TOP 10

TAKEAWAYS FROM THE LEASE ACCOUNTING SUMMIT

lease accelerator

Contents

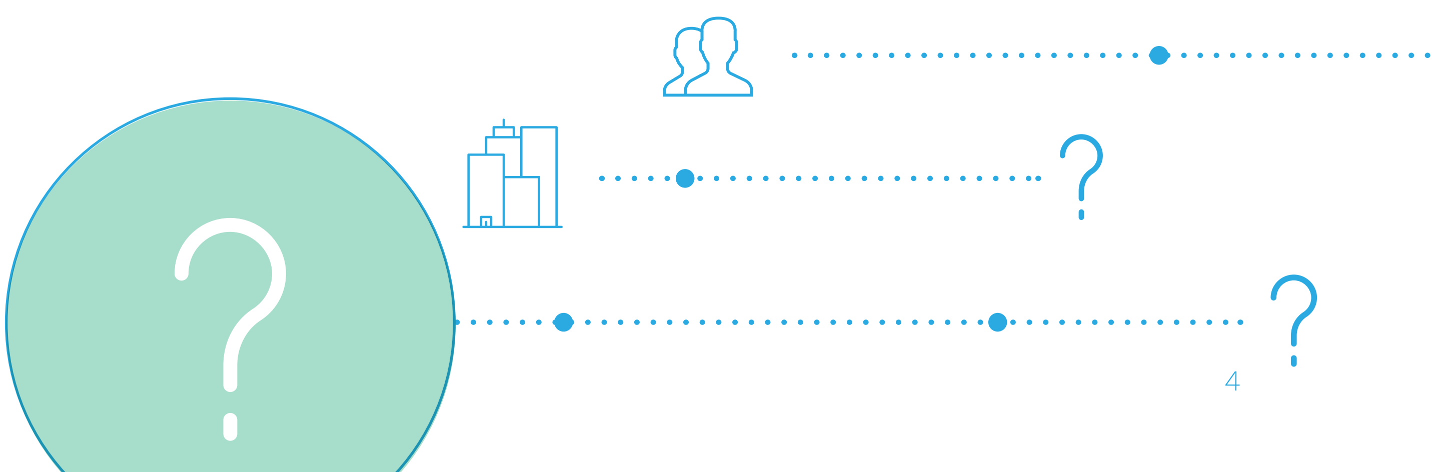
Introduction

On June 20th, we hosted our second Lease Accounting Summit in Chicago. Over 100 financial reporting and technical accounting leaders were on-site to discuss strategies for implementing the new lease accounting standards. We held 10 panel sessions with companies discussing topics ranging from audit and financial disclosure preparation to general ledger integration. During these sessions, the panelists discussed the state of their projects, best practices for implementation, and pitfalls to avoid. We've compiled the highlights from the panel sessions into the Top 10 Takeaways from the Summit.

1

Audit criteria remains a big unknown

Although, lease accounting teams regularly have discussions with their external auditors about ASC 842, there remains little clarity on the criteria that will be used post-adoption. Most audit firms are still busy with revenue recognition implementations as public companies have just started filing their first disclosures under ASC 606 (and IFRS 15). As a result, their views on potential audit criteria are still evolving. Nonetheless, lease accounting project teams cannot afford to wait to begin establishing policies and controls for the new standards. Most technical accounting leaders believe that the biggest areas of focus for year one audits will be completeness and accuracy.



Completeness

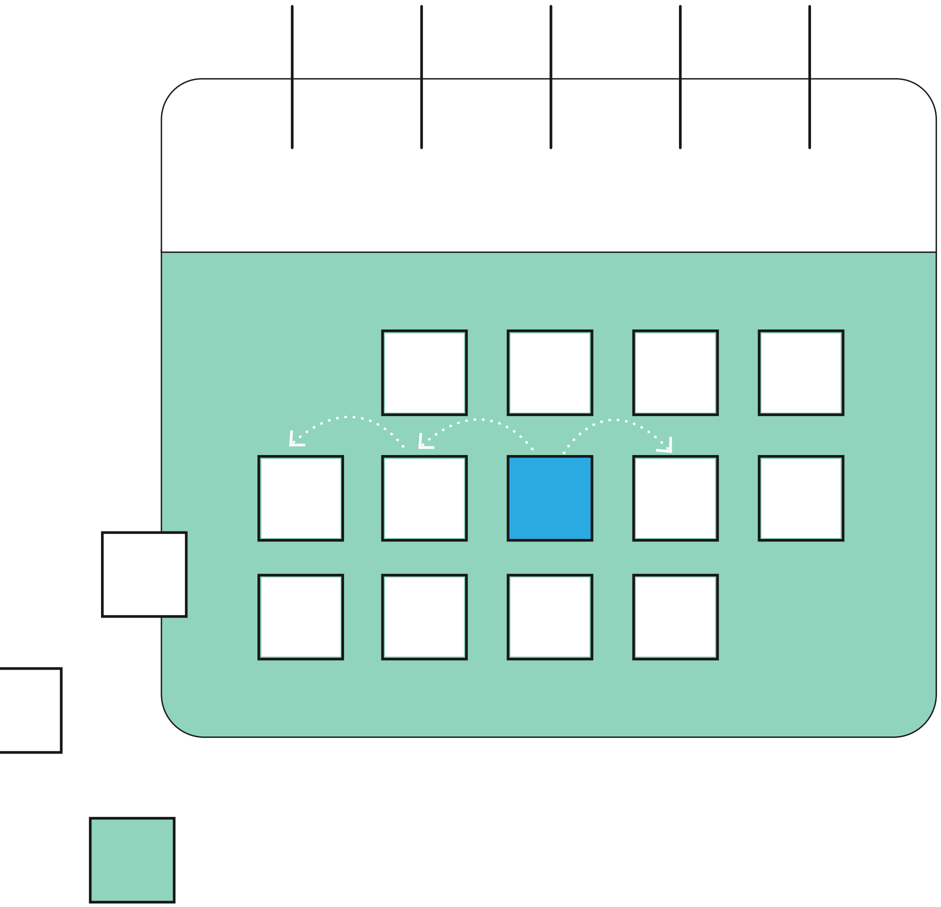
Corporate accounting teams will need to demonstrate that all existing leases have been identified and that processes and controls are in place to capture new leases as they are signed. Companies have a variety of strategies for demonstrating completeness. Some plan to use data analytics to track down recurring payments in the accounts payable system. Others are sending surveys to stakeholders in IT, Real Estate, and Operations to track down assets on lease.

Accuracy

Accounting teams will also need to demonstrate that the balance sheet, income statement, cash flow statement, and maturity analysis reports are accurate. One best practice is to review a random sampling of lease contracts with varying structures to ensure that all values in the system have been calculated correctly. SOC 1 reports from software providers will be useful to support external audits, but will not be sufficient in most cases to prove the accuracy of results.

Another step companies can take now is to leverage the internal audit group to conduct a pre-implementation audit of current lease accounting processes to determine what needs to be developed. Some companies have also already presented their plans for policies and controls to their auditors to get initial approval before proceeding further into the future state design of the leasing program. However, companies should still prepare for auditor guidance to change in the future as their understanding of the standards evolves.

2 Day 1 is a moving target



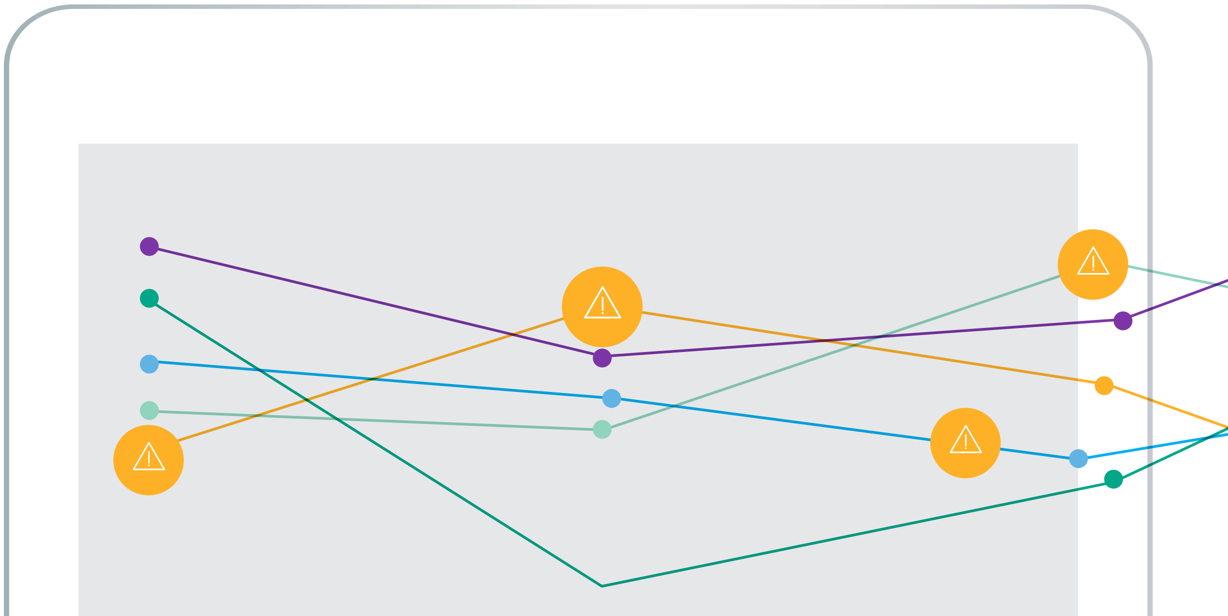
Although the initial deadlines for public companies are just six months away, the end dates for implementation projects are still up in the air at most companies. As one financial reporting leader put it – "There are three Day 1s:"

1. **FASB Day 1** – The effective date of the standards as defined by FASB and IASB.
2. **Best Case Day 1** – A day prior to the effective date on which testing of the new lease accounting systems, processes, and controls can begin.
3. **Worst Case Day 1** – The last possible day to finish. In other words, the last day of the first quarter after the effective date. For example, the worst case for a public company filer with a calendar fiscal year would be March 31st, 2019.

Although the Worst Case Day 1 scenario is a theoretical possibility, most companies prefer to avoid that path. If they find themselves in that situation, the accounting teams would need to reconcile all the leasing transactions completed in the first quarter from the effective date onward during the close process.

Of course, most companies are still hoping to achieve the Best Case Day 1 scenario, which would allow time to identify and correct errors before the FASB effective date. Ideally, companies would have a mock Day 1 at least 90 or more days prior to the effective date. New systems and processes could be tested during a "dry run" period to identify possible errors and validate system calculations. Regardless of which Day 1 scenario companies are targeting, virtually all agreed that a well-designed cutover plan is a must-have to ensure a smooth transition.

One short-cut that companies are taking to reach Day 1 faster is de-scoping selected business process and systems updates from the Day 1 effort in order to keep the project on schedule. Although most companies would prefer to automate the upload of journal entries from the lease accounting application into the general ledger, few expect to have this integration in place before the deadline.



3 Hindsight is anything but 20/20

The practical expedients of the new standards were designed to ease implementation. However, there is still a healthy debate about which practical expedients to select. Most companies are planning to take the so-called "package of 3," which eliminates the need to reassess lease classification, initial direct costs, or whether or not contracts contain leases. However, there are a few exceptions. One insurance company mentioned that the reassessment process would actually prove useful in helping their company identify errors they had previously made in identifying and classifying leases.

Views on the hindsight practical expedient are less clear. Most companies are still unsure of whether they want to use hindsight when determining lease term and assessing impairment.

Lease Term:

The way companies assess their lease term hasn't changed, but there's a question of whether lease terms were assessed properly in the past. It can be costly to go back and verify whether all lease terms are accurate. However, it will be beneficial to at least make sure those errors are not material. One possible short-cut is to calculate the average remaining term and use that as a basis to ensure confidence about the materiality of potential errors.

Impairment:

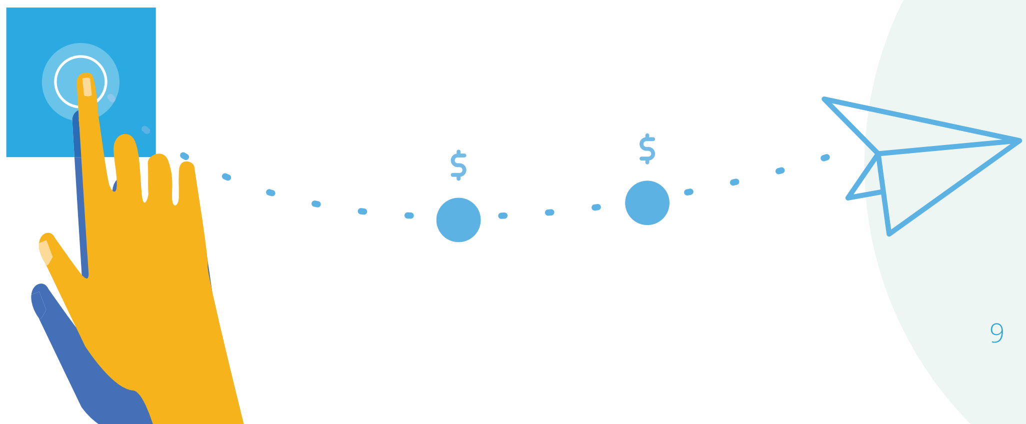
Recent updates from the FASB have simplified the transition options companies can take by eliminating the need to restate the comparative period. As a result, some of the issues with hindsight have become less of a focus. For example, one panelist noted that the hindsight expedient for impairment was more relevant for those companies planning to restate for the comparative periods.

4

Accountants experience separation anxiety (for lease and non-lease components)

There's another practical expedient that's receiving mixed reviews from companies. This expedient allows companies to choose, by asset class, to not separate lease and non-lease components.

Electing this expedient would certainly reduce the burden of separating the components, which can be extensive. While at first glance it may seem simple to allocate the costs listed in the contract to the separate components, in actuality it's more complex. Under the new standard, allocation is not based on the cash paid for a component, but rather on the standalone observable price. Tracking down the standalone observable price is expected to be challenging, and for some asset classes, it may not be worth the effort. In those cases, there's a strong argument for electing the expedient.



However, electing the expedient also comes with some drawbacks, including:

Capitalizing more on the balance sheet:
the value of both the lease components and the non-lease components will need to be reported on-balance sheet, so companies will see their assets and liabilities increase more than they already would have under the new standard.

Potentially triggering a finance lease
One of the criteria for a finance lease is that the present value of the lease (plus guaranteed residual value) is greater than "substantially all of the fair market value" of the asset on lease. Including non-lease components in the calculation of present value could push the lease over the threshold. If the classification changes from operating to finance, the income statement may also be impacted.

Potentially triggering an impairment:
If the value of the right-of-use asset recorded on the balance sheet is greater than the market value of the right-of-use asset, it could trigger an impairment. Including non-lease components on the balance sheet may be enough to push the recorded value of the asset over its market value.

Many companies will likely choose to take this expedient for some of their asset classes, but not all. Those companies will need to track down the standalone observable price for the asset classes where the expedient is not applied. A good place to start the search is with the lessors who keep detailed information for their leases, and might know the true value of the components.

5 Hidden difficulties: determining commencement date & lease term

Two of the fields that should be tracked are commencement date and lease term. On the surface, both fields seem straightforward. The commencement date is when the lessee and lessor's lease obligations begin. Lease term is the length of the lease. However, there are situations that could make both of these fields more difficult to pin down.

Lease Term: Most companies are expected to report their minimum non-cancellable lease terms because it's difficult to foresee whether or not you will choose to take a renewal option in the future. However, if the company is reasonably certain to take a renewal option, the option needs to be included when calculating the lease term. One situation where this might happen is when a leased asset will continue to be necessary from a business perspective, like in the case of a flagship store. Another example would be if the company had invested significantly in improving the property throughout the term of the lease.

Commencement Date: Both real estate and equipment assets commencement date can be identified using the same approach. Determine: 1) When the asset is available for use, and 2) When you gain control of the asset.

Equipment: The easiest way to determine the commencement date is to look at the receiving document for the asset to find out when it arrived at the loading dock.

Real Estate: The commencement date can be complicated by situations that prevent the tenant from taking full control of the property, even after the lease is signed. For example, the commencement date can be delayed by construction for leasehold improvements which often lasts an unpredictable amount of time. To determine commencement date for your real estate properties, find out when you were granted unlimited access to the property.

6

Internal borrowing rate is a source of confusion

One newly required data field that has caused significant confusion is the internal borrowing rate, or IBR. To calculate IBR, companies should take their corporate borrowing rate and adjust it for security for some level of collateral. Then, if necessary, adjust foreign currency cash flows to the borrowing currency.

However, some companies do not have a corporate borrowing rate to start with. To determine corporate borrowing rate, companies can potentially look at the borrowing rate for an index they are part of, and then adjust that rate for their company. Also consider leveraging Treasury for this process, as they may already hold some of the data necessary to calculate IBR .

7

Accounting can't do this alone

Unlike many other new FASB standards, the leasing project cannot be completed by the accounting organization alone. Accounting will need to rely on stakeholders from around the business to track down all leases and implement processes. Two organizations that can be especially helpful for capturing data from leases are Procurement and Treasury.

Procurement: One of the key controls needed under the new standard is a control to capture new leases when they are signed. Since all leases pass through Procurement, the organization can be responsible for sending new leases to the accounting organization to be documented in the lease accounting system. Consider working with Procurement now to develop a process for data capture. If possible, build in a dry run period for this process before the effective date, as it may take time to establish this policy so that it is consistently followed.

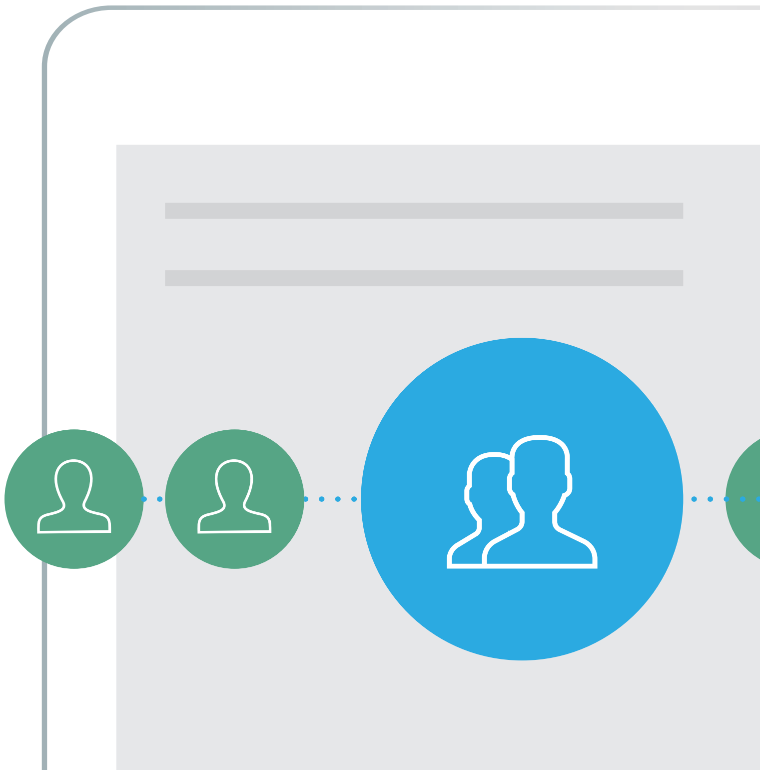
Treasury: Treasury can also play a role in the data capture process. Even before Procurement signs a lease, Treasury can conduct a lease versus buy analysis on asset requests so that as soon as a leased asset is approved, it can be documented in the lease accounting system. If your treasury organization does not have an established lease versus buy analysis process, or if asset requests are not consistently submitted to Treasury, consider establishing a policy that all high-value asset requests should pass through Treasury before they can be approved.

8 A COE and communication are key

Many companies are trying to centralize the leasing program under a leasing center of excellence (COE). However, at companies with large lease portfolios, it's unlikely that the COE will be able to keep track of each asset on each lease. As a result, the COE will need to regularly communicate with the stakeholders who actually use the assets in order to keep lease data accurate.

It may be difficult to get responsive communication from the stakeholders – after all, keeping track of lease data is not their primary responsibility. However, that data is now required in order to stay in compliance. Consider offering incentives to stakeholders so that they are invested in keeping the lease data up-to-date. For example, if they help eliminate an evergreen payment, that expense could go back into their budget.

The COE will also likely need help with contract analysis, as they won't be able to look at every lease contract that comes through the door. In addition to serving as a data capture point, Procurement can also help identify the contracts that will need to be analyzed by accounting experts – whether that's because the contract is for a high-value lease or because the contract might contain an embedded lease. The COE can also utilize artificial intelligence applications that are able to determine if contracts are in or out-of-scope.



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The 1, 2, 3 of integrating the ERP

Most organizations that have invested in a lease accounting software have at least thought about integration with the ERP. At monthly close, debits and credits will need to be uploaded to the general ledger. In addition, the ERP stores valuable master data that will be required by the lease accounting system, including company, country, and cost center. Master data could also include FX rates, addresses, and the project number. While some of these values will remain constant, like company and country, values like cost center and FX rates will change regularly, and so should be integrated with the lease accounting system at least once per month to remain up-to-date.

There are three standard models of integration:

1. API: A RESTful API is invoked using https.

2. File-Based Integration: File-based integration uses a secure file transfer protocol (SFTP), which accepts xml, csv, and xlsx file types.

3. Import & Export: This method uses a template to import data into the system, and generates reports that can be exported through email. This method is often appropriate for smaller subsidiaries that have their own ERP.

10

The project is more complicated than you think. Start now!

There are many project management best practices that companies can follow to efficiently implement the new standards. However, the number one best practice, which is at the center of all others, is to start as soon as possible. Most companies have decentralized lease portfolios, so it will take a significant amount of time to gather the data. Then, you also have to make time to design the processes, policies, and controls that will keep you in compliance on Day 2 and beyond. Luckily, there are some other steps you can follow to expedite your implementation if you're falling behind.

1. **Executive Sponsorship:** Securing executive sponsorship as early as you can is critical. The executive sponsor will help you secure the budget for the project in addition to impressing upon stakeholders the importance of compliance to get everyone on board.

2. **Touchpoints with Stakeholders:** Establishing recurring touchpoints with stakeholders will allow you to track down leases and feel confident that the data you are gathering is up-to-date.

3. **System Logic:** Before you start extracting data, first take time to learn your lease accounting system's logic. If you don't know what data you need to gather for your system, you may miss important fields and have to repeat the data collection process – a leading cause of project delays. Test multiple use cases so you know what data needs to be gathered and how to properly populate the system.

4. **Project Governance:** Hire a project manager to run the day-to-day operations of the project. This person will be able to bring a high-level perspective to managing the project team. Also consider hiring consultants who can provide valuable insight on the lease accounting standards as well as best practices.

LeaseAccelerator offers the market-leading SaaS solution for Enterprise Lease Accounting, enabling compliance with current and new FASB and IFRS standards. Using LeaseAccelerator's proprietary asset-based Global Lease Accounting Engine, customers can account for all categories of leases including real estate, fleet, IT, material handling and other equipment at an asset-level.

On average, LeaseAccelerator's lease Sourcing and Management applications generate savings of 17% on equipment leasing costs with smarter procurement and end-of-term management.

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