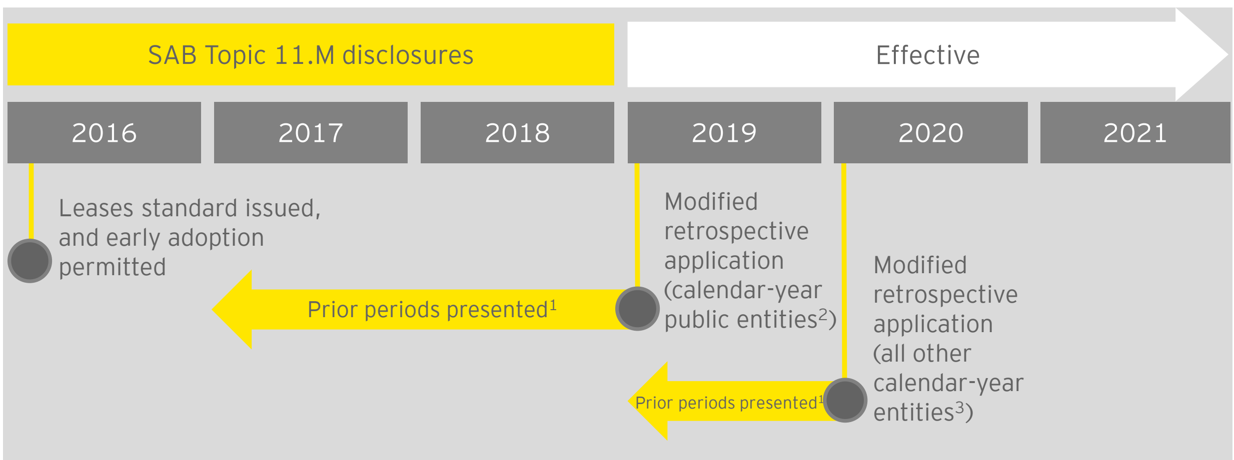
The steps in the roadmap should be completed by all teams. Teams on audits of clients that assert they are not "materially" affected by the adoption of ASC 842 will still need to perform sufficient procedures to determine whether we concur with management's assertion (this is discussed further in section 3.7, *Extent of testing if the entity asserts it is not materially affected*).

Please keep in mind that the steps of the roadmap align with EY Global Audit Methodology (EY GAM), but audit teams may not perform the steps in the order listed, and the steps may be iterative in nature. The extent of documentation necessary in each step will depend on the entity's facts and circumstances and the effects of the adoption.

## 1.3 Summary of effective dates and transition

ASC 842 is effective for public business entities (PBEs) and certain not-for-profit entities and employee benefit plans for annual periods beginning after 15 December 2018 (i.e., 1 January 2019 for a calendar year-end entity), and for interim periods therein.[1] For all other entities, ASC 842 is effective for annual periods beginning after 15 December 2019, and interim periods beginning after 15 December 2020. Early adoption is permitted for all entities.

Lessees and lessors are required to adopt ASC 842 using a modified retrospective approach as illustrated in the following graphic:




[1] If the FASB finalizes the proposed optional transition method, an entity that elects that method would not retrospectively adjust the prior periods presented. That is, the entity would continue to apply ASC 840 in those periods.

[2] Public entities include public business entities and certain not-for-profit entities and employee benefit plans.

[3] Assumes two years of financial statements are presented.

Lessees and lessors are prohibited from using a full retrospective transition approach.

Under the current requirements, entities will have to record adjustments to each prior reporting period presented in the financial statements during the year of adoption (i.e., in the financial statements for 2017 and 2018 for a calendar year-end entity that adopts the standard on 1 January 2019 and presents three years of financial statements) and any adjustment to retained earnings to capture the cumulative effect of adoption as of the date of initial application. These transition adjustments for lessees will include the recognition of a new ROU asset and lease liability starting with the later of the date of initial application or the commencement date of the lease for all leases (except for leases that qualify as short-term leases if the entity elects to apply the short-term lease exception discussed in section 1.4, *Transition practical expedients and other policy elections affecting transition*).

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[1] Refer to section 11.1 of our ASC 842 FRD for the definition of a PBE and not-for-profit entity.

The modified retrospective transition method generally results in an entity applying concepts from both ASC 840 and ASC 842 to certain leases that existed before the effective date.[2] For example, a lessee that classified a lease as an operating lease under ASC 840 will use its remaining minimum rental payments as defined under ASC 840[3] and a discount rate determined at the later of the date of initial application or the lease commencement date to initially measure its lease liability and ROU asset. The lessee would continue to apply the transition provisions until certain lease modifications or remeasurement events occur following the effective date. Absent a lease modification or a remeasurement of the lease liability and ROU asset,[4] the pattern of expense recognition will not change as a result of the adoption of ASC 842, unless certain elections are made in transition. As a result, an entity could be required to continue applying guidance from ASC 840 to certain existing leases after the effective date of ASC 842.

#### Proposed optional transition method

The Financial Accounting Standards Board (FASB) has proposed amending the new leases standard to give entities another option for transition. The proposed optional transition method would allow entities to continue to apply the guidance in ASC 840, including its disclosure requirements, in the comparative periods presented in the year that they adopt ASC 842.

Entities that elect this option would still adopt the new leases standard using a modified retrospective transition method, but they would recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption rather than in the earliest period presented. In this guide, we note where this proposed Accounting Standards Update could affect our audit considerations; however, we do not expect the election of the transition option to significantly alter our audit approach or our expectation of management's controls.

#### Disclosures

An entity that is a Securities and Exchange Commission (SEC) registrant is required to comply with the disclosure requirements of SEC Staff Accounting Bulletin (SAB) Topic 11.M (issued as SAB 74), which requires the disclosure of the anticipated effects of adopting a new accounting standard in the quarterly and annual financial statements leading up to the effective date. Refer to section 3.4.1.4, *Evaluate management's disclosures during the transition period*, and Appendix D, *SAB Topic 11.M disclosures*, for a discussion of the audit considerations for SAB Topic 11.M disclosures.

## 1.4 Transition practical expedients and other policy elections affecting transition

The standard provides several transition practical expedients to assist entities with implementation. [5]

#### The package of practical expedients

Lessees and lessors are permitted to make an election to apply a package of practical expedients that allows them to not reassess:

- Whether any expired or existing contracts are or contain leases
- Lease classification for any expired or existing leases
- The accounting for initial direct costs for any expired or existing leases

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[2] Refer to section 11.3.5 of our ASC 842 FRD for examples of the application of the modified retrospective approach.

[3] Refer to section 11.3.3.5 of our ASC 842 FRD for a discussion of determining minimum rental payments for operating leases under ASC 840.

[4] Refer to sections 4.5 and 4.6 of our ASC 842 FRD for discussions of the remeasurement and modification guidance under ASC 842.

[5] Refer to section 11.2 of our ASC 842 FRD for detailed information on the transition provisions and practical expedients.

These three practical expedients must be elected as a package and must be consistently applied to all leases. An entity cannot choose which of the practical expedients to apply or which leases to apply them to (i.e., an entity must apply all three of these practical expedients to all leases or apply none of them).

As previously discussed, we expect most entities to elect to apply the package of practical expedients. Teams should be mindful that implementing the standard could be significantly more complex for entities that do not elect the package of practical expedients, particularly when lease classification changes for existing leases. Members of the Quality Network are available to assist teams on audits of entities that choose not to apply the package of practical expedients.

#### The hindsight practical expedient

Entities are also permitted to make an election to use hindsight when determining the lease term (i.e., evaluating a lessee's option to renew or terminate the lease or to purchase the underlying asset) and assessing impairment of an entity's ROU assets (lessees only). If the hindsight practical expedient is elected, entities would consider all facts and circumstances that have changed, through the effective date. The hindsight practical expedient may be elected separately or in conjunction with the package of practical expedients described above. An entity that elects the hindsight practical expedient must apply it consistently to all leases. Throughout this guide, we discuss how the election of this practical expedient would affect management's processes and controls and our audit procedures.

#### Easements practical expedient

The new leases standard also includes an optional transition practical expedient that permits an entity to continue applying its current policy for accounting for land easements that existed as of, or expired before, the effective date of ASC 842. An entity that elects this practical expedient will be required to apply it to all of its existing or expired land easements that were not previously accounted for under ASC 840. Entities will still need to evaluate whether land easements entered into or modified on or after the effective date meet the definition of a lease under ASC 842. This practical expedient is not discussed further in this guide because we do not expect its use to require most teams to do more work during the implementation of ASC 842. The Regional Leases Champions are available to assist teams with any technical accounting questions related to the application of this practical expedient.

#### Short-term lease policy election

Lessees can make an accounting policy election (by class of underlying asset to which the ROU relates) to apply accounting similar to ASC 840's operating lease accounting to leases that meet ASC 842's definition of a short-term lease (the short-term lease exception). A short-term lease is defined as a lease that, at the commencement date,[6] has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The short-term lease election can only be made at the commencement date.[7]

Lessees that make this election will not recognize an ROU asset and lease liability on the balance sheet for qualifying leases. Instead, the lessee will recognize lease payments as an expense on a straight-line basis over the lease term and will recognize variable lease payments that do not depend on an index or rate as expense in the period in which the achievement of the target that triggers the variable payments becomes probable.

If an entity applies the hindsight practical expedient, the revised lease term determines whether the entity can apply short-term lease accounting to a lease if the policy election is made for the class of underlying asset to which the lease relates. If, as a result of applying hindsight, the entity concludes that the lease term is more than 12 months, the lessee would not apply short-term lease accounting.

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[6] Refer to section 2.2 of our ASC 842 FRD for guidance on determining the commencement date.

[7] Refer to section 4.1.1 of our ASC 842 FRD for an expanded discussion on determining the class of underlying asset, identifying a short-term lease and the requirements to make the short-term lease policy election.

This guide does not address additional audit considerations for short-term leases during our audit of the implementation because the treatment is similar to existing accounting under ASC 840. However, audit teams for entities that apply this policy election need to perform appropriate testing of management's determination of the lease term to support the entity's use of the short-term lease exception. Teams also need to understand management's plan for gathering the necessary data for short-term leases in order to meet the disclosure requirements under ASC 842.

## 1.5 Transition accounting considerations

This summary of the accounting considerations when an entity elects the package of practical expedients is designed to help teams understand the audit implications related to transition for existing operating and capital leases. Reading this summary is not a substitute for reading section 11 of our ASC 842 FRD.

**Initial recognition of leases previously classified as operating leases under ASC 840 that remain operating leases under ASC 842**

Existing operating leases will continue to be classified as operating leases at adoption (i.e., lease classification is not reassessed in transition when the entity elects the package of transition practical expedients). However, entities will be required to initially recognize a lease liability and an ROU asset at the later of the date of initial application or the commencement date of the lease.

The components of the initial measurement of the lease liability include:

- Discount rate[8]
- Remaining minimum rental payments as determined under ASC 840[9]
- Amounts it is probable a lessee will owe under a residual value guarantee

The lessee records an ROU asset measured at an amount equal to the lease liability, adjusted for the following, as applicable:

- Prepaid or accrued lease payments
- Remaining balance of any lease incentives received
- Unamortized initial direct costs
- Carrying amount of an exit or disposal cost (ASC 420) liability

During periods prior to and following the effective date, subsequent measurement of the ROU asset and the lease liability for leases that existed before the effective date will continue to follow the transition provisions of ASC 842. Before the effective date, the lessee will apply the guidance in ASC 840 to assess whether a modification has occurred and to account for the lease modification. Beginning on the effective date, the lessee applies the guidance in ASC 842 to account for lease modifications and the remeasurement of lease liabilities.

The lessee recognizes expense (through the amortization of the ROU asset and lease liability) consistent with its existing recognition pattern under ASC 840 for the life of the lease unless certain events occur that require modification or remeasurement under ASC 842 on or after the effective date.

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[8] Refer to a detailed discussion of how the discount rate is determined in section 11.3.3.4 of our ASC 842 FRD.

[9] Refer to section 11.3.3.5 of our ASC 842 FRD for a discussion of determining minimum rental payments for operating leases under ASC 840.

ROU assets are required to be evaluated for impairment in accordance with the guidance in ASC 360, *Property, Plant, and Equipment*. However, the FASB staff believes that prior to the effective date, a lessee's impairment analysis would consider the ROU asset as its own unit of account rather than as part of an ASC 360 asset group. As a result, we expect it to be rare that an ROU asset would be impaired prior to the effective date. In contrast, the FASB staff confirmed that, after the effective date, an ROU asset would be evaluated for impairment as part of an asset group, following the principles of ASC 360.[10]

If the entity elects to apply the hindsight practical expedient, it should consider all facts and circumstances that have changed through the effective date in determining the lease term. If applying the hindsight practical expedient results in the conclusion that the lease term should change, the calculation of the lease liability and the ROU asset is adjusted accordingly. The entity will also need to reassess the depreciable life of any leasehold improvements associated with the lease.

**Initial recognition of leases previously classified as capital leases under ASC 840 that are classified as finance leases under ASC 842**

Existing leases classified as capital leases will be classified as finance leases upon adoption of ASC 842 (i.e., lease classification is not reassessed in transition when the entity elects the package of transition practical expedients). At the later of the date of initial application or the commencement date of the lease, entities will recognize an ROU asset as the sum of the carrying amount of the capital lease asset and any unamortized initial direct costs under ASC 840. Entities will recognize a lease liability at the carrying amount of the capital lease obligation that they recognized under ASC 840 as of the same date.

Subsequent measurement of the ROU asset and the lease liability will be in accordance with ASC 840 for periods before the effective date and in periods on or after the effective date until the lease is modified or the lease liability is remeasured. The lessee recognizes expense consistent with its existing recognition pattern under ASC 840 for the life of the lease unless certain events occur that require modification or remeasurement under ASC 842 on or after the effective date. This treatment is similar to that of operating leases.

If the entity elects to apply the hindsight practical expedient, management considers all facts and circumstances that have changed through the effective date, in determining the lease term. We believe that if applying the hindsight practical expedient results in a conclusion that the lease term should change, the entity adjusts the initial recognition of the carrying amount of the ROU asset and lease liability to reflect the amounts that would have been recorded for the capital lease asset and obligation under ASC 840 if the revised lease term had always been used. To determine the capital lease obligation that would have been recorded, the entity adjusts its discount rate to reflect the revised lease term. This adjustment will have an offset to the opening balance of retained earnings. The entity will also need to reassess the depreciable life of any leasehold improvements associated with the lease.

## 1.6 Effect of implementation on our audit approach and planning

While management may not finalize the transition adjustments until the quarter of adoption, it needs to begin its implementation processes and controls early in the transition period. This includes determining how to apply the subsequent measurement requirements to existing lease contracts and report on new or modified leases after the effective date.

To make sure we conduct an effective and timely audit of the effects of adopting ASC 842, we should begin performing our audit procedures (including ICFR procedures) during the transition period. We need to obtain contemporaneous evidence of the precision of the implementation controls. We also need to substantively test management's determination of the transition adjustments and begin to evaluate prospective accounting and disclosure policies, processes and controls during the transition period.

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[10] Refer to section 11.2.4 of our ASC 842 FRD, *Impairment of right-of-use assets prior to the effective date*, for further discussion of the impairment considerations in transition.

When designing our audit of the implementation, we may determine that we need to change our assessments of significant accounts or significant classes of transactions (SCOTs) or our combined risk assessments (CRAs) for leases. We also may need to change these assessments for the prospective period.

### Significant accounts

For entities that have operating leases under ASC 840, the audit team will need to identify significant accounts for material ROU assets and lease liabilities that are required to be recognized under ASC 842 and related income statement accounts. If an entity previously had capital lease assets and liabilities, we may have already identified a significant account related to the capital lease asset and obligation and related income statement accounts but should consider any changes that might occur once ASC 842 is adopted.

### New or modified SCOTs

#### *Implementation SCOT*

In many cases, audit teams may identify a significant class of transactions (SCOT) related to the implementation of ASC 842 for existing leases. This SCOT will cover the processes and controls an entity employs to address the completeness of its population of leases, the completeness and accuracy of lease data used in calculating the transition adjustments, the calculation of the transition adjustments, the design and establishment of new accounting policies and procedures to address the accounting and disclosure requirements under ASC 842 for the prospective period and disclosures under SAB Topic 11.M.

If management asserts that the effect of adoption is not material, some teams may find that the controls related to adoption of the new standard are adequately documented in the entity-level control process. However, during implementation, management will still need to design new accounting policies, processes and controls to address the requirements for prospective accounting and disclosures under ASC 842 (refer to section 3.6, *Prospective accounting policies*, for additional discussion).

In group audits, we should consider whether implementation controls need to be identified at components, especially when multiple SCOTs related to leases exist due to different locations using different processes and/or systems and having different control owners. For example, the implementation processes and controls for real estate leases may be handled by personnel at one location that is staffed with individuals who specialize in negotiating such contracts, but all of the entity's other leases (e.g., leases of computer equipment or office furniture) may be handled centrally in its corporate offices. The underlying contract initiation, accounting and monitoring controls are likely different in this structure for real estate leases and all other leases, which may result in a different assessment of implementation risks. Thus the Primary Team may determine that it is most efficient for a component team to perform testing of the implementation for real estate leases. Refer to Appendix A, *Group audit considerations*.

#### *Prospective SCOT*

We expect an entity's processes and controls for the prospective period to differ from those the entity uses in implementation. Therefore, as part of our audit of the implementation, we need to understand management's prospective SCOT so that we are prepared to perform a quarterly review in the quarter of adoption and assess significant changes in ICFR. This SCOT will cover the processes and controls related to the accounting for leases that existed on the effective date and the processes and controls for leases that commence or are modified after the effective date, which will require different sub-processes.

For the prospective accounting under ASC 842, management's process and controls need to address the risks of material misstatement when an entity (1) identifies a contract and determines whether it is or contains a lease, (2) identifies and separates lease and non-lease components and allocates contract consideration, (3) determines the lease term, including the commencement date of the lease, (4) determines lease classification, (5) initially records and subsequently measures the lease, (6) evaluates lease modifications and (7) determines the appropriate presentation and disclosures required for the leases. Refer to our prospective guide for further discussion of the risks and controls that audit teams should consider and evaluate after the adoption of ASC 842.

### Combined risk assessment for the implementation

This section discusses some of the more common situations we expect teams to encounter in our audit of the implementation and how they may affect our combined risk assessment (CRA).

While determining the completeness of the population of leases is not a new issue for entities, it will take on greater importance for operating leases because ROU assets and lease liabilities will be recorded on the balance sheet for the first time. As part of our evaluation of the CRA for lease-related accounts during implementation, we evaluate the facts and circumstances for the entity that increase the difficulty of identifying a complete population of leases and whether these lead to a higher inherent risk during the implementation of ASC 842. For example, we need to consider whether the inherent risk is higher in audits of entities with decentralized procurement, administration and accounting functions, or different processes for different types of leased assets (e.g., equipment versus real estate). The risk related to completeness of the lease population and audit procedures that address the risk are discussed further in sections 2.3.1, *Risks related to the completeness of the population of leases*, and 3.4.1.1, *Assess the completeness of the population of leases*.

Entities and audit teams need to consider the risk that systems may not be fully functional in time for adoption. This could result in additional complexities that may result in a higher inherent risk assessment. For example, entities may need to calculate the transition adjustments using Excel while they are implementing a new IT system. This may require the entity to design and implement multiple sets of controls to support the IT system and/or end user computing tools. The effect of IT on the implementation is discussed further in sections 2.3.4, *Additional risks arising from the use of IT in the implementation*, and 3.5, *Use of IT in the implementation and related data considerations*.

The areas of judgment that could affect the initial valuation of the ROU asset and lease liability include the discount rate and election of the hindsight practical expedient. The risk of using incorrect discount rates is greater (1) for leases with significant remaining minimum rental payments and/or (2) when the entity does not have observable debt transactions. Our assessment of management's ability to appropriately determine the inputs to estimate the discount rate may lead us to assess the inherent risk related to valuation as higher during implementation.

Similarly, the inherent risk related to the valuation assertion may be higher for audits of entities that elect the hindsight practical expedient, particularly if there are a significant number of contracts to be evaluated during transition. Entities will need to document adequate support for changes or lack of changes to estimated lease terms, based on hindsight, or their assessment of the likelihood that they will exercise options to extend the lease term or terminate the lease. The effect of the hindsight practical expedient on the accounting for leases during the transition to ASC 842 is discussed further in sections 2.3.3, *Risks related to applying the ASC 842 transition provisions*, and 3.4.1.3, *Apply the ASC 842 accounting framework and determine transition adjustments and disclosures*.

Although ROU assets are evaluated for impairment following the principles of ASC 360, we expect the risk of material misstatement relating to this estimate to be low for periods prior to the effective date. This is because the ROU asset is evaluated as its own unit of account rather than as part of an ASC 360 asset group in transition. As a result, lessees should not reassess the measurement and allocation of impairment losses recognized in the asset group to which the new ROU asset relates prior to the effective date when an ROU asset is recognized upon adoption of ASC 842.[11]

Teams should be mindful that implementing the standard could be significantly more complex for entities that do not elect the package of practical expedients, particularly when lease classification changes for existing leases. An entity that does not elect to apply the package of practical expedients applies, as of

[11] Refer to section 11.2.4 of our ASC 842 FRD, *Impairment of right-of-use assets prior to the effective date*, for further discussion of impairment considerations in transition.

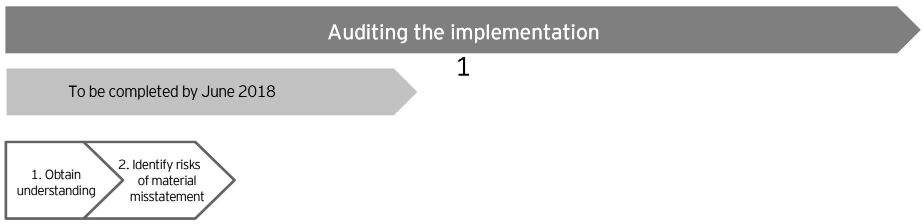
the lease commencement date (or most recent modification that does not result in a separate new lease), ASC 842 to determine the lease classification and then follows the transition provisions of ASC 842. Teams on audits of clients that do not elect the package of practical expedients need to consider whether this represents a higher inherent risk given the additional effort required in implementation.

The following table lists inherent risk factors that teams should consider when auditing the implementation of ASC 842. Our assessment of whether these factors represent a higher inherent risk is a matter of professional judgment and should be clearly documented.

| Inherent risk factors — Implementation of ASC 842 | |
|---|---|
| Entity-level factors: | Account-specific factors: |
| • Time pressure on management to complete the implementation<br>• The sufficiency and competency of resources to complete the implementation in a timely manner<br>• Changes in management during the implementation<br>• Whether a significant event or transaction (e.g., tax reform, a business combination) is planned during the transition period or year of adoption or we are auditing ICFR for the first time in either year<br>• Complexity of the organization (e.g., multinational operations) and/or decentralization of leasing or procurement operations<br>• Whether leasing is a core operation for the entity<br>• The entity's experience in implementing new accounting standards (e.g., ASC 606, *Revenue from Contracts with Customers*)<br>• How much management and/or the audit committee is focusing on the implementation | • Whether management elects to use the package of practical expedients during transition<br>• Whether management elects to use the hindsight practical expedient during transition<br>• Whether management elects the optional transition method, assuming the FASB finalizes the proposal<br>• Risks of material misstatement due to fraud<br>• Audit adjustments related to lease accounting or disclosures in recent periods<br>• Whether the entity has restated its financial statements for leases within the last three years<br>• Size and composition (e.g., materiality, complexity, use of nonstandard contracts) of existing leases<br>• The level of judgment required (e.g., lease term, renewals, discount rate) to account for and make disclosures about leases<br>• Implementation of new IT systems for lease accounting<br>• Leases tracked using Excel before and/or during implementation<br>• Lease accounting system separated from lease administration system<br>• How well the entity tracks information about operating leases<br>• Volume of lease contracts and other contracts (e.g., service contracts) that need to be evaluated for embedded leases |

Teams on audits of public entities should also consider referring to the factors identified in the Leases Readiness Survey that resulted in the entity's implementation complexity being designated "higher," "normal" or "less."

# 2 Understand the entity's process and identify risks




## 2.1 Understand management's process for implementing ASC 842

We obtain and document our understanding of management's process for implementing ASC 842, including the following elements:

- Management's overall project plan, including the timeline and governance structure (see sections 2.1.1, *Critical assessment of management's timeline*, and 2.2, *Understand entity-level controls*)
- Management's plan for identifying a complete population of leases (see section 2.3.1, *Risks related to the completeness of the population of leases*)
- Management's plan for gathering the data needed to apply the new standard (see section 2.3.2, *Risks related to the data that is used to apply the transition provisions)*
- Management's plan on whether to apply the transition practical expedients (see section 1.4, *Transition practical expedients and other policy elections affecting transition*)
- Management's plan for applying the ASC 842 accounting framework to its existing lease contracts to calculate the transition adjustments and make the required disclosures (see sections 2.3.3, *Risks related to applying the ASC 842 transition provisions*, and 2.3.5, *Risks related to management's disclosures*)

### 2.1.1 Critical assessment of management's timeline

We should critically assess management's overall project plan and timeline and consider whether the entity has sufficient and competent resources to complete the implementation.

In its Staff Practice Alert No. 15, *Matters related to auditing revenue from contracts with customers*, the Public Company Accounting Oversight Board (PCAOB) staff addressed the effect on the audit of a company being late in implementing the new revenue recognition standard. Although the alert addresses the adoption of ASC 606, teams need to be mindful of the following excerpt, which is also relevant to the adoption of ASC 842:

> "Circumstances where a company is late in implementing the new revenue standard might create incentives and pressures on the auditor that could inhibit the exercise of professional skepticism and allow unconscious bias to prevail. Incentives and pressures may arise, for example, to avoid significant conflicts with management or provide an unqualified opinion prior to obtaining sufficient appropriate audit evidence. In addition, the implementation of the new revenue standard could heighten scheduling and workload demands, putting pressure on partners and other engagement team members to complete their assignments too quickly. This might lead auditors to seek audit

> evidence that is easy to obtain but may not be sufficient and appropriate, to obtain less evidence than is necessary, or to give undue weight to confirming evidence without adequately considering contrary evidence."

As we assess management's timeline, we need to be mindful that in addition to implementing policies, processes and controls to apply the transition provisions and calculate the transition adjustments, management will also need to separately develop policies, processes and controls to be ready to account for new and modified contracts and make required disclosures on or after the effective date. Management's timeline needs to allow adequate time for the preparation and review of these policies, including the audit team's evaluation.

As the complexity of the implementation increases, we expect management's timeline to begin earlier in the transition period and the resources identified to have sufficient competence to handle such matters. If management has not budgeted sufficient time or allocated the right resources to the implementation, we need to critically assess whether the entity is at risk of not meeting its timeline. In determining the right resources, management may need to involve personnel from other areas of the entity (e.g., procurement, legal) to make sure it identifies a complete population of leases and understands the key contract terms and conditions related to leases. We should also evaluate whether management's timeline is reasonable based the entity's experience in implementing ASC 606.

As shown in the table in section 1.6, *Effect of implementation on our audit approach and planning*, there are a number of factors that could affect the complexity of implementing the new standard, including entity-specific factors (e.g., complexity of the organization, changes in management during the implementation) as well as complexities specific to leases and applying the ASC 842 accounting framework (e.g., volume of contracts, complex leasing transactions, election of the hindsight expedient).

In addition, many entities will need to implement new IT systems (or upgrade existing ones) to support accounting for leases under the new standard and/or track their portfolio of leases. Clients that implement new IT systems or upgrade their existing systems will need to factor in sufficient time into their project plan to perform testing to make sure their systems comply with the requirements of ASC 842. They will also need to make sure they have appropriate IT change management controls. There are a variety of possible challenges in this area, including the fact that although many third-party vendors are designing ASC 842 compliant systems, their releases continue to be delayed. We expect it to be difficult for entities with a sizable portfolio of leases to maintain spreadsheets to track the data, make the necessary computations, and compile the data needed for disclosures without a significant time investment. Thus, performing manual calculations (e.g., using an Excel spreadsheet to perform complex calculations) may indicate a higher risk of error.

As part of understanding and assessing management's timeline, audit teams can consider the leases benchmark timeline that can be found on the AC supplemental topics page in EY Atlas. This benchmark timeline represents our baseline expectations of when key activities should be completed for an entity to be on track to complete its implementation on a timely basis. The timeline was developed based on our experience assisting entities with the implementation of the new leases standard as well as insights gained from entities implementing the new revenue standard. Although the benchmark timeline identifies specific phases of implementation in a linear manner, the implementation activities are typically iterative and could take place more than once.

Teams can share certain enablers from the *Leases Diagnostic Framework* with management to assist in an entity's implementation. The *example diagnostic timeline* highlights activities management may perform as it assesses the potential effects of the new standard on the organization.

As a reminder, teams auditing public entities are required to discuss their views on management's implementation status with audit committees during each quarterly meeting. To prepare for these discussions, teams will need to have a robust understanding of management's implementation plan and timeline.

## 2.2 Understand entity-level controls

We obtain an understanding of entity-level controls relating to the entity's adoption of ASC 842 to help us identify and assess risks of material misstatement due to fraud or error and determine the appropriate audit strategy. In general, we expect management's plan to include the following elements:

- Control environment — The tone at the top regarding the entity's implementation of the new standard is important and will influence the focus and attention placed on accounting changes by the organization. The entity should develop a plan to train all affected business functions, including accounting, finance, procurement, legal and tax.
- Risk assessment — Management should perform a risk assessment to identify the new financial reporting risks, including fraud and significant risks, related to the implementation and prospective accounting.
- Control activities — Management should assess whether transaction-level controls over lease accounting or IT general controls (ITGCs) over any new or revised IT systems have been designed to properly mitigate the risks to an appropriate level.
- Information and communication — Management should evaluate whether modifications are needed to internal and external reporting systems to reflect the new accounting while maintaining the quality and integrity of the information. Management should also develop a process to communicate roles and responsibilities related to new controls to be performed by members of the organization.
- Monitoring — Management should develop a plan to monitor new or modified controls arising from the implementation of the standard and the prospective accounting under the new standard (e.g., by performing ongoing evaluations to ascertain whether controls are present and functioning).

We need to obtain an understanding of entity-level controls during the transition period (i.e., as part of our 2018 audit for audits of PBEs that do not early adopt) as well as in the year of adoption.

Certain entity-level controls relating to the implementation of ASC 842 could be similar to those related to the adoption of ASC 606 because the objectives of the controls will be the same. For example, management needs to properly train its accounting staff when a new accounting standard is released. The structure of the training program used to train staff on ASC 842 could be similar to the program used for ASC 606.

We will need to obtain sufficient appropriate audit evidence to support that the entity-level controls related to ASC 842 are operating effectively by performing procedures beyond inquiry of the entity's personnel. The audit evidence we obtain may include the entity's project plan and timeline, documentation outlining the entity's governance structure for implementing ASC 842 and presentations summarizing the entity's plan.

### 2.2.1 Example entity-level controls for each COSO 2013 Framework principle

The table below lists the 2013 Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control — Integrated Framework (COSO 2013 Framework) financial reporting principles and provides example entity-level controls that address each principle.

Management of an entity that uses the COSO 2013 Framework is required to design and execute controls to address all of its principles. However, we do not expect that management will need to develop new or additional entity-level controls during the implementation of ASC 842 to address each principle; existing entity-level controls may be adequate to address certain principles related to the implementation.

| COSO 2013 Framework principles | Example entity-level controls addressing principles |
|---|---|
| **Control environment** | |
| The organization demonstrates a commitment to integrity and ethical values. (COSO Principle #1)<br>The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control. (COSO Principle #2)<br>Management establishes, with board oversight, structures, reporting lines and appropriate authorities and responsibilities in the pursuit of objectives. (COSO Principle #3) | The entity has established an appropriate governance structure for the implementation of a new accounting standard and given the key decision makers, including those in IT, tax and operations, if applicable, the necessary authority. The audit committee effectively oversees the implementation of changes to internal control relating to each new accounting standard. |
| The organization demonstrates a commitment to attract, develop and retain competent individuals in alignment with objectives. (COSO Principle #4) | A training program for affected departments, both accounting and non-accounting, has been put in place and is managed by a qualified project leader. Periodic evaluation of staffing needs (for both transition and ongoing resources) is performed by the project leader. With respect to transition activities, work is prepared and reviewed by someone with knowledge of the transition requirements of ASC 842. |
| The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives. (COSO Principle #5) | Performance management processes for individuals responsible for executing new or revised controls are in place. Management is involved in the performance of control activities in a timely manner. |
| **Risk assessment** | |
| The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives. (COSO Principle #6)<br>The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed. (COSO Principle #7) | The risk assessments related to the new leases standard are evaluated and updated as part of the entity's implementation plan. |
| The organization considers the potential for fraud in assessing risks to the achievement of objectives. (COSO Principle #8) | The entity's fraud risk assessment considers any new fraud risk factors related to the implementation of the new leases standard. |
| The organization identifies and assesses changes that could significantly impact the system of internal control. (COSO Principle #9) | The entity identifies new controls or changes to existing controls that address new financial reporting risks arising from the implementation of the new leases standard. |

| COSO 2013 Framework principles | Example entity-level controls addressing principles |
|---|---|
| **Control activities** | |
| The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels. (COSO Principle #10) | The design of new control activities is evaluated to make sure the activities achieve the objective set out by the project team and effectively mitigate risks in the transition and prospective periods to an acceptable level. |
| The organization selects and develops general control activities over technology to support the achievement of objectives. (COSO Principle #11) | IT general controls for new systems or change management for revisions to existing systems are identified and tested. |
| The organization deploys control activities through policies that establish what is expected and procedures that put policies into action. (COSO Principle #12) | Management establishes policies and procedures to mitigate the risks of material misstatement related to the implementation and prospective accounting.<br>The operating effectiveness of new control activities is evaluated to make sure these activities follow the policy that establishes the expectations and the procedures put in place for that control. |
| **Information and communication** | |
| The organization obtains or generates and uses relevant, quality information to support the functioning of internal controls. (COSO Principle #13) | Management retains sufficient appropriate audit evidence about the design and operating effectiveness of controls over the relevance and reliability of information and data. |
| The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control. (COSO Principle #14) | Management communicates modifications to objectives or control responsibilities related to new accounting standards to key internal stakeholders, including those in different geographic locations or in non-accounting functions such as IT, procurement, treasury, tax, internal audit and legal. |
| The organization communicates with external parties regarding matters affecting the functioning of internal control. (COSO Principle #15) | The entity communicates relevant and timely information regarding the new accounting standards to external parties, including shareholders, partners and regulators. |
| **Monitoring** | |
| The organization selects, develops and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning. (COSO Principle #16) | Management monitors new controls by developing a testing plan to be included in its periodic evaluations. |
| The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate. (COSO Principle #17) | Management communicates any deficiencies in the controls over the implementation and takes timely corrective action to address deficiencies identified, if any. |

## 2.3 Risk assessment

### 2.3.1 Risks related to the completeness of the population of leases

Identifying the complete population of contracts that are or contain leases is a critical first step for management. This includes making sure that entities identify all lease modifications and consider the terms in the latest contracts.

A complete population of leases will need to be identified as of each reporting date, beginning with the date of initial application. If the FASB finalizes the proposed optional transition method and an entity elects to use that approach, management's assessment of completeness will be performed as of the effective date. However, we expect that management's controls and our substantive audit procedures will be similar and that management will need to perform procedures before the effective date to address the risk that management may not have identified a complete population of leases, regardless of whether the entity elects the proposed optional transition method.

Management needs to reconsider whether its existing controls are sufficiently precise to identify all leases under ASC 840. This is especially true for operating leases because the risk of understatement of the ROU asset and lease liability did not exist prior to the adoption of ASC 842. In addition, the election of the package of practical expedients does not grandfather incorrect conclusions under ASC 840.

In some instances, an entity may not have robust processes in place to distinguish between leases and service contracts because the accounting treatment for operating leases under ASC 840 is similar to the accounting for service contracts. Based on the entity's risk assessment, it may need to design new controls to determine whether service contracts are leases or contain leases under ASC 840. Entities need to evaluate all contracts that require the use of an asset to perform a service to determine whether the contract contains both a lease element (the identified asset) and a non-lease element (the service). Examples of arrangements that may contain both a lease and a non-lease element include multiple-element service arrangements (e.g., IT, telecom) and power purchase arrangements.

Refer to section 2.3.2.1, *Risks when additional lease contracts are identified during management's assessment of completeness*, for a discussion of additional risks when management identifies new lease contracts during implementation.

The following are example what can go wrongs (WCGWs) related to the completeness of the population of leases for entities that elect the package of practical expedients.

**Example WCGWs — completeness of the population of leases**

- The entity has not identified all arrangements that are or contain a lease under ASC 840. (C)
- The entity has not identified all lease modifications in accordance with ASC 840. (C)

### 2.3.2 Risks related to the data that is used to apply the transition provisions

Before computing the transition adjustments, management needs to determine that the data used to calculate such adjustments is complete and accurate.

For entities that elect the package of practical expedients, some of the key inputs used to determine the transition adjustments are based on conclusions previously made in accordance with ASC 840. For example, for leases that were classified as operating leases under ASC 840 and are classified as operating leases under ASC 842, the following are key inputs[12]:

- The remaining minimum rental payments (amounts and timing) as defined in ASC 840[13]
- The remaining lease term
- The amounts it is probable the lessee will owe under a residual value guarantee
- Cumulative prepaid or accrued lease payments
- Unamortized lease incentives
- Unamortized initial direct costs
- Carrying amount of an exit or disposal cost liability

For leases that were classified as capital leases under ASC 840 and are classified as finance leases under ASC 842, the capital lease obligation under ASC 840 is recognized as the lease liability. To determine the ROU asset, the unamortized initial direct costs under ASC 840 are added to the carrying amount of the lease asset under ASC 840 (i.e., the initial direct costs are reclassified to the ROU asset).[14]

Other inputs that are important for applying the transition provisions for entities that elect the package of practical expedients include the following:

- The discount rate for the lease (for operating leases)
- The lease term including reassessment for entities that elect the hindsight practical expedient

The risks associated with making these judgments under ASC 842 are addressed in section 2.3.3, *Risks related to applying the ASC 842 transition provisions*.

In addition to risks related to the use of incomplete or inaccurate data, entities also need to consider risks related to the implementation of new IT systems that store or process lease data. Refer to section 2.3.4, *Additional risks arising from the use of IT in the implementation*, for a discussion of risks when management chooses to use an IT system in the implementation of ASC 842.

**Management's assessment of its systems and controls over lease data**

Management needs to assess whether there are effective controls that it can rely on to address the risks of using incomplete or inaccurate lease data in the implementation of ASC 842. If the entity's existing controls over the completeness and accuracy of the lease data are effective, management may not need to implement new controls. In this case, the risks primarily relate to any transfer of lease data. For example, if management creates a new Excel spreadsheet to calculate the transition adjustments, management needs to address the risk that data may be modified or lost during transfer, or input, to this new spreadsheet.

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[12] Refer to section 11.3.3 of our ASC 842 FRD for lessee accounting guidance on the treatment of leases previously classified as operating leases under ASC 840 that remain operating leases under ASC 842 during transition.

[13] Refer to section 11.3.3.5 of our ASC 842 FRD for a discussion of determining minimum rental payments for operating leases under ASC 840.

[14] Refer to section 11.3.1 of our ASC 842 FRD for lessee accounting guidance on the treatment of leases classified as capital leases under ASC 840 that are classified as finance leases under ASC 842 during transition.

On the other hand, if the entity's existing controls over the completeness and accuracy of the lease data are not effective (i.e., are not sufficiently precise to address the risk of material misstatement in the implementation of ASC 842) or management doesn't have existing controls, management would need to implement new controls to make sure the lease data is complete and accurate. For example, management's review of the supporting schedules for the lease commitment note to the financial statements under ASC 840 may not have been performed at a threshold that would be sufficiently precise when applying ASC 842. Management may have waived differences between the lease contracts and the information reported in the lease commitment note that could be material now that an ROU asset and lease liability will be recorded.

The following is an example WCGW related to the data that is used to apply the transition provisions for entities that elect the package of practical expedients:

**Example WCGW — data that is used to apply the transition provisions**

- The lease data used to calculate the transition adjustments does not agree with the terms and conditions of the contract. (E/O, C, M/V, R/O)

### 2.3.2.1 Risks when additional lease contracts are identified during management's assessment of completeness

If management identifies contracts that should have been accounted for as a lease under ASC 840 (e.g., leases previously accounted for as executory contracts, embedded leases that weren't identified), it will need to evaluate the accounting for the contract pursuant to ASC 840, including:

- Lease classification
- Identification of lease and non-lease elements and allocation of the payments and other consideration
- Unamortized initial direct costs as of the date of initial application (or the lease commencement date, if later)
- For operating leases, the remaining lease term as of the date of initial application (or the lease commencement date, if later)
- For operating leases, the remaining minimum rental payments[15] as of the date of initial application (or the lease commencement date, if later)
- For capital leases, measurement of the remaining capital lease obligation and asset as of the date of initial application (or the lease commencement date, if later)

Management will also need to consider whether any of the following are present for operating leases (since they will affect the lease liability or ROU asset amounts)

- Amounts it is probable a lessee will owe under a residual value guarantee
- Cumulative prepaid or accrued lease payments
- Remaining balance of any lease incentives received
- Carrying amount of an exit or disposal cost (ASC 420) liability

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[15] Refer to section 11.3.3.5 of our ASC 842 FRD for a discussion of determining minimum rental payments for operating leases under ASC 840.

The following is an example WCGW when management identifies a contract that should have been accounted for as a lease under ASC 840 as part of its assessment of completeness even when the package of practical expedients is elected:

| **Example WCGW — assessment of additional lease contracts identified in implementation** |
| --- |
| ▸ For contracts that should have been accounted for as a lease under ASC 840, the lease is not properly classified by the lessee. (E/O, M/V, R/O) |

Refer to section 3.4.1.2.1, *Address risks when additional lease contracts are identified during management's assessment of completeness*, for further information on what we do when we identify a prior-period error during implementation.

## 2.3.3 Risks related to applying the ASC 842 transition provisions

Once management has identified a complete population of leases and captured the information needed to apply the transition provisions, the entity will calculate the transition adjustments. All entities will face the risk that the determination of the ROU asset and lease liability is not calculated in accordance with the transition provisions of ASC 842 (refer to section 1.5, *Transition accounting considerations*, for a summary of the transition provisions).

Management will need to consider certain risks resulting from the application of the transition provisions (see example WCGWs below). The risks depend on the terms and conditions of the entity's leases and whether the hindsight expedient is elected. This guide addresses the more prevalent risks that audit teams are expected to face. The transition accounting guidance differs from the prospective accounting guidance and therefore audit teams should carefully read section 11, *Effective date and transition*, of our ASC 842 FRD.

**Income tax considerations**

ASC 842 does not change the way an entity accounts for the income tax effects of leases under ASC 740, *Income Taxes*. However, an entity may need to account for new temporary differences or changes in existing temporary differences when it adopts the standard. The most significant change is expected for operating leases. Under ASC 840, a lessee generally records a deferred tax asset related to the difference between the rent expense recorded for book purposes (i.e., straight-line rent) and the amount deductible for tax purposes. Entities will likely need to record new temporary differences for these leases when they adopt the standard because they will be recognizing ROU assets and lease liabilities for the first time, and those assets and liabilities will have no corresponding tax basis.

In all cases, entities will need to execute the following steps during implementation:

- Identify existing temporary differences related to all leases under ASC 840
- Identify all temporary differences once ASC 842 is adopted
- Calculate the adjustments necessary to reflect the post-adoption deferred tax amounts
- Evaluate the need for a valuation allowance for any new deferred tax assets recorded upon adoption

Entities with significant lease portfolios, especially leases in multiple jurisdictions, should not underestimate the effort this process may require.

#### Estimates

Another area that will present risk is determining the discount rate used to measure lease liabilities for operating leases. The definition in ASC 842 of the rate that must be used is different than the guidance in ASC 840. Also, the discount rate must be estimated on a lease-by-lease basis, unless the portfolio approach is used. Refer to section 3.4.1.3.1, *Testing the discount rate in implementation*, for a discussion of how the standard defines the discount rate and guidance on how to test the discount rate.

Entities that elect the hindsight practical expedient will need to determine the lease term based on facts and circumstances through the effective date.[16]

The following table lists example WCGWs in applying the transition provisions of ASC 842, assuming the lessee elects the package of practical expedients:

| Example WCGWs — applying the transition provisions |
| --- |
| ▸ The entity elects to apply the hindsight practical expedient but does not appropriately reassess the lease term based on all facts and circumstances through the effective date. (M/V, P/D) |
| ▸ The entity does not use an appropriate discount rate to measure the lease liability. (M/V, P/D) |
| ▸ The entity does not appropriately measure the lease liability. (M/V, P/D) |
| ▸ The entity does not appropriately measure the ROU asset. (M/V, P/D) |
| ▸ The entity does not appropriately account for the income tax effects of adopting the new standard. (M/V, P/D) |

### 2.3.4 Additional risks arising from the use of IT in the implementation

Many entities may find that their existing IT systems are not adequate to support the calculation of the transition adjustments and/or the prospective accounting for and disclosures about leases under the new standard. Other entities may not currently have an IT system for lease accounting and disclosure but may determine that one is necessary to meet the requirements of the new standard.

Additional risks need to be addressed if an entity implements new systems or modifies its existing systems. Audit teams should read our Audit Matters publication, *System implementations can create new risks that we need to address in our audits,* issued on 17 October 2017, which discusses in more detail the risks that exist when an entity implements new systems. In these situations, we should consider the following example WCGWs:

| Example WCGWs — new or modified IT systems |
| --- |
| ▸ Lease data is not transferred completely and accurately from the entity's current system to the new system. (C, M/V) |
| ▸ The entity's new or modified IT system does not function in a manner that complies with the requirements of ASC 842. (C, M/V, P&D) |
| ▸ Unauthorized users have access to an entity's new or modified IT system. (C, M/V) |
| ▸ New or modified system interfaces (e.g., from a lease administration system to a lease accounting system) do not transfer information between IT applications or databases completely or accurately. (C, M/V) |
| ▸ Configurations that customize a new or modified system are not appropriate (e.g., they don't reflect policy elections that affect the computations performed by the system). (C, M/V) |

[16] See the guidance in section 2.3 of our ASC 842 FRD for a discussion of evaluating the lease term.

During the transition to the new leases standard, some entities might use manual processes until automated processes and controls are implemented. Audit teams should be aware that manual calculations (e.g., using an Excel spreadsheet to perform complex calculations) often have a higher inherent risk than automated calculations subject to effective ITGCs. It also may be difficult for entities with a large number of leases to maintain spreadsheets to track lease data and make the necessary computations and disclosures.

#### 2.3.4.1 Use of service organizations (added July 2018)

When the entity uses a service organization as part of its implementation, it must consider the risks that arise from the part of the process or processes performed by the service organization. Because many entities did not use a service organization to help them perform their accounting under ASC 840, it is important for the entity to understand how using a service organization will affect the risks associated with the implementation and prospective accounting processes. Some of the risks previously discussed in this section may relate to processes performed by the service organization and therefore may be addressed by controls at the service organization.

Entities may use lease accounting software that is provided and hosted by a third party (i.e., under a software-as-a-service or SaaS arrangement). The risks resulting from a SaaS arrangement include the risks that arise from implementing a new system which were discussed in the previous section.

Refer to the discussion of considerations when relying on a SOC 1 report in section 3.5.1, *Addressing risks when management uses a service organization*.

### 2.3.5 Risks related to management's disclosures

Entities that are SEC registrants need to comply with SAB Topic 11.M, which requires disclosure of the anticipated effects of new accounting standards if the effects are known. As with any other disclosure, a registrant must design controls to assess the completeness, accuracy and adequacy of these disclosures.

The SEC staff has monitored registrants' disclosures about the effect of adopting recently issued accounting standards (e.g., ASC 606) and, in some cases, is requesting expanded disclosures. We expect the SEC staff to focus on registrants' disclosures related to the new leases standard in their filings prior to the effective date. Refer to section 3.4.1.4, *Evaluate management's disclosures during the transition period*, and Appendix D, *SAB Topic 11.M disclosures*, for further discussion of the audit considerations for SAB Topic 11.M disclosures.

**Example WCGW — management's disclosures about adoption**

- The entity's disclosures prior to the effective date do not comply with SAB Topic 11.M. (C, P&D)

### 2.3.6 Identify significant risks, including fraud risks

**Significant risks**

A significant risk is an inherent risk with a higher likelihood of occurrence and a higher magnitude of potential misstatement in the financial statements. Lessees will recognize ROU assets and lease liabilities relating to operating leases for the first time and these amounts could be multiples of planning materiality (PM). We consider the guidance in EY GAM UTB *Understand the Business* 4 when making an assessment about whether this represents a significant risk. We also consider the same factors discussed in section 1.6, *Effect of implementation on our audit approach and planning*, related to our CRA to determine whether factors that represent a higher inherent risk also represent a significant or fraud risk.

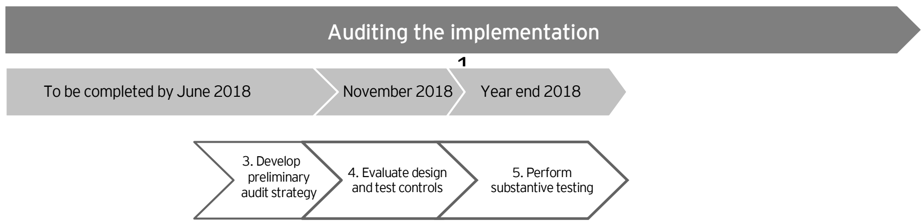
### Fraud risks

Although the implementation of the new standard is not expected to have a significant effect on most entities' reported earnings, teams should still consider whether the implementation could pose new or heightened fraud risks. It is important for the team to discuss how management could perpetrate and conceal fraud, including omitting or presenting incomplete or inaccurate disclosures. When making this assessment, we consider the guidance in EY GAM FRAUD-RISK.

Some of the factors that may cause an audit team to identify a fraud risk include:

- Entities are incentivized to minimize the amounts of their reported assets or liabilities due to debt covenants or other key financial ratios.
- Nonfinancial management participates excessively in the selection of accounting policies or the determination of significant judgments related to the implementation of ASC 842.
- Management attempts to justify marginal or inappropriate accounting on the basis of materiality.

# 3 Design and execute tests of controls and substantive audit procedures




## 3.1 Develop and execute our audit strategy

Our preliminary audit strategy for the implementation of ASC 842 needs to include our plan to evaluate management's ICFR related to the implementation, if we are performing an integrated audit or using a controls reliance strategy. That includes evaluating how management addresses the risks related to determining the transition adjustments and making adequate quantitative and qualitative disclosures about the effect of adoption (i.e., SAB Topic 11.M disclosures). We also need to plan substantive audit procedures that address these risks. Our audit procedures should also consider our evaluation of management's policies, processes and controls for implementing ASC 842 and its policies, processes and controls for the prospective accounting under ASC 842 to be implemented in the quarter of adoption.

Executive involvement during the development of our preliminary audit strategy is critical because of the implementation risks relating to the standard's transition provisions.

This section provides guidance on the nature and extent of our audit procedures. It also provides example controls management may implement to address the risks outlined in section 2, *Understand the entity's process and identify risks*, and example substantive procedures we may perform. However, the examples are not intended to be all-inclusive. Teams need to design an audit strategy that responds to the risks they identify for a particular client.

### Team events and Project Insight

Teams on audits of public entities will need to complete two team events during the transition period that are designed to encourage all professionals working on the audit of the implementation, including FAIT and Tax, to hold meaningful discussions about the team's audit strategy. At both events, the team will discuss considerations for the critical stages of our audit.

Teams performing integrated audits are required to use Project Insight to understand the critical path of the implementation SCOT and the design of controls. The two team events will satisfy the team meeting requirements of Project Insight.

Teams auditing calendar-year entities are expected to complete Leases Team Event 1 by 30 June 2018. Teams will discuss their understanding of the entity's leasing activities, their initial evaluation of the effect of the new standard and the entity's implementation plan for ASC 842. Based on this discussion, teams will identify the risks relating to the implementation, develop an expectation of the relevant controls and develop a preliminary audit strategy. Upon completion of Team Event 1, teams on integrated audits will have completed Step 1 of Project Insight with respect to the implementation SCOT, which will include (1) developing a preliminary placemat depicting the steps in the critical path, including IT applications and the flow of data, (2) identifying points where misstatements can occur (i.e., WCGWs), (3) identifying controls that mitigate the WCGWs and (4) identifying information produced by the entity (IPE) used in those controls. To maximize the effectiveness of Team Event 1, it is important for teams to have a thorough understanding of management's implementation plan before the meeting. The Team Event 1 preparation checklist, among other things, includes a series of questions that teams can ask management to prepare for the team event.

Teams auditing calendar-year entities are expected to complete Leases Team Event 2 by 30 November 2018. This event is designed to assist audit teams in reviewing the results of our evaluation of the design and operating effectiveness of implementation controls, reassessing the risks identified in Team Event 1, or any new risks, and evaluating our plan for substantive testing based on these assessments. In preparation for Leases Team Event 2, teams on integrated audits need to complete Step 2 of Project Insight, which is the walkthrough of the implementation SCOT. This includes confirming our understanding of the critical path, assessing whether management's controls address the identified risks, including whether there are any missing controls, and validating that the evidence obtained during the walkthrough and related documentation is commensurate with the importance and risk of the controls. Step 3 of Project Insight will be completed during Team Event 2 when teams confirm that the audit strategy is responsive to the CRA and information obtained during the walkthrough.

Typically, the steps of Project Insight are completed within a short timeframe. However, since it may take management several months to implement the new standard, the time between the steps may be greater than is typically expected under Project Insight.

**Considerations related to our walkthrough of the implementation SCOT**

As required by EY GAM, we perform a walkthrough of management's implementation SCOT in order to confirm our understanding of the processes and procedures in place and to assess whether we have identified all of the risks of material misstatement. If we are also walking through controls as part of an integrated audit or controls reliance strategy, or walking through relevant controls over significant risks, highly automated SCOTs and journal entries that are part of the financial statement close process (FSCP), we confirm our understanding of the design of the controls that are relevant to our audit and to the risks identified.

As discussed in section 1.2, *Leases audit roadmap for lessees*, the steps for auditing the implementation of ASC 842 are presented sequentially to align with EY GAM. However, teams may not perform the steps in this order, and the steps may be iterative in nature due to the complexity of the implementation and the time required by management to design and implement transition controls. Even if our clients have not completed their own processes, audit teams should not delay in identifying risks and developing our expectations of processes and controls. Our assessment will allow us to provide timely feedback to management and avoid delays in our procedures that could lead to time constraints at a later point in our audit of the implementation.

When we confirm our understanding of management review controls (e.g., management at an appropriate level reviews the calculation of the transition adjustments prepared by another individual), we will need to understand the scope and precision of the review, the activities performed to verify the completeness and accuracy of data used in the control, the criteria used for identifying items for investigation and how management follows up on these items and resolves them. While the sources of information may vary, the evidence management collects needs to be sufficient to provide reasonable assurance that the objective of the control is met. Our objective is to evaluate whether the judgments made by management are reasonable and supportable.

As part of our walkthrough, we consider the competence and authority of the individuals performing the reviews in the implementation controls, including their knowledge of ASC 842 and the transition provisions.

In our documentation, we need to describe the attributes of the control in detail to help us conclude that the scope, procedures and precision are adequate, that IPE used in the performance of the control has been identified and that the relevant risks of its use are addressed. Refer to our Audit Matters, *Testing management review controls and documenting our work*, published on 29 September 2016, for more information on control attributes.

## 3.2 Planning materiality and tolerable error considerations

An entity's adoption of the new leases standard does not affect how we calculate PM and tolerable error (TE). We should compute PM and TE in accordance with EY GAM for the year of adoption (e.g., 2019 for a public entity that does not early adopt) and use that TE to establish the threshold to test the transition adjustments.

Because teams will be performing audit procedures in the periods prior to adoption, teams may find it more practicable to use the PM and TE established in the year prior to adoption (e.g., 2018). In this case, we need to reassess the extent of our procedures based on the PM and TE established in the year of adoption if significant changes in PM and TE occur.

When we substantively test the disclosures required by SAB Topic 11.M that contain amounts or ranges, we use TE related to the year the disclosures are made to perform our testing and assess errors (e.g., the 2018 TE when testing the SAB Topic 11.M disclosures in the 2018 Form 10-K).

## 3.3 Reminders regarding the timing of our audit procedures over the transition adjustments and workpaper archiving

The final transition amounts will be initially disclosed in the quarter of adoption (e.g., 31 March 2019 for a calendar year-end public entity that does not early adopt). However, in order to timely assess the appropriateness of the transition adjustments during the transition period, we need to perform our audit procedures shortly after management performs its processes and controls. We also need to begin to evaluate management's processes, policies and controls for the prospective accounting so that we are prepared to perform a quarterly review in the quarter of adoption. Timely completion of our audit procedures over the transition adjustments and our evaluation of management's prospective accounting policies will also help us review and evaluate management's SAB Topic 11.M disclosures in the year prior to adoption.

We will finalize our auditing of the transition adjustments, including our assessment of any control deficiencies and misstatements in the quarter of adoption.

Because teams need to perform the majority of their implementation audit procedures in the year prior to adoption, we are likely to retain the same workpapers in multiple EY Canvas files. The following table summarizes the workpapers that should be included in the 2018 and 2019 EY Canvas files for a calendar-year public entity that does not early adopt.

| 2018 EY Canvas | 2019 EY Canvas |
|---|---|
| ▸ Workpapers that support amounts presented in the SAB Topic 11.M disclosures in the 2018 financial statements<br>▸ Workpapers that support our control testing over management's implementation controls and entity-level controls<br>▸ Workpapers that support our substantive testing over the transition adjustments<br>▸ Workpapers that support our evaluation of management's prospective accounting policies, processes and controls | ▸ Workpapers that support our testing and conclusions over management's implementation controls and entity-level controls<br>▸ Workpapers that support our substantive testing over the final transition adjustments, tie-out to the reported amounts and related conclusions<br>▸ Workpapers that support our final evaluation of management's prospective accounting policies, processes and controls and related conclusions<br>▸ Workpapers that support amounts presented in the quarterly and annual disclosures in the 2019 financial statements |

# 3.4 Extent of testing procedures

## 3.4.1 Addressing identified risks of implementation

Section 2.3, *Risk assessment*, identifies the risks facing entities and audit teams during the implementation of ASC 842. We discuss example controls management may use to mitigate these risks and the substantive audit procedures teams may perform to respond to the risks below. The example WCGWs discussed in section 2.3 are repeated in the risk/control/substantive procedure tables in the following sections.

Sections 3.4.2, *Define the population of lease contracts and the sampling unit*, and 3.4.3, *Determine the sample size for testing of lease contracts*, discuss how we determine our strategy for stratifying the population of leases and how we make our selection of contracts to test.

### 3.4.1.1 Assess the completeness of the population of leases

As discussed in section 2.3.1, *Risks related to the completeness of the population of leases*, the first risk we should consider in auditing the implementation of ASC 842 is the risk that a complete population of leases is not identified as of each reporting date in the comparative financial statements and the financial statements for the year of adoption. For a calendar-year public entity, this would be the financial statements for 2017, 2018 and 2019, unless the FASB finalizes the proposed optional transition method and the entity elects to use it. The risk of completeness is greater under ASC 842 than under ASC 840 because ROU assets and related lease liabilities for operating leases are now recorded on the balance sheet.

If we are performing an integrated audit or using a controls reliance strategy, we need to test the operating effectiveness of management's controls over the completeness of the population of leases. As discussed in section 1.1, *Overview*, this guide assumes that our client has elected the package of practical expedients. Entities that elect the package of practical expedients do not need to reassess whether any expired or existing contracts are or contain leases. However, electing the package of practical expedients does not grandfather incorrect conclusions under ASC 840 about whether a contract is or contains a lease. Thus, if management believes that there is a risk that certain lease contracts were not identified under ASC 840, it may need to implement new controls during the transition period to address this risk.

As a starting point, we expect entities to develop a Master Lease Schedule and reconcile the population of leases in the Master Lease Schedule to the prior-year lease commitment disclosure under ASC 840. However, this procedure by itself may not be sufficient to address the risk of completeness because the prior-year lease commitment note may not have been complete, particularly if the entity did not have well-designed processes and controls in place to identify all leases and lease modifications. We expect that most entities will need to perform additional procedures during the implementation to address the risk of completeness of the lease population (examples are included in the table below).

The evaluation of gaps in controls and policies between ASC 840 and ASC 842 should be performed as early in the implementation process as possible because it may lead to additional work for both management and the audit team during implementation.

For our substantive audit procedures, we need to test whether the population of lease contracts included in the transition adjustments is complete. If there is a risk that lease contracts were not identified under ASC 840, or that our risk assessment in prior years resulted in limited procedures over lease identification, our substantive procedures during the implementation need to be more robust.

If our substantive procedures identify contracts that are leases or contain leases that are not included on the Master Lease Schedule, we consider the effect on our evaluation of the design and operating effectiveness of management's implementation controls.

Refer to section 3.4.1.2.1, *Address risks when additional lease contracts are identified during management's assessment of completeness*, for controls and substantive procedures we may perform when management's assessment of completeness identifies new leases.

### Group audit considerations

Entities with significant components and decentralized finance and procurement operations need to consider whether this structure poses a risk to the completeness of the population of leases. Refer to Appendix A, *Group audit considerations*, for more information on implementing ASC 842 for a group audit.

The following table provides example controls and substantive procedures teams may perform to address the risks identified in section 2.3.1, *Risks related to the completeness of the population of leases*. Our expectations of management's controls and our planned substantive procedures are responsive to the entity's risks.

| WCGWs | Example controls[1] | Example substantive procedures[1] |
|---|---|---|
| ▸ The entity has not identified all arrangements that are or contain a lease under ASC 840. (C) | ▸ The controller reviews the reconciliation prepared by the senior accountant of the Master Lease Schedule to the information used to prepare the lease commitment disclosures in the prior-year financial statements. All reconciling items above the review threshold are investigated to determine whether the Master Lease Schedule is complete.<br>▸ For real estate leases, management considers the list of properties as disclosed in Item 2 of an entity's Form 10-K to determine whether any properties may contain a ground lease or other leasing relationship. | ▸ Reconcile the Master Lease Schedule to the information in our workpapers that we used to test the lease disclosures in the prior-year financial statements. If there are any differences, resolve the difference and assess the effect on our assessment of the completeness of the Master Lease Schedule. |
| | ▸ The senior accountant surveys internal stakeholders (e.g., legal, finance, operations, procurement) to identify contracts that may be leases or may contain leases, including any amendments or modifications to those contracts.[2] The controller reviews the results of the survey to determine whether any contracts not previously considered may contain a lease and selects a sample of contracts to review. During the review, the controller makes sure the survey was sent to the appropriate individuals within the entity. The controller determines whether additional follow-up is needed to conclude that the Master Lease Schedule is complete. | ▸ If management conducts its own survey, consider requesting to be copied on all survey distribution emails and responses to obtain contemporaneous evidence. If we rely on management's process, evaluate the list of respondents and conclude, based on our understanding of the entity's operations, that all relevant individuals and/or departments were sent the survey and that they responded. Obtain evidence of the follow-up performed based on survey results and evaluate the responses and the conclusions reached.<br>  ▸ Consider performing an independent inquiry of survey respondents to confirm their responses and any accounting implications.<br>▸ Perform an independent survey of internal stakeholders (e.g., legal, finance, operations, procurement) to identify contracts that may be leases or may contain leases.[2] |

| WCGWs | Example controls[1] | Example substantive procedures[1] |
|---|---|---|
| | ▸ The controller reviews an analysis prepared by the senior accountant of recurring vendor payments (e.g., the same amount each month) obtained from the cash disbursements register to determine whether any payments relate to a lease that was not included on the Master Lease Schedule. As part of this review, the controller reviews the underlying contracts for a sample of recurring payments determined not to be leases.<br>▸ The controller reviews an analysis prepared by the senior accountant of vendors that are paid each month (or on another recurring basis) to determine whether the payments relate to a lease that was not included on the Master Lease Schedule. As part of this review, the controller reviews the underlying contracts for any significant vendor relationships not identified as a lease.<br>▸ For each analysis:<br>  ▸ The controller reviews the significant assumptions used by the senior accountant to develop the analysis, such as the date range or how the preparer defined a recurring payment (e.g., the frequency of the payment or whether the payment is for the same amount or a range of amounts) and the completeness and accuracy of data used in the analysis. | ▸ Obtain a list of recurring vendor payments (i.e., the same amount each month) from the cash disbursements register.[3] Based on the knowledge gained in our prior-year audit or other procedures performed during implementation, exclude vendors that we know do not have a leasing relationship. Document our rationale for excluding such vendors. For a sample of recurring vendor payments, evaluate the underlying contract to determine whether the contract is a lease or contains a lease that was not included on the Master Lease Schedule.<br>▸ Obtain a list of vendors that are paid each month (or on another periodic basis).[3] Based on the knowledge gained in our prior-year audit or other procedures performed during implementation, exclude vendors that we know do not have a leasing relationship. Document our rationale for excluding such vendors. For a sample of vendors, evaluate the underlying contract to determine whether the contract is a lease or contains a lease that was not included on the Master Lease Schedule.<br>▸ For each analysis:<br>  ▸ Document the significant assumptions to develop the analysis such as the date range or how we defined a recurring payment (e.g., the frequency of the payment or whether the payment is for the same amount or a range of amounts)<br>**Note**: If the team performs both of these substantive procedures, there may be overlap in the vendors identified. Teams need to consider available client data and which analysis is most effective to achieve our audit objective, or if both are necessary.<br>We are also mindful that, based on the underlying contract, some leases may have been executed late in the year, and no payments may have been made until after year end. As such, we may need to design our procedures to identify vendor payments that are made near year end or in the subsequent period in order to address this risk. We can combine this with our search for unrecorded liabilities, which is discussed in the procedures below. |

| WCGWs | Example controls[1] | Example substantive procedures[1] |
|---|---|---|
| | ‣ The controller reviews an analysis (including vendor name, service, product and annual payment amounts) prepared by the senior accountant of active vendors in the procurement database (or master vendor file) to identify vendors for which the entity may have executed a lease. This review includes a review of explanations provided by the senior accountant for each vendor in the analysis. The controller reviews a sample of contracts for any significant vendor relationships not identified as a lease. | ‣ Obtain a listing of the entity's active vendors and eliminate vendors we have previously determined do or do not represent leasing relationships during our current and prior-year audits. For a sample of the remaining vendors, evaluate the underlying contract or invoice and perform inquiries of the procurement department to identify any contracts that may be a lease or may contain a lease. |
| | ‣ The entity confirms the number of contracts and the date of each contract, including any modifications, with vendors that have a significant number of leases. For each confirmation, the controller confirms that the vendor replied to the confirmation, reviews explanations of variances between the confirmation and the Master Lease Schedule and reviews a sample of contracts not included in the Master Lease Schedule.<br>**Note:** In determining whether obtaining confirmations is a necessary procedure, management will need to evaluate whether its existing controls are sufficient to address the risk of completeness. The purpose of this procedure is to test the completeness of the lease population for specific vendors that the entity has a significant number of leasing relationships with (e.g., copiers or vehicles). | ‣ Consider whether to prepare independent confirmations to confirm the number of contracts and the date of each contract, including any modifications, for the entity's significant leasing relationships. If we perform an independent confirmation, document the resolution of discrepancies between the confirmation and the Master Lease Schedule. |
| | ‣ The controller reviews an analysis prepared by the senior accountant of service contracts not on the Master Lease Schedule to determine whether the contracts qualify as leases under ASC 840. The controller determines whether the contracts have been appropriately included in or excluded from the Master Lease Schedule.<br>**Note**: This procedure could be performed in connection with the analysis of vendors discussed above. | ‣ Select a sample of service contracts to determine whether the contracts are leases or contain a lease under ASC 840. Determine that the contracts were appropriately included in or excluded from the Master Lease Schedule. |

| WCGWs | Example controls[1] | Example substantive procedures[1] |
|---|---|---|
| | ▸ Management obtains quarterly (or on another periodic basis) representations from division leaders and legal, finance, operations and procurement personnel affirming that they have complied with the entity's contract processes and controls and have fully disclosed to management all contracts, including any modifications. The controller confirms that all representations have been received, reviews explanations prepared by the senior accountant of variances between the representations and the Master Lease Schedule and reviews a selection of contracts not included in the Master Lease Schedule. | ▸ Obtain management's quarterly (or on another periodic basis) representations from division leaders and legal, finance, operations and procurement personnel affirming that they have complied with the entity's contract processes and controls and have fully disclosed to management all contracts, including any modifications. Evaluate the representations made, including any variances between the representations and the Master Lease Schedule. Evaluate a sample of contracts not included in the Master Lease Schedule.<br>▸ As part of our general audit procedures:<br>  ▸ Read the minutes of the meetings of the Board of Directors and its committees for evidence of new contracts or modifications to existing contracts.<br>  ▸ Perform additional inquiries of individuals as part of our planning and/or year-end procedures regarding arrangements or types of contracts that may indicate a lease. Individuals of whom we may inquire include internal audit, general counsel, the Board of Directors or other accounting department employees who are not involved in lease accounting.<br>▸ As part of our testing of subsequent cash disbursements to identify unrecorded liabilities, consider new or recurring payments in the subsequent period, new vendors with significant payments or other factors that indicate a lease based on our knowledge of the entity and its operations and the results of other substantive procedures performed during implementation. |
| ▸ The entity has not identified all lease modifications in accordance with ASC 840. (C) | ▸ The controller reviews surveys made of the procurement department, legal and/or operations to confirm that all lease modifications have been reflected on the Master Lease Schedule. As part of this review, the controller reviews the accounting conclusion for the treatment of any previously unidentified modifications under ASC 840 and confirms that appropriate updates have been made to the Master Lease Schedule.<br>**Note**: The controls related to vendor confirmation and representations from company personnel can also be included in the suite of controls to address this risk. | ▸ Evaluate the responses to surveys (see the procedures above) to identify any lease modifications. If any modifications are identified, determine that the modification was appropriately accounted for.<br>**Note**: The procedures related to vendor confirmation and our general audit procedures and subsequent cash disbursements can also be included in the suite of procedures to address this risk. |

[1] We should consider performing dual-purpose testing, when appropriate. Reminders from EY GAM about how to use this approach are discussed in section 3.4.3.1, *Dual-purpose testing*.

[2] If an entity has multiple locations for legal, finance, operations or procurement or if any responsibilities are dispersed, we would expect this survey to be sent to all individuals who may provide valuable insight. Management, or the audit team, may find our *Lease identification questionnaire* useful in designing its survey of internal stakeholders. The questionnaire is part of our *Leases Diagnostic Framework*. If management chooses not to use this enabler for its internal analyses of the completeness of its population of lease contracts, management should design controls to address how it has considered the questions in this enabler. This survey should contain sufficient background information to allow an individual without knowledge of accounting for leases to complete the survey.

[3] Before performing this analysis, teams need to consider whether the data is readily available to perform the procedure. Teams are encouraged to contact their Regional analytics leaders and coordinators to assist in evaluating the most efficient way to gather the data and in understanding the tools available to perform the analysis.

#### Attribute testing

When the objective of our procedures to test the completeness of the lease population results in a binary "yes" or "no" conclusion (e.g., whether a contract is a lease or contains a lease), we believe that attribute sampling is appropriate. However, when the objective of our procedures does not result in a binary "yes" or "no" conclusion, attribute sampling is not appropriate. Attribute sampling generally results in a sample of 25 for populations larger than 250 items. Refer to EY GAM SAMPLE 2.3.4 and 4.5.3c for further information.

### 3.4.1.2 Assess the completeness and accuracy of the data that is used to apply the transition provisions

Section 2.3.2, *Risks related to the data that is used to apply the transition provisions*, discusses the risks associated with gathering complete and accurate data for each lease contract in the population used to determine the transition adjustments. To respond to these risks, we and the entity may need to perform contract reviews, unless management and the audit team are able to rely on existing controls over lease data.

The overall objective of an entity's contract reviews, and of our audit procedures, is to confirm that the data used to determine the transition adjustments is complete and accurate based on the underlying contract. If an entity's controls or our audit procedures do not adequately address this objective, the risk of misstatement in the transition adjustments increases.

When assessing the design of management's controls and designing our substantive audit procedures, we consider the following:

- How the data was collected during the transition to ASC 842 (i.e., manually compiled in Excel or maintained in and extracted from an IT system)
- The extent of evidence management has gathered to support the completeness and accuracy of the data collected
- How the risks associated with IPE were addressed (refer to our discussion of IT systems and manual calculations in section 3.5, *Use of IT in the implementation and related data considerations*)
- How management selected contracts for review (i.e., whether management reviewed all contracts on the Master Lease Schedule or a sample, and if management used a sample, how it selected the sample)
- The nature and composition of the lease contracts selected for testing (i.e., whether there is a significant number of contracts with the same terms or many different types of contracts)

Additional guidance and considerations for determining our sample size can be found in section 3.4.3, *Determine the sample size for testing of lease contracts*.

### Considerations about the entity's historical controls over the lease data

As we are designing our audit strategy, we need to consider the entity's existing controls over the completeness and accuracy of the lease data (refer to section 2.3.2, *Risks related to the data that is used to apply the transition provisions*, for further information). If the entity's existing controls over the completeness and accuracy of the lease data are effective and we tested and relied on those controls, we may be able to eliminate or reduce the number of contracts selected to test the completeness and accuracy of the lease data in implementation. For example, if management can provide evidence that the existing controls over lease initiation and monitoring are sufficiently precise to address the completeness and accuracy of the lease data, it may not need to revisit the underlying contract. But if the entity's existing controls over the completeness and accuracy of the lease data are not effective or we chose not to test them, we would need to select more contracts to test the completeness and accuracy of the lease data in implementation.

### Evaluation of whether to carry forward prior-year substantive testing

When designing the nature and extent of our substantive testing over the lease data, we need to evaluate whether we can rely on our prior-year substantive procedures. For example, if a team tested a new lease contract in the prior-year audit (including testing the completeness and accuracy of the underlying data), we may be able to rely on this testing to reduce the number of contracts selected for testing during implementation.

When we carry forward prior-year documentation to support our testing of the completeness and accuracy of contract data, we follow EY GAM DOC + ARC 2.4.

### Data gathering for disclosures under ASC 842

As part of the process to gather complete and accurate data for its lease contracts, management needs to consider the expanded disclosure requirements of ASC 842. In order to prepare for these disclosures, management needs to perform a gap analysis between the current disclosure requirements and those under the new standard and determine the additional information that will be needed and that can be gathered while performing its implementation procedures. For example, management will need to disclose information about the determination of the discount rate for its leases, the weighted average discount rate, the short-term lease cost and the weighted average lease term.

As part of our substantive procedures during the implementation, we need to understand management's gap analysis and its plan for prospective disclosures. This may include reading draft disclosures prepared by management or reviewing schedules prepared to support future disclosures as part of our procedures over the completeness and accuracy of lease data.

### Group audit considerations

When designing our testing of lease data in a group audit, we may test controls at the entity, regional or component level or a combination of these depending on the precision of the design of the controls at each location. Refer to Appendix A, *Group audit considerations*, for more information about our strategy for a group audit.

The following table provides example controls and substantive procedures to address the risks related to the lease contract data identified in section 2.3.2, *Risks related to the data that is used to apply the transition provisions*. For existing capital leases under ASC 840, the audit team should consider the procedures performed in prior-year audits and evaluate if additional procedures are needed (e.g., if the hindsight practical expedient is elected), considering that those were already recognized on the balance sheet.

Our expectations of management's controls and our planned substantive procedures must be responsive to the entity's risks and other facts and circumstances.

| WCGW | Example controls [1] | Example substantive procedures [1] |
|---|---|---|
| ‣ The lease data used to calculate the transition adjustments does not agree with the terms and conditions of the contract. (E/O, C, M/V, R/O) | ‣ The controller reviews a memo summarizing management's strategy to test the completeness and accuracy of the data used to calculate the transition adjustments, including an analysis of existing controls over lease data and whether relevant data was obtained from the contract or another data source[2] (e.g., a lease management system).<br>‣ For a sample of contracts, the controller reperforms the procedures performed by the senior accountant. For each lease, the senior accountant compares the data (e.g., the remaining term of the contract as of the evaluation date and the remaining minimum rental payments as of the evaluation date) in the Master Lease Schedule to the original contract (or modified contract, if applicable) or other data source.[2] Any differences are investigated. | ‣ For a sample of contracts, perform a contract review and compare the data (e.g., the term of the contract at inception or modification, the remaining term of the contract as of the evaluation date and the remaining minimum rental payments as of the evaluation date) in the Master Lease Schedule to the original contract (or modified contract, if applicable). Evaluate relevant clauses in the contract that could affect the determination of the key inputs (e.g., read the description of variable payments in the contract to determine whether they were appropriately excluded or included in the minimum rental payments under ASC 840).<br>**Note:** See discussion above regarding considerations in determining whether we can carry forward prior-year audit work to support our testing of data in the Master Lease Schedule. |

1 We should consider performing dual-purpose testing, when appropriate. Reminders from EY GAM about how to use this approach are discussed in section 3.4.3.1, *Dual-purpose testing*.

2 If another data source is used to support completeness and accuracy, management considers controls over the IPE in that data source and documents these considerations in the memo summarizing the contract review strategy.

### 3.4.1.2.1 *Address risks when additional lease contracts are identified during management's assessment of completeness*

As discussed in section 2.3.2.1, *Risks when additional lease contracts are identified during management's assessment of completeness*, if a contact has been identified that should have been accounted for as a lease under ASC 840, management will need to evaluate the accounting for the contract pursuant to ASC 840.

Management's controls and our procedures need to address the following under ASC 840:

- Lease classification
- Identification of lease and non-lease elements and allocation of the payments and other consideration
- Determination of the unamortized initial direct costs as of the date of initial application (or the lease commencement date, if later)
- For operating leases, the determination of the remaining lease term as of the date of initial application (or the lease commencement date, if later)
- For operating leases, the determination of the remaining minimum rental payments[5] as of the date of initial application (or the lease commencement date, if later)
- For capital leases, the measurement of the remaining capital lease obligation and asset as of the date of initial application (or the lease commencement date, if later)

Management will also need to consider whether any of the following are present for operating leases (since they will affect the lease liability or ROU asset amounts):

- Amounts it is probable a lessee will owe under a residual value guarantee
- Cumulative prepaid or accrued lease payments
- Remaining balance of any lease incentives received
- Carrying amount of an exit or disposal cost (ASC 420) liability

As part of our audit procedures (i.e., contract analyses), we need to evaluate contract provisions that may indicate that any of these items exist and need to be included in the calculation of the transition adjustments.

When we identify an error or errors in the prior period that do not relate to the adoption of ASC 842 (e.g., incorrect lease classification under ASC 840), we should follow the guidance in EY GAM MISSTATE 3.2.

The following table provides example controls and substantive procedures to address the risks relating to the identification of lease contracts during implementation. Our expectations of management's controls and our planned substantive procedures are responsive to the entity's risks.

| **WCGW** | **Example control** [1] | **Example substantive procedure** [1] |
| --- | --- | --- |
| ‣ For contracts that should have been accounted for as a lease under ASC 840, the lease is not properly classified by the lessee. (E/O, M/V, R/O) | ‣ From an analysis prepared by the senior accountant that determines the classification of leases, the controller selects a sample of leases and reviews the underlying contract to determine whether the lease has been properly classified as an operating or capital lease. | ‣ For a sample of contracts that should have been accounted for as a lease, perform a contract analysis and determine that the lease was appropriately classified under ASC 840.<br>**Note:** After testing the lease classification, we need to test the completeness and accuracy of the lease data and the calculation of the transition adjustments for all leases on the Master Lease Schedule. Refer to the discussion in 3.4.3, *Determine the sample size for testing of lease contracts*, for further information. |

[1] We should consider performing dual-purpose testing, when appropriate. Reminders from EY GAM about how to use this approach are discussed in section 3.4.3.1, *Dual-purpose testing*.

### 3.4.1.3 Apply the ASC 842 accounting framework and determine transition adjustments and disclosures

As discussed in section 2.3.3, *Risks related to applying the ASC 842 transition provisions*, audit teams and management need to address the risks of incorrectly applying the ASC 842 guidance to contracts to calculate the transition adjustments. The incorrect application of the guidance in ASC 842 could result in a material misstatement, particularly for operating leases because of the new requirement to recognize an ROU asset and a lease liability.

Management may elect some or all of the transition practical expedients permitted under the standard. We need to be aware of management's plans to elect the practical expedients and consider them when assessing management's controls and designing our audit procedures over the transition adjustments. As discussed in section 1.1, *Overview*, this guide assumes that entities will elect the package of practical expedients; however, the calculation of the transition adjustments will also depend on whether management will elect any of the other transition practical expedients (e.g., hindsight) or whether it will make other accounting policy elections such as to apply the short-term lease exception.

Entities may elect hindsight when they believe the effect of the election would result in shorter lease terms, which would lead to lower lease liabilities being recognized on the balance sheet. For example, retail companies may benefit from this election if they plan to move or close locations and not exercise renewal options that they previously included in the lease term under ASC 840 after concluding that they were reasonably certain to exercise them. However, entities should evaluate both the drawbacks and benefits of electing the hindsight practical expedient. The election of hindsight could make transition more complex because it would require entities to reassess the lease term for all leases considering all facts and circumstances that have changed, through the effective date. In addition, the entity would also need to reevaluate the useful lives of leasehold improvements.

In an integrated audit or when we use a controls reliance strategy, we evaluate the design and operating effectiveness of controls over the computation of the transition adjustments, including management's considerations in instances where the standard requires judgment. We expect that management's suite of controls may vary based on the classification of existing leases because the implementation WCGWs are different for each classification. For example, many of the risks identified in section 2.3.3, *Risks related to applying the ASC 842 transition provisions*, are specific to operating leases, such as establishing a discount rate for existing leases (the discount rate was established at lease inception for capital leases and no further evaluation of that rate is required in transition unless the entity elects to apply the hindsight practical expedient and concludes that the lease term has changed).

Our substantive audit procedures are also designed to test whether the lease liability and ROU asset are fairly stated based on the transition provisions of ASC 842 and management's election of practical expedients. While testing the balance sheet effect of the lease contracts, we should also evaluate the income statement effect, such as lease expense, interest expense and amortization expense. This will include testing the amortization schedules for the ROU assets and lease liabilities. Under the transition requirements of ASC 842, entities will generally "run off" their expense recognition for leases that existed before the effective date when lease classification does not change.

How an entity calculates the transition adjustments will depend on entity-specific facts and circumstances. The approach may be highly automated (i.e., the entity may calculate the transition adjustments using a system-based solution) or manual (i.e., the entity uses a spreadsheet to calculate the transition adjustments for each lease). The example controls and procedures discussed in this section relate to all situations, regardless of whether the calculations are performed manually in Excel or in an automated system. However, we need to be alert to the risks that need to be addressed and the controls that need to be performed, including ITGCs, if IT is used in this phase of the implementation of ASC 842. We also need to perform appropriate substantive procedures to address the risks related to use of IT in the implementation. This is discussed further in section 3.5, *Use of IT in the implementation and related data considerations*.

### Income tax considerations

As previously discussed in section 2.3.3, *Risks related to applying the ASC 842 transition provisions*, there will be tax-related effects of the adoption of the standard that will affect the calculation of associated deferred tax assets and liabilities. Furthermore, the tax effect of the transition adjustments on prior periods that are recast will also need to be considered if the entity presents the transition adjustments in the prior comparative periods in the year of adoption. We should involve our tax professionals in our discussions with management as well as our planning of procedures to address the tax-related risks.

### Group audit considerations

When designing our testing of the calculation of the transition adjustments in a group audit, we may test controls at the entity, regional or component level or a combination of these depending on the precision of the design of the controls at each location. Refer to Appendix A, *Group audit considerations*, for more information about our strategy for a group audit.

This table lists example controls and substantive procedures to address the risks identified in section 2.3.3, *Risks related to applying the ASC 842 transition provisions*. Teams need to understand the transition provisions of ASC 842 to determine whether the risks, example controls and example substantive procedures apply.

Our expectations of management's controls and our planned substantive procedures are responsive to the entity's risks.

| WCGWs | Example controls [1] | Example substantive procedures [1] |
| --- | --- | --- |
| ‣ The entity does not use an appropriate discount rate to measure the lease liability. (M/V, P/D)<br>‣ The entity does not appropriately measure the lease liability. (M/V, P/D)<br>‣ The entity does not appropriately measure the ROU asset. (M/V, P/D) | ‣ The Head of Treasury reviews and approves the estimated incremental borrowing rate for each lease in the Master Lease Schedule based on entity-specific factors. The review considers the entity's corporate borrowing rate and expectations of adjustments that are necessary.<br>‣ The controller reviews and approves management's accounting policies for implementing ASC 842 to make sure the entity's election of available practical expedients, or other accounting policy elections, are appropriately documented, that all lease classifications (i.e., operating, capital) are addressed, and that the policies are appropriate considering the transition guidance in the standard.<br>‣ The controller reviews the leases in the Master Lease Schedule, which was prepared by the senior accountant, to determine that the transition adjustments were properly calculated under ASC 842 and in accordance with the implementation accounting policies. The scope of the review focuses on whether:<br>  ‣ The discount rate used in the calculation of the transition adjustments was reasonable.<br>  ‣ The ROU asset and lease liability were appropriately calculated based on a review of a sample of operating leases and finance leases, including assessing any differences between the lease liability and the ROU asset.<br>  ‣ The total transition adjustments reconcile to the amounts recognized on the balance sheet and income statement in the quarter of adoption.<br>The controller follows up on any differences identified during the review until such differences are resolved.<br>‣ When using the portfolio approach (e.g., applying one discount rate for all leases of underlying assets with similar remaining lease terms and minimum rental payments), the controller reviews an analysis prepared by the senior | ‣ Read management's accounting policies for implementing ASC 842, including any election of available practical expedients, or other accounting policy elections, that all lease classifications (i.e., operating, capital) are addressed and determine whether the policies are appropriate considering the guidance in the standard.<br>‣ Recalculate the transition adjustments for a sample of leases (this sample should be the same sample used to test the completeness and accuracy of data; refer to the discussion of sample size in section 3.4.3, *Determine the sample size for testing of lease contracts*) by performing the following procedures:<br>  ‣ Agree terms previously tested in the Master Lease Schedule (e.g., remaining lease term, remaining minimum rental payments) with the calculation<br>  ‣ Test the reasonableness of the discount rate used in the calculation. This may include performing a sensitivity analysis of the lease liability to changes in the discount rate or involving EY Transaction Advisory Services (TAS). Refer to section 3.4.1.3.1, *Testing the discount rate in implementation*, for further considerations, including procedures to perform if management uses the portfolio approach.<br>  ‣ Determine that the transition adjustments (e.g., ROU asset, lease liability) and any differences between the lease liability and the ROU asset were calculated pursuant to the provisions of ASC 842.<br>  ‣ Consider the procedures performed in prior-year audits to test the amounts previously recognized on the balance sheet (e.g., prepaid or accrued lease payments, unamortized initial direct costs, capital lease asset and obligation) and evaluate if additional procedures are needed (e.g., if the hindsight practical expedient is elected). |

| WCGWs | Example controls [1] | Example substantive procedures [1] |
|---|---|---|
| | accountant that supports the conclusion that applying the portfolio approach doesn't produce a materially different result from applying the guidance to individual leases. (Refer to section 3.4.1.3.1, *Testing the discount rate in implementation*, for further information on the portfolio approach.)<br>▸ The controller reviews the journal entries to record the transition adjustments by agreeing the amounts to those calculated in the Master Lease Schedule. | ▸ Agree the total ROU asset and lease liability for operating and finance leases to the amounts recognized in the balance sheet in the quarter of adoption. Test that the income statement effect is properly calculated and recorded.<br>**Note:** If the entity does not elect to apply the hindsight practical expedient, the amounts presented in the income statement for existing leases should not change from the amounts previously reported for the prior comparative periods presented in the financial statements for the year of adoption (i.e., 2017 and 2018 for a PBE that does not early adopt). |
| ▸ The entity elects to apply the hindsight practical expedient but does not appropriately reassess the lease term based on all facts and circumstances through the effective date. (M/V, P/D) | ▸ For each lease, the senior accountant assesses whether the use of hindsight would change the lease term. For a sample of leases, the controller reviews the assessment of the lease term to determine that the judgments made for individual leases have appropriate support and comply with the requirements of ASC 842. For the sampled leases, the controller reviews the preparer's assessment of facts and circumstances through the effective date and reperforms the calculation of the effect of any change in lease term to the ROU asset, lease liability and lease expense. Follow-up is performed for differences identified during the review until such differences are resolved. | ▸ Obtain management's calculation of the revised lease term and supporting documentation and analyses for the entity's population of leases. For a sample of leases, determine whether the revised lease term is appropriate considering the facts and circumstances identified by management.<br>▸ Based on our knowledge of the entity or information obtained from other audit procedures, determine whether there are other events that occurred prior to the effective date that should be considered in the determination of the lease term.<br>▸ Based on the revised lease term, determine that the ROU asset, lease liability and lease expense were properly calculated. |
| ▸ The entity does not appropriately account for the income tax effects of adopting the new standard. (M/V, P/D) | ▸ Management (e.g., tax director or tax manager) reviews the analysis of existing temporary differences related to all leases, the calculation of deferred taxes upon adoption for each tax-paying component at the jurisdiction level, any adjustments to reflect the deferred tax amounts upon adoption, and the assessment of recoverability for any new deferred tax assets recorded upon adoption. | ▸ Obtain the analysis of temporary differences related to all leases. Determine whether the identified existing temporary differences and the calculation of deferred taxes upon adoption for each tax-paying component at the jurisdiction level are appropriate. Determine whether any adjustments to reflect the deferred tax amounts recorded upon adoption are appropriate.<br>▸ Test the mathematical accuracy of the calculations.<br>▸ Obtain the analysis of whether a valuation allowance is necessary for any new deferred tax assets recorded and evaluate whether positive evidence outweighs negative evidence in determining the need for and amount of a valuation allowance. |

[1] We should consider performing dual-purpose testing, when appropriate. Reminders from EY GAM about how to use this approach are discussed in section 3.4.3.1, *Dual-purpose testing*.

#### 3.4.1.3.1 *Testing the discount rate in implementation (updated July 2018)*

The discount rate is a key assumption in measuring the lease liability for operating leases and typically will involve judgment and estimation. In addition, the discount rate is estimated on a lease-by-lease basis, which may create higher inherent risk if the entity has a significant number of leases.

Lessees are required to use the lessor's rate implicit in the lease if that rate can be readily determined. We believe that lessees often will be unable to determine the rate implicit in the lease. When the lessee cannot readily determine that rate, the lessee uses its incremental borrowing rate (IBR). In this section, we have assumed that lessees will use their IBR as the discount rate. Lessees that are not PBEs are permitted to make an accounting policy election to use a risk-free rate for the initial and subsequent measurement of lease liabilities.

This section is designed to help teams plan their substantive audit procedures to test the IBR and evaluate management's control attributes around the IBR estimation if we are performing an integrated audit or taking a controls reliance strategy.

Our evaluation of management's controls over estimating the IBR should consider the competence and authority of the individual or third-party specialist performing the estimation process. If management uses a specialist, we need to follow the guidance in EY GAM SPECIALIST. Our expectation of the level of effort required by management to support its selection of the IBR will depend on how management determines the rate, as discussed below.

**General discount rate discussion**

Management will measure the lease liability for operating leases as the present value of the sum of (1) the remaining minimum rental payments and (2) any amount it is probable a lessee will owe under a residual value guarantee. The IBR is established at the later of (1) the date of initial application or (2) the commencement date of the lease. For leases that existed at the date of initial application, a lessee can elect to use either of the following periods to measure its IBR:

- The total lease term measured at lease inception under ASC 840
- The remaining lease term as of the date of initial application

This election should be applied consistently to all operating leases.

For example, assume Lessee entered into a lease for a 20-year term commencing on 1 January 2005 and the date of initial application is 1 January 2017. Lessee could elect to determine its incremental borrowing rate as of 1 January 2017 based on a 20-year term (i.e., the total lease term) or on an eight-year term (i.e., the remaining lease term as of the date of initial application).

**Considerations in auditing the estimation of the IBR**

The IBR is the rate of interest that the 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. In other words, this is an entity-specific collateralized borrowing rate. In addition, for purposes of determining its IBR, a lessee should assume that the lender would have recourse to its general credit in addition to the collateral. Based on this guidance, two entities could enter into the same lease (e.g., same term, same asset, same payment structure) but estimate different IBRs.

The determination of the IBR is likely to involve estimation, which will require the audit team to assess the level of estimation uncertainty and categorize the estimate consistent with EY GAM ESTIMATES. When evaluating the level of estimation uncertainty and designing the nature and extent of our testing of the IBR, teams should consider the following questions:

- Is the measurement of the lease liability sensitive to a change in the incremental borrowing rate?

  Audit teams should consider performing a sensitivity analysis to understand the threshold at which a change in the IBR would materiality affect the amount of the lease liability. This threshold will decrease as the term of the lease lengthens and the amount of lease cash flows increase. If the lease liability is highly sensitive to changes in the discount rate, our procedures to test management's IBR will need to be more extensive.

  Teams should keep in mind that during implementation, the lease liability will likely be more sensitive to changes in the IBR than it will be in the prospective period. This is because entities will be initially recognizing all of their operating leases on the balance sheet for the first time on the date of initial application. In the prospective period, entities will only need to estimate the IBR for new leases or existing leases that are modified or remeasured.

- Does the entity have observable debt transactions on which to base its estimation of the IBR?

  If management is able to leverage existing borrowings to estimate the IBR, we consider (1) the extent to which the debt borrowing reflects the collateral of the leased asset, (2) any differences between the term of the debt and the term of the lease, (3) whether the debt reflects the current market environment (e.g., prevailing interest rates at the time the IBR is estimated), (4) whether the currency of the debt is consistent with the currency of the lease payments and (5) whether the debt reflects the credit risk of the entity obligated to make the lease payments (i.e., parent or subsidiary; refer to the discussion of this consideration below).

  Management needs to estimate the IBR using a collateralized borrowing and adjust the rate as it considers the factors above. We expect that the IBR would be lower than the corporate unsecured rate due to the addition of collateral.

  When the entity does not have observable debt transactions, estimating the IBR becomes more challenging. In this case, the entity would need to assess its overall credit risk and then evaluate corporate borrowings from entities of similar credit risk based on the circumstances of the lease. We would generally expect management to engage a third-party specialist if the entity does not have a sophisticated treasury department. The audit team may involve TAS, depending on the level of estimation uncertainty and evidence provided by management to support the estimated IBR.

- What is the variation in the type of assets leased, the lease terms and the lease payments within the entity's lease portfolio?

  ASC 842 applies to individual lease contracts. Thus, as the variation in the lease portfolio increases, the complexity of the estimation process increases. The FASB acknowledged these concerns in the Basis of Conclusions (BC 120), which states that an entity can use a portfolio approach when "the entity reasonably expects that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio."[17]

  An entity may consider applying the portfolio approach to estimate the IBR if it has a large number of leases of similar assets with the same lease terms. For example, assume Lessee entered into 200 individual leases of vehicles, each with a term of four years. Further assume that the vehicles were of the same make and model, subject to the same terms and were executed within the same month (and rates have not changed significantly in a month). If Lessee concludes that it is able to estimate the IBR for the 200 leases using a portfolio approach, it would apply a single discount rate to the 200 leases when determining the transition adjustment. If Lessee applies the portfolio approach to estimate the IBR, it is important for the audit team to understand how Lessee grouped contracts with similar terms and conditions and to obtain support from management that the effect of applying the leases model to a portfolio of contracts would not differ materially from the application of the leases model to individual leases in that portfolio.

- Is the IBR being estimated for a subsidiary?

  The FASB indicated in the Basis for Conclusions (BC 201) that it might be appropriate in some cases for a subsidiary to use its parent's IBR as the discount rate. For example, if a subsidiary does not have a separate treasury function, and the entity's funding is managed centrally at the parent's level, the lease negotiation may result in the parent entity providing a guarantee of the lease. In this circumstance, use of the parent's IBR would be appropriate. Absent the aforementioned considerations, a subsidiary may have a different IBR than the parent entity or another subsidiary entity.

**Use of TAS in auditing the IBR**

It is the responsibility of the audit team to conclude whether management's estimate of the IBR is reasonable. We may consider involving TAS based on the estimation uncertainty. When the team involves TAS, we need to follow the guidance in EY GAM SPECIALIST.

Timely coordination between the audit team and TAS is critical. It is also important for the audit team to provide TAS with sufficient information to evaluate the IBR, including (1) the lease term, (2) the cash flows of the lease, including any items that would affect those cash flows such as the currency of the lease payments, (3) the type of asset being leased, (4) the location of the leased asset (5) whether the portfolio approach is being used, (6) information about the entity's borrowings and (7) how the entity manages its treasury function (i.e., centralized or decentralized).

Please refer to the *Lease accounting contact list* for a list of resources in TAS.

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[17] Refer to section 4.8.4 of the ASC 842 FRD for a further discussion of the portfolio approach.

### 3.4.1.4 Evaluate management's disclosures during the transition period (updated July 2018)

As discussed in section 2.3.5, *Risks related to management's disclosures*, the following WCGW relates to the disclosures management must make in the transition period:

- The entity's disclosures prior to the effective date do not comply with SAB Topic 11.M. (C, P&D)

Typically, the internal controls that are in place to support an entity's SAB Topic 11.M disclosures may include some or all of the following, depending on the status of the entity's implementation effort and the nature of the disclosure:

- Controls over the contract reviews performed by management to determine the effect of the adoption of ASC 842 on the entity's existing lease portfolio and typical leasing transactions
- Controls over the application and disclosure of elected practical expedients
- Controls over the development and approval of the implementation and prospective accounting policies (refer to discussion of our expectations of the prospective accounting policies in section 3.6, *Prospective accounting policies*)

We will need to perform substantive testing of the estimated amounts (or range of amounts) of the effect, once disclosed, even if the disclosure says that there is no material effect.

Refer to Appendix D, *SAB Topic 11.M disclosures*, for our expectations of disclosures as the effective date nears, our expectation of management's controls and our responsibilities.

## 3.4.2 Define the population of lease contracts and the sampling unit

**Define the population**

When defining the population of lease contracts for our substantive testing, our starting point is determining whether the population of contracts in the Master Lease Schedule has the same characteristics (i.e., is homogenous). To make this assessment, we consider the following from EY GAM SAMPLING FAQs:

- Are all items in the population subject to the same or similar SCOTs and controls?

  In many cases, teams may be able to conclude that management uses one process for determining the transition adjustments for operating leases because the process to calculate the transition adjustments is the same for all operating leases, once the lease data has been determined to be complete and accurate. However, if this is not the case, it may be appropriate to stratify the population.

  Teams should keep in mind that management may have different SCOTs and controls over implementation and the prospective accounting, which may result in the team reaching a different conclusion in the prospective periods.

- Are all items in the population processed through the same or similar IT systems?

  Teams should consider whether the entity will use the same IT system or end user computing tool to calculate the transition adjustments. In most instances, we expect management to calculate all of the transition adjustments using either an IT system or Excel. However, if certain transition adjustments are calculated using an IT system and others are calculated using Excel, we consider whether it would be appropriate to stratify the population.

- Do we expect any potential errors identified in the sample to be consistent throughout the population?

  We consider whether potential errors would be systematic and therefore appropriate to extrapolate across the rest of the population or whether the potential error would be isolated to a certain portion of the population. If the team concludes that the lease data is complete and accurate (which is the starting point for calculating the transition adjustments for all leases) and that management uses one process for determining the transition adjustments, we believe any errors would likely be systematic and therefore would support a conclusion that the population is homogenous.

Because the process to calculate the transition adjustments is different for operating leases and capital leases and any potential errors could not be considered systematic, teams should stratify operating leases and capital leases into separate populations. The team would then need to evaluate whether each population is homogenous. This analysis may result in further stratification based on specific facts and circumstances.

Determining whether the population of lease contracts is homogenous will require professional judgment. Refer to the guidance in EY GAM SAMPLE 2.1, 3.2 and 4.3 and SAMPLING FAQs for further information. Refer to section 3.4.1.1, *Assess the completeness of the population of leases*, for procedures on assessing the completeness of the population.

**Example 1 — Identifying homogenous populations**

Assume that Lessee, a calendar-year public entity, elects the package of transition practical expedients with a date of initial application of 1 January 2017. Lessee has a significant number of operating and capital leases. Assume that:

- All of the leases were previously maintained and accounted for in Excel.
- Management's existing controls over lease initiation and monitoring support the completeness and accuracy of the lease data.
- Lessee will use the same process for determining the transition adjustments for all operating leases. Lessee will use Excel to calculate the lease liability and ROU asset based on predetermined formulas.
- Lessee will use the same process for determining the transition adjustments for all capital leases.

The audit team stratifies the operating and capital leases into separate populations. The team then determines whether the population of operating leases is homogenous. For operating leases, because the process to determine the transition adjustments is the same, all items in the population are processed through Excel and any errors identified would be considered systematic, the population of operating leases is considered to be homogenous.

For existing capital leases under ASC 840 that become finance leases under 842, the audit team should consider the procedures performed in the prior-year audits and evaluate whether additional procedures are necessary.

**Example 2 — Identifying homogenous populations**

Assume that Lessee, a calendar-year public entity, elects the package of transition practical expedients with a date of initial application of 1 January 2017. Lessee has a significant number of real estate operating leases and various other operating leases (e.g., vehicles, computer equipment). Assume the following:

- The real estate leases are administered by the entity's real estate leasing department. The real estate leases are maintained in an IT system that tracks all real estate leasing arrangements. The system has effective ITGCs, and management's controls over the identification and monitoring of real estate leasing contracts support the completeness and accuracy of the data maintained in the IT system.
- All other leases are maintained in an Excel spreadsheet, and the procurement department is responsible for identifying leasing arrangements. Management determines that it will need to implement new controls to verify the completeness and accuracy of the lease data in the Excel spreadsheet.
- The transition adjustments for the real estate leases will be calculated using a new IT system. For all other leases, the transition adjustments will be calculated using Excel based on predetermined formulas.

Because the process to determine the transition adjustments is different for real estate leases and all other leases, any errors identified could not be considered systematic. Therefore, the total population of leases could not be considered homogenous and the real estate leases and all other leases would be treated as separate homogenous populations.

### Define the sampling unit

The sampling unit for the lease population is a lease contract. As we will need to perform testing of the lease population at each reporting date, teams may choose to leverage the same sample of lease contracts across all periods being audited (i.e., we will select our sample on the date of initial application and use that sample to test all reporting periods). This is typically a more efficient approach than selecting a sample at each reporting date for entities that have longer-term leases. If the FASB finalizes the proposed optional transition method and the entity elects to apply it, we need to perform procedures before the effective date and therefore cannot wait until the date of application to select our sample.

If we leverage one sample across all periods, teams need to consider any new or modified leases during the transition period. If new or modified leases are equal to or exceed TE, teams likely will need to obtain additional evidence (either through key item testing or representative sampling) to address the risk of material misstatement. Teams also need to consider the risk that arises from expired or terminated contracts during the transition period (i.e., the risk that management removes a material ROU asset and lease liability that should still exist or the risk that management does not remove a material ROU asset and lease liability that should not exist).

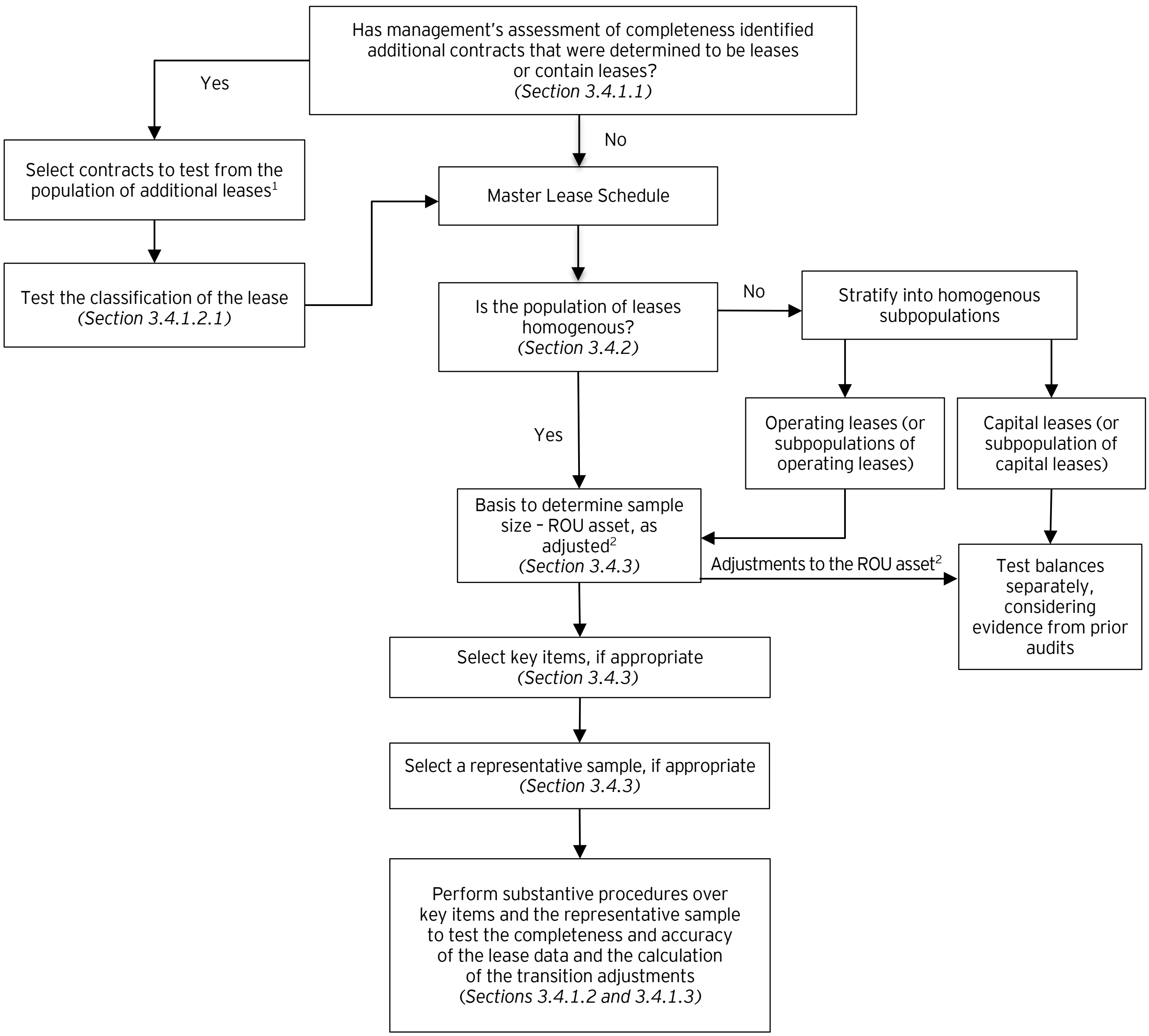
**Example — Determining our sampling strategy when new leases commence during the transition period**

Assume that Lessee, a calendar-year public entity, elects the package of transition practical expedients with a date of initial application of 1 January 2017. Lessee has a significant number of five-year railcar operating leases, none of which expire prior to 1 January 2019. Lessee also enters into 30 new railcar leases in 2017 and 40 new railcar leases in 2018. The team concludes that the population of leases is homogenous.

In this case, the team selects a sample of the five-year railcar leases as of the date of initial application and uses that sample to perform its substantive procedures in 2017 and 2018 rather than selecting separate samples in each of those years. In addition, the team selects key items and a sample of the new railcar leases entered into in 2017 and 2018 to test based on the materiality of the leases in each reporting period.

## 3.4.3 Determine the sample size for testing of lease contracts (updated July 2018)

The following flowchart is intended to help teams design their testing strategy and determine the sample size for the number of contracts to test. Refer to EY GAM SAMPLE 4.8 for further details on evaluating and concluding on our sample results. As a reminder, this flowchart is not a substitution for reading this guide.




[1] Refer to the discussion below in *Considerations when additional leases are identified in management's assessment of completeness* for further information.

[2] The basis to determine the sample size is the ROU asset excluding (1) prepaid or accrued lease payments, (2) remaining balance of any lease incentives received, (3) unamortized initial direct costs and (4) the carrying amount of an exit or disposal cost (ASC 420) liability.

### Key items and representative sampling

Our determination of sample size for the number of contracts to test will be based on the ROU asset excluding the following:

- Prepaid or accrued lease payments
- Remaining balance of any lease incentives received
- Unamortized initial direct costs
- Carrying amount of an exit or disposal cost (ASC 420) liability

The ROU asset after adjusting for these items is the same amount as the lease liability. Thus, our testing strategy will yield the same testing coverage of both the ROU asset and liability. In addition, since the excluded amounts were previously recognized on the balance sheet, teams should consider relying on their prior-year testing to support these amounts. If we determine that additional testing is necessary, we will test these amounts separately.

Our sampling approach to address the completeness and accuracy of lease data and the calculation of the transition adjustments will typically involve key item testing and representative sampling (as appropriate). When we select items from the relevant population for testing, we start by selecting key items.

Key items can be significant because of their size (e.g., there is a risk of material misstatement simply because these lease contracts contain larger lease payments) or as a result of qualitative risk factors (e.g., contracts with a longer term could be significantly affected by the discount rate determination). It is important to consider and document our consideration of both types of key items when designing our procedures and why we believe these items are not representative of the population.

If there are insufficient key items from which to draw our conclusions, we perform additional procedures. This may include extending our testing to a representative sample from the remaining population. We use our professional judgment to determine whether to use judgmental or statistical sampling techniques to determine the size of a representative sample. If we choose a representative sample, the extent of our testing will depend on (1) the CRA for the relevant assertions (E and M/V), (2) the amount determined for TE, (3) the amount of audit evidence we plan to obtain from other substantive procedures and (4) the level of expected misstatements in our sample.

When statistical sampling is used, teams use MicroSTART as a starting point to determine a representative sample. The factors identified in the previous paragraph become inputs into MicroSTART, in addition to the population value (i.e., the ROU asset, as adjusted) and the value of key items.

We would use the sample selected to perform the substantive procedures (which are included in the tables in sections 3.4.1.2 and 3.4.1.3) to test the completeness and accuracy of the data and the calculation of the transition adjustments, which includes the lease liability and the ROU asset, and to determine whether that the pattern of expense recognition did not change from that under ASC 840 if the entity doesn't elect the hindsight practical expedient.

If we are testing homogenous subpopulations of contracts (refer to section 3.4.2, *Define the population of lease contracts and the sampling unit*), the testing strategy may be different for each subpopulation (e.g., key item testing and/or representative sampling) as long as substantially all of the population is being tested in a way that appropriately reduces the risk of material misstatement in the significant account. All material portions of the population of leases should be subject to audit procedures.

After the team has completed its testing, it needs to revisit the risks associated with the lease liability (i.e., E, C, M/V, P&D) and determine whether the extent of testing addresses these risks or whether additional testing is necessary. As a reminder, MicroSTART can be used to select a representative sample to test the existence and measurement/valuation assertions for assets and liabilities. Thus, additional samples may not be necessary if the team concludes that these assertions have been appropriately addressed by using the sampling approach described in the previous paragraphs. However, the team must also assess whether the testing performed appropriately addresses the completeness assertion (i.e., the risk of understatement of the lease liability). If the team is satisfied that it has performed sufficient procedures to address the completeness of the lease population (refer to example procedures in section 3.4.1.1, *Assess the completeness of the population of leases*), additional testing may not be necessary.

Teams also consider whether the extent of testing on the lease-related income statement accounts is sufficient. Under the transition provisions of ASC 842, the pattern of expense recognition for existing leases should not change, unless the entity has elected the hindsight practical expedient and it concludes that the lease term has changed. If there is an effect on the income statement, teams will need to test the activity in the lease-related income statement accounts. Because we will be testing the lease-related income statement accounts in connection with the performance of our substantive audit procedures on the related balance sheet accounts, the team should consider the evidence it has gathered through these procedures. If the team determines that additional audit evidence is necessary to conclude that the lease-related income statement accounts are free of material misstatement, the team will need to perform additional audit procedures. To determine what additional testing is necessary, teams may use, where appropriate, statistical sampling, judgmental sampling or the income statement sampling tables, keeping in mind they should be taking credit for the work already performed to test the balance sheet accounts. Refer to EY GAM SAMPLE 4.5 for further information.

**Considerations when additional leases are identified in management's assessment of completeness**

When management has identified contracts that should have been accounted for as a lease under ASC 840, we use attribute sampling (refer to the guidance in section 3.4.1.1, *Assess the completeness of the population of leases*, for further information) to test whether the lease is appropriately classified under ASC 840. After this testing, we follow the approach described above to determine the sample size to test the completeness and accuracy of the lease data and the calculation of the transition adjustments for all leases on the Master Lease Schedule. Teams need to keep in mind that it would not be appropriate to reduce the sample size for testing the completeness and accuracy of the lease data and the calculation of the transition adjustments by the sample of additional leases selected to test the lease classification.

### 3.4.3.1 Dual-purpose testing (updated July 2018)

| Excerpt from PCAOB Auditing Standard 2315 |
|---|
| AS 2315.44 |
| In some circumstances, the auditor may design a sample that will be used for dual purposes: as a test of control and as a substantive test. In general, an auditor planning to use a dual-purpose sample would have made a preliminary assessment that there is an acceptably low risk that the rate of deviations from the prescribed control in the population exceeds the tolerable rate. For example, an auditor designing a test of a control over entries in the voucher register may design a related substantive test at a risk level that is based on an expectation of reliance on the control. The size of a sample designed for dual purposes should be the larger of the samples that would otherwise have been designed for the two separate purposes. In evaluating such tests, deviations from the control that was tested and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes. |

We consider performing certain of our implementation audit procedures using a dual-purpose testing approach if this would be more efficient. When performing dual-purpose tests, we are mindful of the guidance in EY GAM CONTROLS 5.2 *Design the nature of tests of controls*:

> We may design our tests of controls to be performed concurrently with our tests of details (substantive procedures) on the same transaction or item, known as a dual purpose test. We design our dual purpose tests to achieve the purposes of both our:
>
> - Tests of controls (i.e., to evaluate the operating effectiveness of the control to address the WCGWs)
> - Tests of details (i.e., to identify and quantify the effect of material misstatements on the financial statements)
>
> A dual purpose test includes testing the control. Performing substantive procedures and inferring from the results to conclude that controls are designed and operating effectively is not a dual purpose test.

Because the sample size used for dual-purpose testing is the larger of the samples that would otherwise have been used for each individual test, the team will need to evaluate whether this is an efficient approach to follow.

During our audit of the implementation, teams may find it beneficial to use dual-purpose testing when testing an attribute will result in similar sample sizes for our control and substantive testing. This may be the case when we test the completeness of the population of leases. For example, when testing management's controls to evaluate whether a contract qualifies as a lease under ASC 840, we may select a sample size of 25 based on the guidance in EY GAM CONTROLS 5 *Design tests of controls*. If we perform a similar test for our substantive audit because the objective of our procedure results in a binary "yes" or "no" conclusion (i.e., whether a contract is or contains a lease), the team may select a sample of 25 vendor payments when the population exceeds 250. In this situation, because both tests require the same sample size, it may be more efficient to perform dual-purpose testing. For dual-purpose tests, we document clearly which attributes and evidence relate to control testing and which relate to substantive testing.

While we may perform dual-purpose testing over contracts selected for controls testing, we may also need to select contracts that were not included in our control testing sample as part of our substantive testing procedures, depending on our risk assessment (including IPE risks).

## 3.5 Use of IT in the implementation and related data considerations

Many entities will consider implementing a new IT system, or modifying an existing one, to address the implementation and prospective accounting under ASC 842. Entities need to be mindful of the risk that software developed by others may not be fully functional in time for the adoption of ASC 842. As a result, entities may not be able to implement IT systems that fully comply with the standard before the effective date. In this case, some entities may determine that it is more cost effective and efficient to use Excel to determine the transition adjustments and, perhaps, for the prospective accounting as well. It is important to understand whether the use of IT in determining the transition adjustments will differ from the use of IT for prospective accounting.

If management implements a new IT system or modifies an existing system to calculate the transition adjustments, management needs to test that the system is functioning as intended and design controls to address the risks of using the information it produces (see the discussion in section 2.3.4, *Additional risks arising from the use of IT in the implementation*). Audit teams will need to evaluate the application and/or IT-dependent controls in the SCOT that support the completeness and accuracy of the data (required in an integrated audit) as well as the related ITGCs. We also need to test the completeness and accuracy of any reports produced by the entity that are used to calculate the adjustments. Teams should consider the guidance in our Audit Matters, *System implementations can create new risks that we need to address in our audits*, when evaluating management's controls and designing our substantive procedures.

Regardless of whether the entity implements a new system, modifies an existing one or uses Excel to accumulate lease data and calculate the transition adjustments, management needs to design and implement appropriate controls to address the completeness and accuracy of the data. Risks that could affect the completeness and accuracy include:

- Data processed by the IT application from which reports are produced is not complete and accurate.
- Data extracted from the IT application into the reports is not the intended data or is not complete.
- User-entered parameters when requesting the reports are inappropriate.
- Computations or categorizations performed in the creation of the reports are inaccurate.
- The data output from the IT application to the end-user computing (EUC) tool is modified or lost in transfer (if data is transferred to an EUC for analysis or reporting).
- Information added or changed (including computations and categorizations) using the EUC tool is incomplete, inaccurate or inappropriate.

The risks related to the data and reports are heightened during the implementation because erroneous data used in the implementation could lead to material misstatements of the ROU asset or lease liability.

If management uses Excel to calculate the transition adjustments, it needs to consider the relevant IPE risks and implement controls related to the entry of data into the spreadsheet, the setup of the spreadsheet to comply with ASC 842, and the modifications to formulas or data in the spreadsheet. Our audit procedures need to address the same considerations.

For systems implemented to perform the prospective accounting, management needs to perform testing during the transition period in order to make sure the system is functioning as designed on the effective date. For example, if management has operating and finance leases, it needs to test whether the system appropriately calculates the lease liability, the ROU asset and subsequent expense recognition patterns for both types based on the requirements of ASC 842. The audit team's testing of automated controls needs to consider the entity's leasing transactions and how the entity intends to use the IT system in accounting for these transactions. If management is not able to complete its system implementation or modification and related testing by the effective date, it needs to design additional controls that will address the risks from the effective date until the time the testing can be completed.

Teams should involve our IT professionals throughout the audit to make sure we are appropriately addressing the risks associated with the entity's use of IT in implementing the new standard.

### 3.5.1 Addressing risks when management uses a service organization (added July 2018)

When management uses a service organization to assist in the implementation or in the prospective accounting, we consider the guidance in EY GAM SVC-ORG to assess management's controls and design our substantive procedures.

Management will need to identify controls that are responsive to the risks that arise from the implementation. These controls may exist at a service organization or the entity may need to design controls to address the risks. For example, if management uses lease accounting software that is provided by and hosted by a third party (i.e., under a SaaS arrangement), the risks that must be addressed include those related to implementing a new IT system, which were discussed in 2.3.4, *Additional risks arising from the use of IT in the implementation*. Management will need to assess whether the controls at the service organization address some or all of these risks in order to determine what testing it will need to perform over the system implementation.

In another example, if management uses a third party to read contracts and evaluate the lease accounting using an IT system, the entity will need to address the risks relating to the transfer of information or data to the third party (e.g., the risk that all relevant contracts or information was not provided to the service provider). In addition, if the third party will make any accounting judgments under ASC 842, the entity will still need to address the risk that an incorrect accounting judgment is made (i.e., using a service organization does not mitigate this risk).

Management may obtain a SOC 1 report related to the service organization's processes and controls that affect the entity's internal controls. Management will need to make sure any risks not addressed by the SOC 1 report are adequately mitigated by the entity's own internal controls. In addition, management will need to make sure that the period covered by the SOC 1 report supports its reliance on the service organization. For example, if a service organization was engaged to calculate the transition adjustments, the SOC 1 report will need to cover the period for which the entity relied on the service organization for this purpose. In contrast, if management relies on the service organization to process its lease accounting, the SOC 1 report will need to sufficiently cover the financial reporting period during which the service organization was used.

If a service organization has not obtained a SOC 1 report or if the SOC 1 report does not address all of the risks, management will need to determine how it will address the risks arising from the implementation. That is, the entity may need to perform testing at the service organization. For SaaS arrangements, the SOC 1 report will likely address ITGCs but may not address access controls at the entity or controls over data entry and extraction. In addition, the SOC 1 report will typically not address application controls over data processing (e.g., the calculation of the transition adjustments under ASC 842). In this case, management will need to perform testing to obtain evidence about whether the system is functioning in a manner that complies with ASC 842.

The audit team needs to understand how an entity's use of a service organization affects the implementation SCOT, including the processing of records and transfer of data, so that it can assess risks and design control and substantive testing. As a reminder, teams may be able to rely on a SOC 1 report to support the understanding of the processes performed by the service organization and the assessment of the effectiveness of internal controls performed by the service organization. However, the audit team will still need to perform substantive procedures to test the information processed by the service organization. This testing may involve using evidence provided by the service organization. In addition, the audit team will need to make sure the period covered by the SOC 1 report, along with the client's controls and the team's additional procedures, where necessary, sufficiently cover the period for which the entity used the service organization.

## 3.6 Prospective accounting policies (updated July 2018)

During implementation, entities will need to develop new policies, processes and controls to comply with ASC 842 after adoption. The prospective policies, processes and controls need to address the accounting, presentation and disclosure for leases that commence or are modified after the effective date. Management needs to establish policies, processes and controls to address the risks of material misstatement under ASC 842 when the entity (1) identifies a contract and determines whether it is or contains a lease, (2) identifies and separates lease and non-lease components and allocates contract consideration, (3) determines the lease term, including the commencement date of the lease, (4) determines lease classification, (5) initially records and subsequently measures the lease, (6) evaluates lease modifications and (7) determines the appropriate presentation and disclosures required for the leases.

Management's prospective accounting policies, processes and controls will also need to address the runoff of existing leases after the effective date. As a reminder, due to the unique transition provisions of ASC 842, the accounting for certain leases that exist as of the effective date will include aspects of both ASC 840 and ASC 842. For example, a lessee will continue to recognize lease expense (through the amortization of the ROU asset and lease liability) consistent with its existing recognition pattern under ASC 840 for the life of the lease unless certain events occur on or after the effective date that will require modification or remeasurement under ASC 842. Management will need to make sure that the new monitoring controls it implemented to identify reassessment events or lease modifications under ASC 842 also identify events that would require the remeasurement of existing leases.

In an integrated audit, we need to test management's entity-level controls over the development of the new accounting policies, the approval of those policies and adherence to the policies. Teams need to obtain contemporaneous evidence of the precision of the controls over the review and approval of the new accounting policies.

From a substantive perspective, we evaluate management's accounting policies and determine whether we agree with its application of the guidance in ASC 842. We also evaluate whether the policy includes all classes of underlying assets (e.g., real estate, vehicles, pipelines, computer equipment) and considers all contractual terms that have an accounting consequence. The common risks and controls over the prospective accounting for leases and the audit procedures we might perform to test those controls as well as the substantive audit procedures we may perform are discussed in detail in the prospective guide.

We have observed that when developing prospective accounting policies, management frequently develops accounting white papers that describe the application of the accounting framework for a contract or group of contracts involving a class of underlying leased assets that become the basis for management's policy.

Teams should consider leveraging their evaluation of contracts during implementation to form a basis for our expectations of the entity's new accounting policies (e.g., lease classification).

## 3.7 Extent of testing if the entity asserts it is not materially affected

Some companies may assert that the standard will have no material effect on their financial statements or that they have few or no leases. In these situations, we will need to perform audit procedures to address the risks that the entity (1) has not identified a complete population of contracts that are or may contain a lease and (2) has not applied the requirements in the standard appropriately, including the disclosures. We cannot rely on management's assertion without performing testing of the accuracy of those assertions.

We would expect the entity to have established internal controls and completed documentation supporting the procedures it performed to identify the complete population of contracts that are or may contain a lease, even if the conclusion is that no contracts were identified.

Given the risk that the population of leases could be incomplete, which would result in an understatement of the lease liability and ROU asset, we consider whether it would be appropriate to perform some or all of the audit procedures outlined in this guide, including testing the controls put in place by management during the implementation of the new leases standard. We may adjust the nature and extent of the procedures we perform based on our risk assessment, our knowledge of the business and the understanding we have obtained of the process used by management to corroborate the assertion that the entity is not materially affected by the adoption of the standard.

SEC registrants need to make disclosures under SAB Topic 11.M about the anticipated effects of adoption, even if the effect is not expected to be material. Refer to Appendix D, *SAB Topic 11.M disclosures*, for our expectation of management's controls and our responsibilities in this situation.

# A Group audit considerations

## A1 Overview

The Primary Team will need to consider how the adoption of the new leases standard affects its existing group audit scoping strategy. This appendix was written from the perspective that the Primary Team has already performed its scoping strategy. It highlights matters the Primary Team needs to consider to determine whether more components should be in the scope of the group audit because of the risks associated with the adoption of ASC 842. This is not a substitute for reading the guidance in EY GAM GROUP SCOPE.

In a group audit, the Primary Team is responsible for developing an audit strategy that is responsive to the risks of material misstatement of the group financial statements. The risks related to the implementation of ASC 842 are summarized in section 2 of this guide and include the completeness of the population of leases, the completeness and accuracy of the data used to apply the transition provisions and the application of the ASC 842 transition provisions, including the disclosure requirements.

Many teams will be performing audit procedures related to the implementation in the period prior to the adoption of ASC 842 (e.g., 2018 for a calendar-year entity that does not early adopt). If the Primary Team requires a component to provide assistance to support its audit procedures over the implementation, including the SAB Topic 11.M disclosures, that component would be considered in scope in the period prior to adoption. Regardless of whether additional components were added to the group audit scope in the year prior to adoption, the Primary Team will need to reassess the appropriateness of its scoping of the implementation of ASC 842 in the year of adoption (e.g., 2019) to support the audit opinion in the year that includes the transition adjustments.

To determine whether any modifications should be made to the group audit scoping strategy, the Primary Team needs to consider the following:

- The organizational structure of the entity's leasing activities
- Management's process to implement ASC 842
- Whether a component is significant
- Not significant components

## A2 Organizational structure of the entity's lease activities

The Primary Team considers the extent to which the entity's leasing activities (e.g., procurement, accounting) are centralized or decentralized. Factors to help the Primary Team make this determination include the following:

- How the entity negotiates and executes lease agreements (e.g., whether the entity has a central procurement department that negotiates and executes lease agreements for all components within the group)
- Whether a common IT application is used to track and account for leases across all components
- Whether the accounting and/or financial reporting processes for leases are performed at a central location for all components

If the Primary Team concludes that the entity's leasing activities are primarily centralized and the risks of material misstatement associated with the implementation can be addressed by the Primary Team, it is less likely that the Primary Team will need to modify its group scoping strategy.

## A3 Management's process to implement ASC 842

The Primary Team considers the entity's implementation process to determine how that process may affect the scope of the group audit. The Primary Team should consider:

- Whether a central team is responsible for implementing ASC 842, including establishing and executing the controls that address the risks related to implementation such as surveying internal stakeholders to identify leases and reviewing responses, analyzing vendor payments and collecting the information used to determine that the data is complete and accurate
- The effectiveness of group-wide controls related to the implementation
- Consistency of the IT system application or end-user computing tool (e.g., Excel) used to track and account for leases
- Whether the transition adjustments are calculated for all components at a central location

If the Primary Team concludes that the implementation is primarily being performed centrally and the group-wide controls related to the implementation are effective, it is less likely that the Primary Team will need to modify its group audit scoping strategy. However, the Primary Team would still need to consider whether assistance from a component team is required to test the effectiveness of the group-wide controls.

If an entity's leasing activities or the implementation process is decentralized, the Primary Team considers whether more components should be in the scope of the group audit to address the risks related to the implementation of ASC 842.

## A4 Significance of the component

The Primary Team considers which components give rise to a risk of material misstatement of the group financial statements because of the complexity or significance of the effect of the new standard at that component. Implementation of the new leases standard is unlikely to result in additional components considered significant based on size because the adoption is not expected to have a significant effect on earnings-based measurements (e.g., pretax income or revenue) which are often used to determine the relative size of components in the group. Furthermore, the addition of an ROU asset recorded at a component is unlikely to result in the total assets of that component becoming significant to the group. Accordingly, the analysis is likely to focus on risk rather than size.

Determining which components are significant based on risk is a matter of professional judgement. Examples of factors for teams to consider to determine whether the component is significant based on risk include the following:

- Whether the component has a large number of additional contracts such as service contracts or other significant arrangements (e.g., multiple-element service arrangements (e.g., IT, telecom), power purchase arrangements) that may be leases under ASC 840
- Whether the component's operations are decentralized and require preparers to gather information from many different sources
- Whether the component has a high level of leasing activity
- The level of oversight of the lease portfolio by the component

- Whether the leases are processed in a uniform manner
- Whether the lease accounting is maintained in an end-user computing tool (e.g., Excel)
- The effect of judgements used in the implementation (e.g., the number of leases where the effect of the discount rate will be more significant (e.g., long-term leases))
- Whether material issues (e.g., fraud risks), misstatements or control deficiencies have been reported in the past
- The use of multiple IT systems
- Whether the component was recently acquired and management is therefore unfamiliar with the component's leasing activities and its controls

## A5 Not significant components

Once the Primary Team determines the components that are significant, the Primary Team uses its professional judgment to determine whether the components that are not significant components can, individually or in the aggregate, give rise to a material misstatement of the group financial statements.

There are no prescribed percentages of coverage over the group's significant accounts or components that the Primary Team may rely on to determine whether not significant components should be in the scope of the audit. Our audit objective is to perform testing at a sufficient number of not significant components to conclude that the remaining portion of the accounts that are affected by the transition adjustments have a risk of material misstatement that is at an acceptably low level at the group level. Our group scoping methodology does not require scoping the audit on an account-by-account level, such as the ROU asset.

However, if the ROU asset and related lease liability have a higher level of risk of material misstatement, the amount of evidence needed from additional in-scope components to be selected depends on (1) the sufficiency and appropriateness of the audit evidence obtained for the significant components and (2) the group organization, including group-wide controls. For example, the Primary Team would consider the extent that the ROU asset and related lease liability (i.e., if the ROU asset and related lease liability contain a higher level of risk of material misstatement) are represented by components that are significant and the extent of evidence needed from the not significant components. If the ROU asset and related lease liability or extent of lease activity represented by significant components is small relative to the group, the Primary Team may need to include not significant components in the scope.

As part of its determination, the Primary Team also considers the nature and precision of the group-wide controls over the lease implementation process. We expect that components that are not significant will be subject to the testing of group-wide controls if the Primary Team performs an integrated audit or uses a controls reliance strategy. If group-wide controls are not robust or tested, the Primary Team may have to perform more extensive substantive testing over the implementation at more not significant components.

## A6 Extent of work to be performed at in-scope components

For those additional components scoped in because of the leases implementation, the Primary Team will assign either a full scope or a specific scope or request the component team to perform specified procedures. The final determination will be based on the specific facts and circumstances, but we expect most Primary Teams to assign a specified procedures scope.

## A7 Oversight of component teams (added July 2018)

Audit teams need to assess whether component teams have a sufficient understanding of the new leases standard to be able to effectively perform the procedures assigned to them. This is especially true of component teams in foreign locations because there are certain differences between ASC 842 and IFRS 16, *Leases*, including differences in the transition provisions.

The Primary Team should use professional judgment to determine whether the component team needs to complete additional training beyond EY's standard requirements for foreign audit personnel. Additional training is likely necessary when the Primary Team assigns procedures to the component team that require an in-depth understanding of the new leases standard. The Primary Team may consider it appropriate to require the component team to complete some or all of the lease-specific accounting and auditing training that is required for US professionals. This training can be found on the Lease Accounting Discover page.

# B Lessor auditing considerations

## B1 Introduction (updated July 2018)

This appendix discusses key considerations in auditing a lessor's transition to ASC 842. If a lessor elects the package of practical expedients and does not elect the hindsight practical expedient, adopting the new leases standard may be relatively straightforward. In this case, most lessors will not need to calculate any transition adjustments, and audit teams generally will not need to change their assessment of SCOTs, significant accounts or CRAs. However, lessors need to keep in mind that there may be changes related to presentation and disclosure beginning in the quarter of adoption. Also, the election of the package of practical expedients does not grandfather incorrect conclusions under ASC 840. As such, additional effort may be required during implementation if existing policies, processes and controls are not adequate to gather and monitor information needed to meet the requirements of the new standard.

Like lessees, many lessors are expected to elect the package of transition practical expedients, and this Appendix was developed based on this assumption. The implementation risks when a lessor elects the package of practical expedients include those related to the completeness of the population of leases, the election of the hindsight practical expedient and the entity's SAB Topic 11.M disclosures about the anticipated effects of adopting the new standard.

In addition, if the FASB finalizes the proposed practical expedient to allow lessors to combine certain lease and related non-lease components and a lessor elects this expedient, it will need to address the risks relating to the application of this practical expedient (see section B1.1, *Transition for lessors*, for further information).

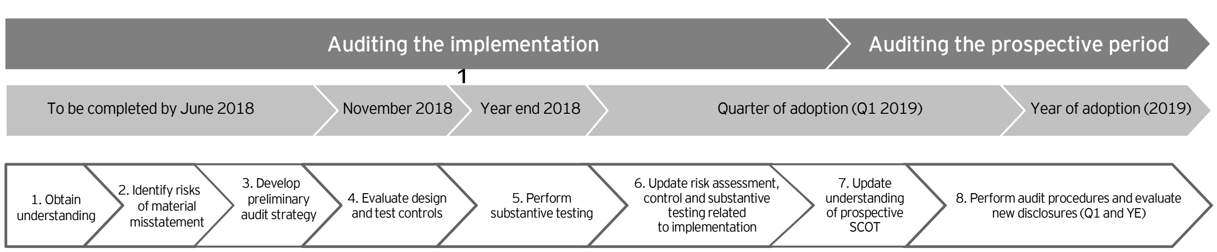
This Appendix discusses these risks and includes example controls and substantive procedures we may perform to address these risks.

This Appendix also highlights the importance of evaluating the prospective accounting policies, processes and controls that an entity develops during the transition period so that we are prepared to perform a quarterly review in the quarter of adoption. This evaluation will also help us audit the SAB Topic 11.M disclosures.

Teams should be mindful that implementing the standard could be significantly more complex for entities that do not elect the package of practical expedients, particularly when contracts no longer qualify as leases or the lease classification changes for existing leases. Members of the Quality Network are available to assist teams on audits of entities that choose not to apply the package of practical expedients.

### Leases audit roadmap

The graphic below shows our expectations for the implementation timeline for a calendar year-end public company that does not early adopt, and activities for auditing the implementation and the first-year of adoption. The steps in the leases audit roadmap should be completed by all teams.



Please keep in mind that the steps of the roadmap align with EY GAM, but audit teams may not perform the steps in the order listed, and the steps may be iterative in nature. The extent of documentation necessary in each step will depend on the entity's facts and circumstances and the effects of the adoption of ASC 842.

## B1.1 Transition for lessors (updated July 2018)

Section 1.3, *Summary of effective dates and transition*, provides a summary of the effective dates and transition provisions of ASC 842, which apply to both lessors and lessees. [18] Teams should refer to this section for more information.

In addition, section 1.4, *Transition practical expedients and other policy elections affecting transition*, provides guidance on the following transition practical expedients to assist entities with implementation:

- The package of practical expedients
- The hindsight practical expedient
- Easements practical expedient

These practical expedients apply to both lessors and lessees. Therefore, teams should consider the effect of applying (or not applying) the practical expedients to all contracts, including those where the entity is the lessee. Teams should refer to this section for more information.

**Proposed practical expedient to not separate lease and non-lease components**

The FASB proposed amending ASC 842 to add a practical expedient that would allow lessors to elect (by class of underlying asset) to not separate lease and related non-lease components if both of the following criteria are met:

- The timing and pattern of transfer of the lease component and the associated non-lease component(s) are the same.
- The lease component would be classified as an operating lease if it were accounted for separately.

If this proposed practical expedient is finalized and a lessor elects to apply it after determining that the criteria are met, the lessor would be required to account for the combined component as a single performance obligation in accordance with ASC 606 if the non-lease component is the predominant component. If the non-lease component is not the predominant component, a lessor would be required to account for the combined component as an operating lease in accordance with ASC 842. The lessor would have to apply the practical expedient to existing contracts as of the date of initial application.

This Appendix will be updated to provide additional audit guidance when the proposed amendment is finalized.

**Transition accounting considerations**

The FASB indicated in the Basis for Conclusions (BC 390) that the practical effect of the modified retrospective transition is that an entity "runs off" its accounting for certain leases that existed before the effective date when lease classification does not change in transition (which is an effect of electing the package of practical expedients).

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[18] Refer to sections 11.1 and 11.2 of our ASC 842 FRD for detailed information on the transition provisions and practical expedients.

When the package of practical expedients is elected, lessors with direct financing and sales-type leases will continue to recognize a net investment in the lease at the later of the date of initial application or the commencement date of the lease, measured at the carrying amount of the net investment in the lease under ASC 840. For direct financing leases, the net investment upon adoption will include any unamortized initial direct costs capitalized in accordance with ASC 840. For operating leases, the carrying amounts of the underlying asset and any lease assets or liabilities (e.g., prepaid or accrued rent) are the same as those recognized under ASC 840. For all lease types, the lessor recognizes income consistent with its existing recognition pattern under ASC 840 for the life of the lease, unless certain events occur that trigger a modification or remeasurement of the lease under ASC 842 on or after the effective date.[19] Refer to section B3.2, *Address risks when the hindsight practical expedient is elected*, for a discussion of the effect of applying the hindsight practical expedient.

### B1.2 Effect of the implementation on our audit approach and planning

Based the transition provisions in ASC 842 discussed above, we likely will not change our assessments of significant accounts, SCOTs, or our CRAs for leases when designing our audit of the implementation but teams need to make this determination based on the facts and circumstances.

## B2 Understand management's process for implementing ASC 842

We obtain and document our understanding of management's process for implementing ASC 842. As part of this understanding, we need to obtain an understanding of the entity-level controls relating to the entity's adoption of ASC 842. Teams should refer to sections 2.2, *Understand entity-level controls*, and 2.2.1, *Example entity-level controls for each COSO 2013 Framework principle*, for further information.

We should critically assess management's overall project plan and timeline and consider whether the entity has sufficient and competent resources to complete the implementation, including the evaluation of the effect of ASC 842 on prospective accounting, presentation and disclosures. As we assess management's timeline, we need to be mindful that management will also need to develop policies, processes and controls to be ready to account for new and modified contracts on or after the effective date. Management's timeline needs to allow adequate time for the preparation and review of these policies, including the audit team's evaluation.

## B3 Assess risks, plan and execute our audit

As indicated above, the implementation risks relate to the completeness of the population of leases, the election of the hindsight practical expedient and the entity's SAB Topic 11.M disclosures about the anticipated effects of adopting the new standard. If we are performing an integrated audit or using a controls reliance strategy, we need to test the operating effectiveness of management's controls to address these risks. Our substantive audit procedures are also designed to respond to the risks. In addition, our audit procedures need to consider our evaluation of management's policies, processes and controls for implementing ASC 842 and for the prospective accounting under ASC 842.

Entities and audit teams also need to consider the expanded disclosure requirements of ASC 842. In order to prepare for these disclosures, management needs to perform a gap analysis between the current disclosure requirements and those under the new standard and determine the additional information that will be needed and that can be gathered during the implementation.

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[19] Refer to section 11.4 of our ASC 842 FRD for discussion of the lessor transition considerations.

As part of our substantive procedures during the implementation, we need to understand management's gap analysis and its plan for prospective disclosures. This may include reading draft disclosures prepared by management or reviewing schedules prepared to support future disclosures as part of our procedures over the completeness and accuracy of lease data.

In planning our audit, teams should consider whether any entity-specific or lease-specific inherent risk factors rise to the level of a significant risk or fraud risk (refer to example factors in section 1.6, *Effect of implementation on our audit approach and planning*). However, if the entity elects the package of practical expedients, we do not expect teams to identify additional significant risks or fraud risks as a result of the implementation because the accounting requirements during the implementation are similar to current accounting under ASC 840.

Refer to section 3.3, *Reminders regarding the timing of our audit procedures over the transition adjustments and workpaper archiving*, for reminders about the workpapers that should be included in the 2018 and 2019 EY Canvas files.

Our considerations with respect to determining PM and TE for our audit of a lessor's implementation of ASC 842 are the same as those discussed for audits of lessees in section 3.2, *Planning materiality and tolerable error considerations*.

**Team events**

Teams on audits of public entities will need to complete two team events during the transition period that are designed to encourage meaningful discussion among members of the team at all levels and any EY specialists involved in our audit of the implementation.

Teams auditing calendar-year entities are expected to complete Leases Team Event 1 by 30 June 2018. Teams will discuss their understanding of the entity's leasing activities, their initial evaluation of the effect of the new standard and the entity's implementation plan for ASC 842. Based on this discussion, teams will identify the risks relating to the implementation, develop an expectation of the relevant controls and develop a preliminary audit strategy. Teams on audits of entities that are solely lessors should plan for this team event to last approximately one to two hours. The Team Event 1 preparation checklist includes a series of questions that teams can ask management to prepare for Team Event 1, among other things.

Teams auditing calendar-year entities are expected to complete Leases Team Event 2 by 30 November 2018. This event is designed to assist audit teams in reviewing the results of our evaluation of the design and operating effectiveness of implementation controls, reassessing the risks identified in Leases Team Event 1 or any new risks, and evaluating our plan for substantive testing based on these assessments.

## B3.1 Assess the completeness of the population of leases

Due to some changes to lessor accounting (i.e., new required presentation and disclosure), entities need to make sure they have identified all leases, including embedded leases, before the first reporting date under ASC 842 (i.e., 31 March 2019 for a calendar-year public entity that does not early adopt).

Management needs to reconsider whether the entity's existing controls are sufficiently precise to identify all leases under ASC 840. For example, an entity may not have had robust processes in place to identify service contracts that contain operating leases because the accounting treatment for operating leases under ASC 840 and service contracts is similar. In this case, the entity may need to design new controls to determine whether these contracts are leases or contain leases under ASC 840.

The following table provides an example WCGW and example controls and substantive procedures to address this risk. Our expectations of management's controls and our planned substantive procedures are responsive to the entity's risks.

| WCGW | Example controls[1] | Example substantive procedures[1] |
|---|---|---|
| ▸ The entity has not identified all arrangements that are or contain a lease under ASC 840. (C) | ▸ Management inquires of internal stakeholders (e.g., legal, finance, operations, procurement) to identify contracts that may be leases or may contain leases. The controller reviews the results of the inquiries to determine whether any contracts not previously considered may contain a lease and selects a sample of contracts to review. The controller determines whether additional follow-up is needed to conclude that the population of leases is complete. | ▸ Perform inquiries of internal stakeholders (e.g., legal, finance, operations, procurement) to identify contracts that may be leases or may contain leases. |
| | ▸ The controller reviews an analysis prepared by the senior accountant of service contracts not previously identified as being leases or containing leases to determine whether the contract or part of the contract meets the definition of a lease under ASC 840. The controller determines whether the contracts have been appropriately included in or excluded from the lease population. | ▸ Select a sample of service contracts to determine whether the contracts are leases or contain a lease under ASC 840. Determine that the contracts were appropriately included in or excluded from the population of leases. |

[1] We should consider performing dual-purpose testing, when appropriate. Reminders from EY GAM about how to use this approach are discussed in section 3.4.3.1, *Dual-purpose testing*.

### Attribute testing

When the objective of our procedures to test the completeness of the lease population results in a binary "yes" or "no" conclusion (e.g., whether a contract is a lease or contains a lease), we believe that attribute sampling is appropriate. However, when the objective of our procedures does not result in a binary "yes" or "no" conclusion, attribute sampling is not appropriate. Attribute sampling generally results in a sample of 25 for populations larger than 250 items. Refer to EY GAM SAMPLE 2.3.4 and 4.5.3c for further information.

## B3.2 Address risks when the hindsight practical expedient is elected

When an entity elects to apply the hindsight practical expedient, management considers all facts and circumstances that have changed, through the effective date, in determining the lease term. If applying the hindsight practical expedient results in the conclusion that the lease term should change, the entity adjusts its income prospectively (i.e., from the later of the date of initial application or the commencement date of the lease). For sales-type or direct financing leases, the entity also adjusts the carrying amount of the initial measurement of the net investment in the lease measured under ASC 840 for the change in the lease term to reflect how the lease would have been recorded under ASC 840 had the revised lease term always been used. For operating leases, the carrying amount of any lease assets or liabilities (e.g., prepared or accrued rent) are adjusted to account for the revised lease term.

The following table provides the example WCGW and related example control and substantive procedures to address this risk. Our expectations of management's controls and our planned substantive procedures are responsive to the entity's risks.

| WCGW | Example control[1] | Example substantive procedures[1] |
|---|---|---|
| ▸ The entity elects to apply the hindsight practical expedient but does not appropriately reassess the lease term based on all facts and circumstances through the effective date. (M/V, P/D) | ▸ For each lease, the senior accountant assesses whether the use of hindsight would change the lease term. For a sample of leases, the controller reviews the assessment of the lease term to determine that the judgments made for individual leases have appropriate support and comply with the requirements of ASC 842. For the sampled leases, the controller reviews the preparer's assessment of facts and circumstances through the effective date and reperforms the calculation of the effect of any change in lease term to the lease-related assets and liabilities and lease income. Follow-up is performed for differences identified during the review until such differences are resolved. | ▸ Obtain management's calculation of the revised lease term and supporting documentation and analyses for the entity's population of leases. For a sample of leases, determine whether the revised lease term is appropriate considering the facts and circumstances identified by management.<br>▸ Based on our knowledge of the entity or information obtained from other audit procedures, determine whether there are other events that occurred prior to the effective date that should be considered in the determination of the lease term.<br>▸ Based on the revised lease term, determine that the lease-related assets and liabilities and lease income were properly adjusted. |

[1] We may consider performing dual-purpose testing, when appropriate. Reminders from EY GAM about how to use approach are discussed further in section 3.4.3.1, *Dual-purpose testing*.

**Other considerations when an entity elects the hindsight practical expedient**

When an entity has elected the hindsight practical expedient, teams should consider the additional time that may be needed to reassess the lease term for each contract and make sure that management has provided for adequate time in its project plan. We would expect management to start work on implementation earlier in the transition period when there are a significant number of existing lease contracts.

Given the additional effort that is expected from management if an entity elects the hindsight practical expedient, teams will likely identify an implementation SCOT. As a reminder, teams on integrated audits should use Project Insight to document their understanding of this SCOT and the design of controls.

## B3.3 Evaluate management's SAB Topic 11.M disclosures

Entities that are SEC registrants need to comply with SAB Topic 11.M, which requires disclosure of the anticipated effects of new accounting standards if the effects are known. As with any other disclosure, a registrant must design controls to assess the completeness, accuracy and adequacy of these disclosures.

The SEC staff has monitored registrants' disclosures about the effect of adopting recently issued accounting standards (e.g., ASC 606) and, in some cases, is requesting expanded disclosures. We expect the SEC staff to focus on registrants' disclosures about the new leases standard in their filings prior to the effective date.

The following WCGW relates to the SAB Topic 11.M disclosures management must make in the transition period:

- The entity's disclosures prior to the effective date do not comply with SAB Topic 11.M. (C, P&D)

The internal controls that are in place to support an entity's SAB Topic 11.M disclosures may include some or all of the following, depending on the status of the entity's implementation effort and the nature of the disclosure:

- Controls over the contract reviews performed by management to determine the effect of ASC 842 on the entity's existing lease portfolio and typical leasing transactions
- Controls over the application and disclosure of elected practical expedients
- Controls over the development and approval of the implementation and prospective accounting policies (refer to discussion of our expectations of the prospective accounting policies in section B4, *Considerations related to prospective accounting policies, processes and controls*).

We will need to perform substantive testing over the entity's SAB Topic 11.M disclosures, even if the disclosure says that there is no material effect.

Refer to Appendix D, *SAB Topic 11.M disclosures*, for further discussion of the audit considerations for SAB Topic 11.M disclosures.

## B4 Considerations related to prospective accounting policies, processes and controls

During implementation, entities will need to develop new policies, processes and controls to comply with ASC 842 after adoption. The prospective policies, processes and controls need to address the accounting, presentation and disclosure for the leases that commence or are modified after the effective date. Management needs to establish policies, processes and controls to address the risks of material misstatement under ASC 842 when the entity (1) identifies a contract and determines whether it is or contains a lease, (2) identifies and separates lease and non-lease components and allocates contract consideration, (3) determines the lease term, including the commencement date of the lease, (4) determines lease classification, (5) initially records and subsequently measures the lease, (6) evaluates lease modifications and (7) determines the appropriate presentation and disclosures required for the leases.

In an integrated audit, we need to test management's entity-level controls over the development of the new accounting policies, approval of those policies and adherence to the policies. Teams need to obtain contemporaneous evidence of the precision of the controls over the review and approval of the new accounting policies.

From a substantive perspective, we evaluate management's accounting policies and determine whether we agree with its application of the guidance in ASC 842. We also evaluate whether the policies include all classes of underlying assets (e.g., real estate, vehicles, pipelines, computer equipment) and consider all contractual terms that have an accounting consequence. The common risks and controls over the prospective accounting for leases and the audit procedures we might perform to test those controls as well as the substantive audit procedures we may perform are discussed in detail in the prospective guide.

We have observed that when developing prospective accounting policies, management frequently develops accounting white papers that describe the application of the accounting framework for a contract or group of contracts involving a class of underlying leased assets that become the basis for management's policy.

### IT considerations in the prospective period

Lessor entities are more likely to have an accounting system in place to track lease income if leasing is core to the lessor's operations. However, management may need to modify its existing IT system, or implement a new system, in order to comply with the requirements of ASC 842.

If management implements a new IT system or modifies an existing system to perform the prospective accounting, management needs to perform testing during the transition period in order to make sure the system is functioning as designed on the effective date. For example, if the entity has operating leases, management needs to test whether the system appropriately calculates the lease assets and liabilities and income recognition patterns based on the requirements of ASC 842. The audit team's testing of automated controls needs to consider the entity's leasing transactions and how the entity intends to use the IT system in accounting for these transactions.

Audit teams should read the Audit Matters, *System implementations can create new risks that we need to address in our audits,* issued on 17 October 2017, which discusses in more detail the risks that exist when an entity implements new systems. Teams should also involve our IT professionals to make sure we are appropriately addressing the risks associated with the entity's use of IT.

# C Use of the GDS Accounting Change COE in auditing the implementation of ASC 842

## C1 Overview of the COE

The Accounting Change Center of Excellence (COE) is part of Global Delivery Services (GDS) and comprises experienced audit professionals and FAAS professionals who have experience helping Channel 2 clients implement ASC 842. Since it was established last year to help teams implement ASC 606, the COE has helped more than 200 audit teams.

Due to the complexity of the new leases standard, auditing an entity's implementation of ASC 842 may require significant effort. Leveraging COE resources will help us complete our work in a timely manner. Some of the key benefits of using the COE are:

- The COE delivers a high-quality work product due to the detailed review performed by a COE manager or above prior to delivery of the work to the audit team.
- Having the COE perform work can free up audit team resources for more subjective and complex areas of the audit.
- Using the COE allows us to take advantage of GDS's favorable cost structure. That is, the GDS rate structure also applies to COE work.

### Nature of the work that may be performed by the COE

The COE may perform only objective audit procedures (i.e., those procedures that require little to no judgment to execute and perform). Objective procedures may include certain tests of controls or substantive procedures.

We cannot assign "subjective" audit procedures to the COE. Performing subjective audit procedures requires the ability to exercise professional judgment, apply professional skepticism, consider fraud risks and identify matters and results that indicate potential fraud.

When determining the objective procedures to assign to the COE, we consider the CRA of the relevant assertions, the extent of interaction with entity personnel required to perform the procedures, the level of supervision needed and any relevant entity-specific facts and circumstances.

Our US Assurance Policy Manual (US APM) 1.12, *Using the Global Talent Hub on our audits*, describes our policy in more detail.

## C2 Integration with the COE

### Audit planning

Timely and effective communication is critical to the success of working with the COE. Audit teams should plan for COE involvement from the initial planning stages of the implementation. Some of the important matters to be considered by the audit team during the planning phase include the following:

- Engage with the COE early in the process to understand how the COE can assist in the audit
- Include COE team members in Leases Team Events 1 and 2 and other relevant team meetings (at a minimum, the COE team members should be involved in discussions about the background of the audit, the strategy to audit the entity's implementation of ASC 842 and the areas where the COE team members will work)
- Establish budgets and the timing of the deliverables
- Identify specific COE team members to be involved

As the COE team members and the audit team execute procedures, it will be critical that the audit team and the COE:

- Communicate changes in timelines so staffing adjustments can be made as soon as possible
- Set up regular periodic touch points to discuss the status of the work and provide real-time feedback about the quality of the work product from the COE

### Procedures the COE may perform on an audit of an entity's implementation of ASC 842

For each step of the roadmap, we include example procedures that the COE may perform. It is the responsibility of the audit team to determine that the nature of these or any other procedures is objective and consistent with the principles in US APM 1.12.

***Step 1 of the roadmap: Obtain understanding***

- Compare the entity's project timeline to the leases benchmark timeline that can be found on the AC supplemental topics page in EY Atlas. Identify and communicate activities that do not meet our baseline expectation of when the activity should be completed.
- Use the information provided by the audit team to draft preliminary documentation of our understanding of the critical path of the implementation SCOT.
- Attend Leases Team Event 1 and record minutes.

***Step 2 of the roadmap: Identify risks of material misstatement***

- Update the preliminary documentation of our understanding of the critical path of the implementation SCOT.
- Compare the entity's risks and controls to the example risk and control matrix (RCM) in Appendix F, *Example risk and control matrix for lessees*. Identify and communicate any differences in the risks or controls to the audit team.
- Draft Part A of Form 276US *Leases (ASC 842) implementation audit form* and/or other related documentation.

*Step 3 of the roadmap: Develop preliminary audit strategy*

- Update EY Canvas to reflect our audit plan based on the discussion at Leases Team Event 1 (e.g., identified risks and controls, and our strategy for testing controls and performing substantive procedures).
- Draft Part A of Form 276US and/or other related documentation.
- Draft a client assistance list for our audit of the implementation of ASC 842.

*Step 4 of the roadmap: Evaluate design and test controls*

- Attend Leases Team Event 2 and record minutes of the meeting.
- Update the documentation of our understanding of the critical path of the implementation SCOT.
- Confirm changes in strategy discussed in Leases Team Event 2 with the audit team and update Part A of Form 276US to reflect these changes.
- Update EY Canvas to reflect any change in the audit plan (e.g., changes to strategy for testing controls, changes to our strategy for performing substantive procedures).
- Test the operating effectiveness of certain control attributes (e.g., attributes for key controls that are tested by inspection of documents, observation or reperformance).
- Update the Summary of control deficiencies for identified exceptions where appropriate.
- Draft Part B of Form 276US and/or other related documentation.

*Step 5 of the roadmap: Perform substantive testing*

Completeness of the population of leases

- Reconcile the Master Lease Schedule to the information in the workpapers that the audit team used to test the lease disclosures in the prior-year financial statements and highlight any differences for further investigation by the audit team.
- Compile responses to a survey of internal stakeholders (e.g., legal, finance, operations, procurement). Highlight matters for further investigation (e.g., locations that have not responded, possible unidentified leases) by the audit team.
- For a sample of vendor payments, review the underlying contract and document the key terms and conditions to help the audit team evaluate whether the contract is or contains a lease that is not included on the Master Lease Schedule.
- For a sample of active vendors, review the underlying contract and document the key terms and conditions to help the audit team evaluate whether the contract is or contains a lease that is not included on the Master Lease Schedule.
- Assist the team in coordinating independent confirmations of the entity's significant leasing relationships. Prepare a summary of the responses and highlight differences between the confirmation and the Master Lease Schedule for further investigation by the audit team.
- For additional contracts identified, review the underlying contract and document the key contract terms to help the audit team evaluate whether the contract is or contains a lease under ASC 840 and, if so, whether it is classified appropriately.

Completeness and accuracy of the lease data

- For a sample of contracts, compare the data in the Master Lease Schedule (e.g., the remaining lease term, the remaining minimum rental payments) to the original contract (or modified contract, if applicable) or other data source.

Transition adjustments and disclosures

- Assist the audit team in testing the calculation of the transition adjustments by:
  - Agreeing the information in the Master Lease Schedule (e.g., remaining lease term, remaining minimum rental payments) to the information used in the calculation and highlighting any differences
  - Agreeing the total ROU asset and lease liability for operating and finance leases to the amounts recorded in the balance sheet and highlighting any differences
  - Checking the mathematical accuracy of the calculations.

Additional risks arising from the use of IT in the implementation

- Assist the audit team in testing how the IPE risks have been addressed. The following are some examples of objective procedures that the COE can execute. This list is not meant to be all-inclusive, and is not a substitute for reading EY GAM IPE or our *Call to action: Addressing the risks of information produced by the entity*:
  - Agree items on the IPE to source documents and agree source documents to items on the IPE, and communicate any differences to the audit team (IPE risks 1, 2(i), 2(ii), 3, 4 and 5).
  - Inspect a screenshot of the parameters input by the management user when preparing the IPE. Based on direction from the audit team, assess if the parameters are appropriate (IPE risk 2(ii)).
  - Agree the totals of amounts in each column of the IPE in the EUC tool (Excel) to an on-screen or non-modifiable version of the IPE (IPE risks 4 and 5).
  - Agree a sample of items of the IPE in the EUC tool (Excel) to an on-screen or non-modifiable version of the IPE (IPE risks 4 and 5).
  - Test the clerical accuracy of the IPE (IPE risk 5).

***Step 6 of the roadmap: Update risk assessment, control and substantive testing related to implementation***

- Update the documentation in EY Canvas to reflect updates to the audit team's risk assessments, control testing and substantive testing, as applicable.
- Compare the entity's final risks and controls to the example RCM in Appendix F. Identify and communicate any differences in the risks or controls to the audit team.
- Assist the audit team in testing the calculation of the final transition adjustments, if necessary (see Step 5 for example procedures).

*Step 7 of the roadmap: Update understanding of prospective SCOT*

- Use the information provided by the audit team to draft documentation of significant changes in ICFR resulting from the adoption, including relevant IT applications.
- Compare the entity's risks and controls for prospective accounting to the example RCM in our prospective guide. Identify and communicate any differences in the risks or controls to the audit team.

*Step 8 of the roadmap: Perform audit procedures and review new disclosures (Q1 and YE)*

- Draft the preliminary documentation of our understanding of the critical path of the prospective SCOT.
- Test the operating effectiveness of certain control attributes.
- Review new or modified contracts and input key contract terms in the *Contract analysis tool for leases* to help the audit team evaluate the entity's policies and processes for its prospective accounting, including whether the contract is or contains a lease under ASC 842 and lease classification.
- Assist the audit team in testing the five IPE risks (see Step 5 for example procedures).
- Assist the audit team in completing the questions related to ASC 842 in Form A13 *GAAP disclosure checklist*.

# D SAB Topic 11.M disclosures

## D1 Requirements of SAB Topic 11.M and SEC comment trends

SEC registrants need to comply with SAB Topic 11.M, which requires disclosure of the anticipated effects of recently issued accounting standards. As with any other disclosure, a registrant must design controls to assess the completeness, accuracy and adequacy of these disclosures. Click here for the full text of SAB Topic 11.M.

Registrants should also consider disclosing whether they plan to apply the transition practical expedients available in the new leases standard, which transition method they plan to elect and other significant matters that might result from adopting the new standard (e.g., planned or intended changes in business practices, effect on debt covenants).

The SEC staff has monitored registrants' disclosures about the new revenue recognition standard and is likely to focus on registrants' disclosures related to the new leases standard. Registrants should also be aware that the SEC staff expects these disclosures to become more specific each quarter. The SEC staff may raise questions if registrants continue to provide high-level disclosures.

If a registrant includes amounts in the audited financial statements, those amount most be audited and cannot be labeled unaudited.

Refer to section 11.1.1 of our ASC 842 FRD for further discussion of the requirements of SAB Topic 11.M as they pertain to the new leases standard.

## D2 Audit responsibilities — controls and substantive

We need to test a registrant's controls over its SAB Topic 11.M disclosures for integrated audits or when we use a controls reliance strategy. Additionally, we need to substantively evaluate the appropriateness of the disclosures, which may include testing quantitative ranges or the registrant's assertion that there is no material effect. In general, the nature and extent of our procedures depends on the nature and specificity of the registrant's disclosures and our risk assessment for the disclosures. In all cases, we should evaluate whether the registrant's disclosures accurately reflect the status of its implementation and comply with the requirements of SAB Topic 11.M.

Our testing of the registrant's implementation of the new standard (e.g., testing the completeness of the lease population) should provide us with evidence to support the registrant's SAB Topic 11.M disclosures. As part of this testing, we should obtain the registrant's analysis and related support. Our control testing and substantive procedures over the disclosures relate to our audit opinion in the year the disclosures are made (i.e., prior to adoption), and therefore the related documentation should be retained in that year's workpapers. Furthermore, we use TE related to the year the disclosures are made to perform our testing and assess errors.

We generally expect registrants to provide one of four types of disclosures about the effect of the new standard: (1) a statement that the registrant is still evaluating the effect, (2) qualitative disclosures, (3) the quantitative effect or (4) a statement that there will be no material effect.

The following table provides some audit considerations related to each of these disclosure types:

<table>
<tr><th>Disclosure of the effect</th><th>Audit considerations</th></tr>
<tr><td>Still evaluating</td><td> If a registrant makes this type of disclosure together with certain qualitative disclosures of the effect (e.g., a description of the new standard's effect on its accounting policies), we need to consider the matters discussed in the qualitative disclosures section below. We would expect it to be rare for registrants to disclose that they are still evaluating the effect in the filing that immediately precedes adoption. If this were to occur, we would consider whether to communicate any concerns about implementation challenges to the audit committee pursuant to PCAOB AS 1301, Communications with Audit Committees, paragraph 13.f. We would also consider whether these concerns indicate that a deficiency exists in the registrant's entity-level controls, including its control environment and risk assessment processes. </td></tr>
<tr><td>Qualitative disclosures — This type of disclosure generally includes a discussion of the significant leasing activities, a description of the new standard's effect on the registrant's accounting policies with a comparison to its current accounting policies, and a discussion of whether the optional practical expedients will be applied.</td><td> Controls For integrated audits or when we use a controls reliance strategy, we should understand management's process and the related controls for developing the disclosures. A registrant's controls will need to support compliance with the requirements of SAB Topic 11.M and the accuracy of the status of the registrant's implementation. They also need to adequately describe the new standard's effect on the registrant's accounting policies with a comparison to its current accounting policies. In order to support these objectives, the registrant would typically have controls that address some combination of: <ul><li>The completeness of the lease population</li><li>The review of lease contracts and identification of contractual terms and conditions that could result in an accounting change between ASC 840 and ASC 842</li><li>The selection of accounting policies for the implementation of ASC 842 and preliminary prospective accounting policies, including any practical expedients elected</li></ul> We need to evaluate whether the relevant controls are designed appropriately to support the specific disclosures made, and we need to test the operating effectiveness of the controls. The extent of our testing will depend on the design of the controls and the risks they are intended to address. Substantive We need to evaluate whether the disclosures (1) comply with the requirements of SAB Topic 11.M, (2) accurately reflect the status of the registrant's implementation and (3) adequately describe the new standard's effect on the registrant's accounting policies. To support our evaluation of the disclosures, our substantive testing may need to include some combination of testing the completeness of the lease population, reviewing lease contracts and evaluating the registrant's selection of its preliminary accounting policies. The nature and extent of our substantive testing will depend on the specificity of the disclosures provided by management and our risk assessment for the disclosures. For example, we may need to inspect a sample of a registrant's lease contracts to evaluate whether the registrant's disclosure of the effect of the new standard on its accounting policies adequately reflects the terms and conditions of its contracts. </td></tr>
</table>

<table>
<tr><th>Disclosure of the effect</th><th>Audit considerations</th></tr>
<tr><td>Quantitative effect — This type of disclosure might provide a point estimate or a range of effects of adopting the new leases standard. It would also generally include qualitative disclosures such as a discussion of the significant leasing activities, a description of the new standard’s effect on the registrant’s accounting policies with a comparison to its current accounting policies, and a discussion of whether the optional practical expedients will be applied.</td><td>Controls<br>For integrated audits or when we use a controls reliance strategy, we need to understand management’s process and the related controls for developing the disclosures. A registrant’s controls will need to support the point estimate or range disclosed, compliance with the requirements of SAB Topic 11.M and the accuracy of the status of the registrant’s implementation. They also need to adequately describe the new standard’s effect on the registrant’s accounting policies with a comparison to its current accounting policies. In order to support these objectives, the registrant would typically have controls that address some combination of:<ul><li>The completeness of the lease population</li><li>The review of lease contracts and identification of contractual terms and conditions that could result in an accounting change between ASC 840 and ASC 842</li><li>The selection of accounting policies for the implementation of ASC 842 and preliminary prospective accounting policies, including any practical expedients elected</li><li>The calculation of the point estimate or range disclosed</li></ul>We would evaluate whether the relevant controls are designed appropriately to support the specific disclosures made, and we would test the operating effectiveness of the controls. The extent of our testing will depend on the design of the controls and the risks they are intended to address. We would generally expect the registrant’s controls (and our related testing) with respect to quantitative disclosures to be more precise than with respect to qualitative disclosures.<br>Substantive<br>We should substantively test the point estimate or range disclosed and evaluate whether the disclosures (1) comply with the requirements of SAB Topic 11.M, (2) accurately reflect the status of the registrant’s implementation and (3) adequately describe the new standard’s effect on the registrant’s accounting policies. To support our testing of the calculation of the point estimate or range disclosed and our evaluation of the disclosures, our substantive testing may need to include some combination of testing the completeness of the lease population, reviewing lease contracts, evaluating the registrant’s selection of its preliminary accounting policies and testing the calculation of the point estimate or range.<br><br>The nature and extent of our substantive testing will depend on the specificity of the disclosures provided by management, the materiality of any amounts disclosed, our risk assessment for the disclosures and whether we are testing controls. For example, we would expect to perform more extensive testing if a registrant discloses a quantitative range that is within PM than if it discloses a quantitative range that is multiples of PM.</td></tr>
</table>

| Disclosure of the effect | Audit considerations |
|---|---|
| No material effect — This type of disclosure indicates that the registrant anticipates that the new standard will not have a material effect and describes the reasons why. | ***Controls***<br>For integrated audits or when we use a controls reliance strategy, we need to understand management's process and the related controls for developing the disclosures. A registrant's controls will need to support the registrant's "no material effect" assertion in addition to supporting compliance with the requirements of SAB Topic 11.M and accurately reflecting the status of the registrant's implementation. To support these objectives, the registrant would typically have controls that address some combination of:<br>▸ The completeness of the lease population<br>▸ The review of lease contracts and identification of contractual terms and conditions that could result in an accounting change between ASC 840 and ASC 842<br>▸ The selection of accounting policies for the implementation of ASC 842 and preliminary prospective accounting policies, including any practical expedients elected<br>▸ The calculation used to support management's conclusion that the adoption of the standard will have no material effect<br>We would evaluate whether the controls are designed appropriately to support the specific disclosures made and we would test the operating effectiveness of the control. The extent of our testing will depend on the design of the controls and the risks they are intended to address. For example, we would expect management to have more precise controls (and we would expect to perform more extensive testing) if a registrant discloses that it has completed its evaluation and concluded that the new standard will not have a material effect than if it discloses that it does not expect there to be a material effect based on a preliminary analysis.<br>***Substantive***<br>For all audits, we need to perform substantive procedures to evaluate the registrant's "no material effect" assertion in addition to evaluating whether the disclosures comply with the requirements of SAB Topic 11.M and accurately reflect the status of the registrant's implementation. The nature of our substantive testing may need to include some combination of testing the completeness of the lease population, reviewing lease contracts, evaluating the registrant's selection of its preliminary accounting policies and testing the calculation used to support management's conclusion that the adoption of the standard will have no material effect.<br>The nature and extent of our substantive procedures will depend on the specific disclosures made, our risk assessment for the disclosures and whether we are testing controls. For example, we would perform more extensive testing if a registrant discloses that it has completed its evaluation and concluded that the new standard will not have a material effect than if it discloses that it does not expect there to be a material effect based on a preliminary analysis. |

## D3 Responsibilities related to quarterly disclosures

During quarterly reviews, our responsibilities for SAB Topic 11.M disclosures are consistent with those for other disclosures made by a registrant in a quarterly filing. We need to evaluate the disclosures for consistency with the results of our quarterly review procedures and perform procedures sufficient to conclude that no material modification to the interim financial information is needed for it to conform with US GAAP.

## D4 Disclosures are incomplete or inadequate

We would generally expect all registrants to provide SAB Topic 11.M disclosures related to the new leases standard. If a registrant does not provide these disclosures, or if we believe a registrant's disclosures are not fairly presented, we follow the guidance in EY GAM MISSTATE and assess whether the omission represents a disclosure difference that should be accumulated on our summary of audit differences. We would also assess whether the omission represents a control deficiency that should be accumulated on our summary of control deficiencies and evaluated for significance.

# E Frequently asked questions

## E1 FAQs — ICFR considerations

***Question 1: When an entity's processes and ICFR change due to the adoption of ASC 842, do the new controls need to be designed and operating effectively in 2017 and 2018 even though an entity's adoption date is 1 January 2019?***

Public entities will need to have process changes and changes in related controls to address risks associated with the post-adoption period (i.e., 2019). These controls may begin to be implemented prior to the adoption date. Because these controls are not part of management's ICFR related to filings for 2017 and 2018, we would not expect these controls to necessarily be operating throughout those periods, and these controls would not be subject to management's certification in accordance with Section 302 of the Sarbanes-Oxley Act during those periods. However, if an entity is an SEC registrant, it is required to comply with the disclosure requirements of SAB Topic 11.M. Management should implement a suite of controls related to these disclosures. Refer to Appendix D for more information.

***Question 2: If there has been a material change in ICFR due to the adoption of the new leases standard, when should management disclose the change?***

In accordance with Section 302 of the Sarbanes-Oxley Act, the signing officers must include (among other things) a statement that their report discloses any changes in the entity's ICFR that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the entity's ICFR. If there are material changes in internal control due to the adoption of the new leases standard, management should disclose these changes no later than the quarter of adoption.

***Question 3: When controls are added or modified to adopt the new leases standard (beyond those already in place to adopt new accounting standards in general) and management and the audit committee request that we evaluate these controls before adoption, do any design or operating deficiencies we identify need to be aggregated, evaluated and reported in accordance with PCAOB AS 2201,*** **An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,** ***and PCAOB AS 1301,*** **Communications with Audit Committees*****?***

There is no requirement to report to the audit committee deficiencies in controls over the adoption of any new accounting guidance because they are not part of management's ICFR until the adoption date (also see question 1). However, because we are required to discuss the adoption of the new leases standard with audit committees in the period leading up to adoption, it is likely that these items would be communicated in the normal course of those discussions.

***Question 4: What is the potential effect on our ICFR and financial statement audits if an entity implements a number of new controls later in the year of adoption to identify, authorize and approve, and account for and disclose information about its leases?***

We acknowledge that an entity's controls may evolve during the year as it implements changes necessary to address the risks associated with the standard. If the entity has controls in place to mitigate risks throughout the year but those controls change, we may need to modify our audit strategy. If the entity adds controls that we believe are key but weren't present throughout the year of adoption, we would likely conclude that a control deficiency previously existed, and this fact should be included on our *Summary of control deficiencies* for further evaluation.

The control testing procedures executed by the entity related to these controls may occur after the balance sheet date (e.g., during the year-end financial statement close process for the period under audit). If the entity is able to execute these controls prior to filing its financial statements, we may conclude that these controls were designed and operating effectively as of the end of the period. However, if we have not been able to test the number of instances suggested by our guidance based on the frequency of the control, we refer to the guidance in EY GAM CONTROLS 8.2 *Determine audit response to control exceptions* to evaluate whether we have sufficient evidence of operating effectiveness.

If we conclude that these controls were designed and operating effectively as of the end of the period, the control deficiency that existed previously would not affect our report on ICFR. However, there could be an effect on our CRA and ultimately the nature, timing and extent of our substantive procedures for the financial statement audit.

Further, if the post-adoption controls do not operate for the entire first year of adoption or different controls are in place in the first part of the year (e.g., because the entity did not complete its implementation timely and implemented temporary controls for the first quarter), we may need to (1) perform multiple walkthroughs, (2) perform tests of controls on multiple populations to determine whether controls were effective for the year, (3) adjust the extent of our procedures for the financial statement audit, and (4) determine whether there are control deficiencies that need to be evaluated for severity.

## E2 FAQs — Quarterly review procedures

***Question 5: What procedures do we need to perform and document to be able to complete a quarterly review in the quarter of adoption (Q1 2019 for calendar-year public entities)?***

In accordance with PCAOB AS 4105, *Reviews of Interim Financial Information*, we obtain an understanding of the entity's business activities and ICFR as they relate to the preparation and fair presentation of both annual and interim financial information. We use this understanding to:

- Identify types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence
- Select appropriate inquiry and analytical procedures that will provide us with a basis for communicating whether we are aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles

For existing audit clients, our inquiries are directed at updating our documentation and our knowledge and understanding of (1) the business, (2) significant sources of information for significant accounts and significant disclosure processes, (3) the interim accounting processes (and how they differ from the processes used to prepare annual financial statements) and (4) ICFR.

If a significant change is noted (e.g., all lessees will need to change their accounting process to comply with the ASC 842 requirements), we extend our procedures to obtain an understanding of the change and its effect, if any, on the financial information subject to our review procedures. We also consider the need to perform walkthroughs to help us formulate our understanding of any changes. If a significant change in ICFR results from adoption of the new leases standard, performing walkthroughs in connection with the first quarterly review after adoption (Q1 2019 for calendar-year entities) may be the most effective and efficient way for teams to document their understanding of the changes. Further, we strongly recommend that such teams begin to obtain an understanding of the changes in ICFR before the first quarterly review in order to provide feedback on management's planned implementation.

For an AS 4105 review, we also evaluate a significant change in ICFR to determine whether, in our judgment, any material modifications should be made to management's disclosures about changes in ICFR in order for management's certifications to be accurate and to comply with the requirements of Section 302 of the Sarbanes-Oxley Act. See EY GAM INTERIM REVIEW 3 *Evaluation of management's certification disclosures about internal control over financial reporting*.

## E3 FAQs — EQR responsibilities (updated July 2018)

***Question 6: What is the engagement quality reviewer (EQR) required to do in the transition to the leases standard?***

The engagement quality review is an integral part of our system of quality control, and the EQR should be involved in evaluating the audit strategy for auditing the entity's adoption of the standard (i.e., the significant judgments made, including significant accounting judgments, key estimates and significant risks identified by the audit team, and related conclusions reached by the audit team). Examples of procedures the EQR may perform include having discussions with the partner in charge of the audit and other members of the audit team, participating in the team events and reviewing the Form 276US *Leases (ASC 842) implementation audit form* and/or the workpapers that are referred to in Form 276US that document the matters required by the form.

The nature, timing and extent of our procedures will vary with the nature and complexity of the audit, including the significance of the effects of adopting the new leases standard. It is important that the EQR exercise his or her professional judgment to determine the nature, timing and extent of the procedures necessary to address the requirements as well as any other procedures that, in his or her professional judgment, are necessary to provide concurring approval for issuance of the auditor's report or for the entity to use the interim review report.

Refer to the US APM 1.2.2 *Engagement quality review for audits*, and US APM 1.2.3 *Engagement quality review for reviews of interim financial information*, for further guidance on EQR requirements for audits of financial statements or reviews of interim financial information.

## E4 FAQs — Change in auditor

***Question 7: If we become the auditor during the transition period or in the year of adoption of the new leases standard and the prior-period financial statements that require adjustments were audited by a predecessor auditor, may we audit the adjustments to the prior-period financial statements and related disclosures? (Note: This FAQ is not applicable if the FASB finalizes the proposed optional transition method and the entity elects to apply it.)***

Pursuant to US Reporting Manual 2.23, as a matter of policy, we will not accept an engagement to audit only the restatement adjustments relating to retroactive accounting changes that (1) have a significant effect on previously reported amounts or (2) affect previously reported net income or net assets.

In addition, we generally will not accept engagements to re-audit financial statements that previously were audited by other auditors but we occasionally will do so after consideration of all relevant factors. **We are required to obtain advance approval from the Professional Practice Director assigned to the Region and the Director of Regional Professional Practice or the Deputy Vice Chair — Assurance Professional Practice prior to accepting any engagement to re-audit financial statements previously audited by other auditors. These matters require advance approval from the Professional Practice Director and should not be delegated to other partners within the Professional Practice group assigned to the Region.**

***Question 8: If EY becomes the predecessor auditor in 2019 (i.e., we are no longer the auditor beginning in 2019) and the new auditor needs to issue an opinion on an entity's 2019 financial statements and the entity recasts the comparative periods it presents that year, should we reengage with the entity to audit the adjustments presented in the financial statements for the comparative periods?***

Pursuant to PCAOB Staff Guidance Section 100.03, we could be reengaged to audit the retrospective application of the change in accounting principle for the adjustments as long as we are independent of the entity. Generally, we would expect that we would be reengaged to audit the retrospective periods since we opined on the periods covered by the retrospective adjustments.

Therefore, we would perform modified client acceptance procedures to reestablish a professional relationship with the client in accordance with SEC Manual 10.9.7, *Reporting on financial statements of former clients*, and comply with the US Independence Guidance G401.3, *Former US SEC audit clients*. We would also perform the post-report review procedures included in SEC Manual 10.9.7.2.

When we amend our auditor's report for the change in accounting principle, we retain the original date of the auditor's report and add a second date (i.e., dual date) that is restricted to the amendment. The dual-date informs the user that our procedures subsequent to the original date on our auditor's report were restricted to the subsequent amendment of the financial statements. Refer to US Reporting Manual 2.22.4.1, *Management agrees to amend financial statements*, for further detail.

## E5 FAQs — Engagement management

***Question 9: Do I need to obtain preapproval for professional services related to an entity's adoption of the new leases standard?***

We expect that all services provided to our SEC issuer audit clients related to the adoption of the new leases standard will require specific audit committee preapproval, particularly services that are not part of the execution of our audit. Teams should separately identify such procedures as part of the audit preapproval process to avoid any confusion. Services that are a required part of our annual audit should be included in the audit committee preapproval for the annual audit.

When we seek audit committee preapproval of services that are not required as part of our audit, we should specifically describe the services to be provided, which could include accounting consultations on new accounting standards, diagnostic services or other related services. While some of our audit teams have "accounting consultation" preapprovals to address periodic discussions, this description by itself may not be sufficient to give the audit committee a thorough understanding of the scope of our services, especially if our services extend beyond answering periodic implementation-related questions. In addition, the description of our services should specifically include a discussion of the use of tools and enablers, if these are provided, and the specific independence considerations evaluated as part of assessing service permissibility. Finally, PCAOB Rules 3524 and 3525 should also be considered where applicable. Refer to question 11 for more information.

Sample preapproval language for audit committees is available to assist audit teams with this communication. Refer to question 14.

As a reminder, audit committee preapproval is required at least annually, although in some instances it may be required more frequently, particularly if the scope of services change over time.

***Question 10: As part of preapproval of professional services related to an entity's adoption of the new leases standard, when would an engagement team need to make expanded disclosures to the audit committee in accordance with PCAOB Rule 3525 (services related to ICFR) or PCAOB Rule 3524 (related to tax services)? Also, what preapprovals are required for permissible services provided in connection with a "diagnostic" related to an entity's implementation of the new standard?***

Some of the services we provide related to the new leases standard may include elements that result in EY providing non-audit services that affect a client's ICFR or certain tax services, both of which have expanded preapproval requirements as outlined in PCAOB Rule 3525 (non-audit ICFR services) and PCAOB Rule 3524 (tax services).

PCAOB Rule 3525 applies to non-audit services that are not a required part of our annual audit of the financial statements and ICFR. If we are reviewing proposed changes to risk and control matrices in advance of the client's implementation of these changes, commenting and proposing recommendations on potential changes to a company's financial processes as a result of the new leases standard, or assessing the effectiveness of internal controls prior to their implementation (e.g., reviewing the results of a client's diagnostic), we must comply with the required PCAOB Rule 3525 disclosures. In evaluating whether services are included in our audit scope, we should presume that if competitive proposals are involved, the procedures are outside the required scope of our audit and the requirements of PCAOB Rule 3525 apply. Similarly, the provision of tax compliance or tax advisory services related to the implementation of the new leases standard require compliance with PCAOB Rule 3524. Documenting the substance of our discussions with the audit committee using Form U354 *PCAOB Rule 3524(c) Audit Committee Preapproval documentation memorandum*, Form U355 *PCAOB Rule 3525(c) Audit Committee Preapproval documentation memorandum* or equivalent documentation is required to comply with the PCAOB Rules.

We expect our preapproval communications with audit committees to be transparent about independence risks or threats associated with performing such services and any services we provide to be preapproved in accordance with the additional PCAOB requirements. That is, we need to discuss and document independence threats related to designing or implementing a client's internal controls, which is a management function, or being placed in a position of auditing our own work.

***Question 11: Where should fees for services provided to an audit client related to implementing the new standard (e.g., testing of SAB Topic 11.M disclosures, client discussions or consultations, internal control reviews or testing) be classified in the proxy disclosure?***

Registrants should generally classify these fees as either "audit fees" or "audit-related fees" because these services often relate to or reasonably relate to the performance of the audit or review of the registrant's financial statements.

As a reminder, Item 9 (e) of SEC Schedule 14A (proxy statement) requires the disclosure of fees as audit fees if they are for "professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements" and as audit-related fees if they are for "assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and not reported under paragraph (e) (1) (audit fees)."

Refer to the EY publication, *2018 proxy statements: an overview of the requirements and observations about current practice*, for further guidance about classifying auditor fees.

*Question 12: What are some examples of services that likely would not be classified as "audit" or "audit related" in the proxy disclosure?*

Although we generally expect fees for services related to the implementation of the new leases standard to be classified as "audit fees" or "audit-related fees," registrants should carefully evaluate the scope of services performed to determine whether the nature of the services reasonably relates to the performance of the audit or review of the registrant's financial statements. For example, some of the permissible services involve advising and providing recommendations about the registrant's project management office (e.g., project setup, governance, communication protocols) or providing insights on the registrant's communication plan with its key stakeholders, which may not reasonably relate to the performance of the audit. In addition, some of the services may involve tax compliance and planning in connection with adoption of the new leases standard, and any fees related to these services would be classified as "tax fees."

*Question 13: What resources are available to help audit teams that need to obtain audit committee preapproval for services related to the implementation of the new leases standard?*

Teams can use the standard audit committee preapproval templates and, more specifically, the Rule 3525 Word template developed for revenue recognition services as a baseline, given the similarity of issues related to adopting both standards.

For ad hoc approvals of services throughout the year, we can use the quarterly audit committee preapproval template, which includes PCAOB Rules 3524 and 3525 disclosures.

Refer to the Audit committee supplemental topics page on EY Atlas to locate the updated *Audit committee preapproval — Annual supplement*, which provides sample preapproval language to assist audit teams in their annual communications.

# F Example risk and control matrix for lessees

The accompanying RCM is designed to assist audit teams with their risk assessment process for a lessee's implementation of ASC 842. It assumes that the entity has elected the package of practical expedients. The RCM contains examples of common risks and controls and may not address all of an entity's risks and controls. We also expect our clients to document their controls in more detail than we include in the matrix (e.g., the frequency with which the control will operate, the reports that the control owner will use to execute the control). Using this RCM is not a substitute for reading the guide. This RCM is for internal use only and cannot be shared with clients due to independence restrictions.

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