 Lease accounting: Six questions CFOs should ask now

More than a decade in the making, the Financial Accounting Standard Board’s (FASB) new standard on accounting for leases finally takes effect for public companies on January 1, 2019. For many CFOs, complying with ASC 842 —hard on the heels of implementing this year’s new revenue recognition standard—promises to be a race to the finish.

Not everyone is winning. According to a recent Deloitte poll (see Figure 1), only 15.6% of respondents say their companies are “extremely” or “very” prepared to comply—an alarming number as the deadline for adoption draws closer.²

There is clearly no time to waste. For many companies with leasing activities, compliance with ASC 842 will require investment in new technology or modification of existing technology; extensive abstracting of existing lease agreements to capture new data points; and close coordination with senior leadership in corporate real estate, procurement, IT, and—where applicable—third-party advisors. Ideally, it also should include a few months of cushion to make sure everything is running smoothly before the go-live date.

For some, this may mean adding one or more designated lease accounting specialists to the team. For others, it could mean developing a new operating model for the accounting organization in which lease accounting is centralized. In this issue of CFO Insights, we will discuss these options, as well as some pressing questions CFOs should consider asking their chief accounting officers to facilitate compliance as the adoption of the new standard enters its final stretch.
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Figure 1. How prepared is your organization to comply with the new lease accounting standard?
Findings over time—C-suite and other executives*

Votes received: 2,522 (Mar. 2016); 1,231 (Oct. 2016); 2,536 (May 2017); 1,659 (Jan. 2018); 2,758 (Apr. 2018)

<table>
<thead>
<tr>
<th>Month</th>
<th>Prepared</th>
<th>Somewhat prepared</th>
<th>Unprepared</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 2016</td>
<td>43.6%</td>
<td>36.1%</td>
<td>10.3%</td>
</tr>
<tr>
<td>October 2016</td>
<td>36.2%</td>
<td>34.9%</td>
<td>29.0%</td>
</tr>
<tr>
<td>May 2017</td>
<td>42.0%</td>
<td>31.4%</td>
<td>26.6%</td>
</tr>
<tr>
<td>January 2018</td>
<td>43.1%</td>
<td>22.4%</td>
<td>34.5%</td>
</tr>
<tr>
<td>April 2018</td>
<td>40.8%</td>
<td>29.5%</td>
<td>30.7%</td>
</tr>
</tbody>
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*Responses may not add to 100% due to rounding.
Source: “Lease accounting: Ready or not…the countdown is on;” Dbriefs webcast, Deloitte Development LLC; April 2018.

Bringing leases onto the balance sheet

The requirements of the new standard are by now well-known. Designed to address off-balance-sheet financing concerns related to operating leases, it requires that companies categorize leases as either operating or finance leases and brings virtually all leases exceeding one-year in length onto the balance sheet. Exclusions include leases of intangible or biological assets, inventory, or assets under construction, as well as leases to explore for, or use, non-regenerative resources. While it takes effect on January 1, 2019, for public companies, it also applies a year later for non-public companies.

The challenges of implementing ASC 842 reflect the changes the standard's writers faced in crafting it. When is an arrangement a service and when is it a lease? What amounts should initially be recorded on the lessee's balance sheet for a lease arrangement? How should the effects of leases be reflected in a lessee's statement of comprehensive income? (a point on which FASB and the International Accounting Standards Board, which issued its own version of the new standard, IFRS 16, could not agree)? And how could the resulting accounting be applied in a cost-effective manner?

The new standard may present significant implementation challenges, both during and after the transition period.

Beyond ensuring that everyone involved in leasing activity understands the technicalities of the new standard, here are six questions public-company CFOs can ask their chief accountants in the run-up to the compliance deadline:

**Question #1**

Have we begun to implement the applicable technology or modify existing systems? The new lease accounting standard presents organizations with data collection and aggregation challenges across multiple locations, in multiple currencies and languages, and across various technology platforms, many of which are not able to easily share information. CFOs need to make sure their organizations have lease accounting software and systems in place that can store lease data from across the enterprise and perform the necessary lease accounting calculations. The more processes are automated using these systems, the less room there will be for mistakes—and the less CFOs will have to worry about errors in financial statements.

Importantly, systems designed to facilitate compliance need to be live in early 2019, to enable quarterly reporting under the new standard by March 31, 2019. To allow for testing, that may mean they should be operational at least by the end of September or early October 2018. Accounting-only solutions are relatively inexpensive and allow for shorter implementation times. More robust lease administration packages can be much more costly, but typically can be integrated more easily with other enterprise systems, and—among other things—may be able to assist in lease-versus-buy decisions, manage lease payments and renewal options, and facilitate operating analysis of leased assets. Larger organizations may find these pricier packages a more sustainable, long-term solution. Unfortunately, implementation times for such packages can stretch out for six months to a year, meaning that any organization that hasn’t already started the process may need to consider a simpler solution in the interim.

**Question #2**

Have we identified data gaps and developed a remediation plan? Among the many quantitative data points that are required by ASC 842 are some that may have been managed manually, but haven't regularly been tracked in existing lease management systems (such as the market value of a leased asset). Other data points haven't always been captured technologically in a manner that facilitates calculations required by the new standard (such as the term of a lease, which now may include not only the initial term, but also any renewal options that are reasonably certain to be exercised). The new standard also requires
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lessees to establish a liability for each of their leases, including operating leases, and an accompanying right-of-use asset. But many organizations historically have not captured, at the required level of detail, the variables necessary to make these calculations.

To address these gaps, CFOs should consider whether their organizations have either designated an in-house lease accounting specialist to commission and oversee the lease abstraction process—including ensuring that all the necessary data points have been identified and are being entered into their lease accounting software—or that these responsibilities have been outsourced to a qualified third party. Companies whose lease portfolios are mostly homogeneous, may be able to utilize internal resources to handle the abstraction process. Companies whose portfolios are more varied, and may require challenging accounting determinations, may prefer to look outside for help.

It should be noted that some companies have been outsourcing their lease administration programs, especially those pertaining to real estate. And to minimize the cost of that activity, they’ve also been minimizing the number of data points, or fields, they track. To comply with the new accounting standard, these companies may now need to populate many new data fields with data previously not abstracted.

Moreover, there are contracts that don’t use the term “lease” (e.g., some service agreements) that nonetheless may be subject to the new accounting requirements. CFOs will want to assure that these contracts are identified and analyzed properly to determine if they are or contain a lease.

**Question #3**

**Have we adjusted our business processes and behaviors?** In the past, a business unit renewing a lease for, say, an office building, had little occasion to reach out to finance and accounting, which primarily cared only about how much the new rent payments would be. But the new standard has far-reaching implications on the tax, accounting, and reporting fronts. At the very least, lease accountants and the business units engaged in negotiating and renewing leases need to stay in close contact so the former can correctly assess the impact of leasing decisions on the balance sheet. Business units also need to factor new accounting realities into their leasing decisions. In the past, for example, many companies carefully structured lease arrangements, including sale leasebacks, so they could be considered operating leases and hence remain off the balance sheet. Under the new standard, most leases will be on the balance sheet regardless of how the transaction is structured, which means those transactions may make little financial sense.

**Question #4**

**Are we using the most effective model for our leasing activities?** Many larger organizations operate with a decentralized structure driven by tax considerations and defined by geographical borders, with lease approvals handled at the plant, local, or business-unit level. But many leading enterprises are shifting to a centralized model for lease administration and accounting. The benefits are expected to accrue not so much to finance, but to operations, giving companies an opportunity to be more strategic about their real estate and equipment leases using better, more complete data, and sophisticated data analytics, to generate economies of scale and negotiate more effectively with their vendors.

**Question #5**

**Do we have the resources to do this work ourselves?** While some organizations may have the in-house bandwidth and knowledge to oversee the migration to the new lease accounting standard, many will not—especially during the implementation phase, if only because the initial lift can be so daunting. CFOs will also want to understand if and how the company may be using external resources to assist in the adoption of the standard. Many companies are turning to third parties to handle lease abstraction activities, implement a new technology solution, and to manage their real estate portfolio. The quality and experience of these parties are critical to getting the accounting right. Of course, what resources need to be brought to bear is contingent on the size and complexity of your lease portfolio.

**Question #6**

**Have we reached out to our auditors?** However thorough your organization may believe itself to be in preparing for the new lease accounting standard, it makes sense to sit down with your auditors now to find out what they’re expecting. They’ll want to know, for example, that they’ll be able to come in after the fact and find that your organization has captured the required details on all leases. Whatever new processes your organization may be implementing, and whatever new software may be installed, your auditors need to be comfortable with your approach.

**Designate a PMO and lease liaison**

For CFOs, one of the leading ways to ensure that these various activities and undertakings are completed on a timely basis may be to designate a project management office (PMO) to coordinate and take responsibility for the effort. They should bring the relevant stakeholders into the project management office, including representatives from accounting, tax, corporate real estate, procurement, IT, and external auditors. The PMO should develop a detailed project plan in coordination with the external auditors, and pay particular attention to ensuring that efforts around data collection and validation, and software implementation, remain on schedule. CFOs also may want to appoint a lease liaison—a lease accountant to be responsible for the new accounting and reporting requirements on an ongoing basis.

The new lease accounting standard will clearly increase transparency, but implementing it will be a big undertaking. For CFOs who might have been monitoring their organization’s progress on adoption only sporadically, this is the time to put it higher on the agenda.
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Endnotes


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