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Why lease accounting laggards face serious risks

By Ken Tysiac
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Cathy Clarke, CPA, worries that companies are underestimating the amount of work required to implement FASB's new lease accounting standard.

As chief assurance officer for CLA, Clarke works exclusively with nonpublic companies and not-for-profits, so she knows the resource constraints smaller organizations face in a lease accounting implementation that is more complicated than it appears.

Maybe they have a limited accounting staff, and they are so busy with another heavy FASB implementation —revenue recognition—that they don't realize that they don't know where some of their lease contracts are. Perhaps they use spreadsheets for their fixed-asset accounting and don't know that they will need to consider modifying their software to perform this accounting. And maybe they haven't considered the effect that new liabilities on their balance sheets will have on their debt covenants with lenders.

"Everybody is looking at this standard and thinking the implementation will be easy. Once they get started, they will realize it is more complicated than it appears on the surface," said Clarke, a member of the AICPA Financial Reporting Executive Committee (FinREC).

Implementation of the new FASB standard is challenging for companies large and small. Like many global companies that are lessees, Bristol-Myers Squibb has real estate, vehicle fleet, and office equipment leases in different languages and formats, often dictated by the many different lessors who contract with the company.

Although there is centralized oversight of real estate and certain equipment leases, document management and limited oversight of other leases maintained at the local level have created challenges for the company to understand its full lease portfolio.

But in the past year, the pharmaceutical company began to gather all those leases in an effort to implement FASB's new lease accounting standard, which seeks to increase transparency in financial reports. The company has dedicated a multifunctional project team and a third-party contractor to the task. Still, the process has proved arduous.

"Data gathering is extremely difficult," said Bob Owens, CPA, the company's vice president and head of accounting. "We are a company that has some resources, and for companies that don't have the resources to apply to it, it's going to be very difficult, particularly if people have not yet started."

The effective date of 2019 for public companies and 2020 for most other organizations might seem distant (note that not-for-profits with conduit debt and certain employee benefit plans face a 2019 effective date, a year earlier than others in their sector). But the lease accounting implementation is so challenging that it reminds Owens, who's also a member of FinREC, of 15 years ago when public companies were implementing Sarbanes-Oxley Act (SOX) regulations that included documenting internal controls.

For many companies, the SOX implementation was costly and challenging, and required substantial in-house and external resources. Owens said lease accounting implementation may be similarly difficult, particularly because its timing is not good for financial statement preparers. Many of them are deeply involved in the adoption of a transformational, high-impact standard on revenue recognition, which takes effect for public companies at the beginning of 2018 and for private companies the following year.

Because the lease accounting rules don't take effect until a year after the revenue recognition standard's effective date, the leasing implementation has been delayed by some preparers. Almost one-fourth (23%) of companies surveyed in May by PwC and commercial real estate services firm CBRE said they haven't started their lease accounting adoption efforts yet. And a Deloitte survey showed that 31.4% of more than 2,150 executives polled in May said their organizations were unprepared to comply with the new standard.

Search for transparency

Issued in February 2016, Accounting Standards Update No. 2016-02, *Leases (Topic 842)* (http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167901010&acceptedDisclaimer=true), requires balance sheet recognition by lessees of assets and liabilities created by all leases with terms of more than 12 months. The standard was intended to increase transparency for liabilities that previously were not included on the balance sheet, giving financial statement users a better understanding of companies' obligations.

When the standard was issued, there was hope that implementation would proceed with just a moderate level of difficulty for preparers. Upon issuance, FASB Vice Chairman James Kroeker said it would be possible for some companies to leverage their existing systems with the change, and that indeed may be the case for some preparers.

The standard imposed minimal changes on lessor accounting, and FASB chose not to create a transition resource group (TRG) for lease accounting. The board did create TRGs to aid preparers with implementation of new standards on revenue recognition and accounting for credit losses, but the lease accounting changes are easier to understand.

"We decided not to develop a leases TRG because the scope of educational changes is not as significant as these other projects," FASB Chairman Russell Golden said in June at a Financial Executives International event in Philadelphia, while also explaining that the board has monitored the types of questions it has received and provided educational documents, videos, and a webcast on the lease accounting changes.

But the challenge with the lease accounting standard is not that it's difficult to understand. The problem many preparers are facing (aside from their preoccupation with implementing other standards) is that it's difficult to locate the many leases that are scattered throughout their organizations.

Further complicating the problem, many lessee organizations don't have standard lease contracts, as terms and formats often conform to the wishes of the lessors. Depending on where they are located, the contracts may be in different languages. This makes it a challenge to extract the data that need to be considered and reported to comply with the lease accounting standard.

Finally, placing lease data into a system that performs the necessary accounting may be challenging for many companies. Almost half (43%) of respondents to the PwC/CBRE survey said they expect to implement a new lease management system to comply with the standard, and an additional 20% said they plan to modify their existing ERP system to accommodate the changes.

Many companies that have performed lease accounting manually in offline spreadsheets in the past may find they need to embed the data extracted from leases into their overall financial processes. But Owens said there are not a lot of viable system options in the market that are fully developed and tested.

All these challenges lead Owens to conclude that it's essential for all organizations to start implementing the lease accounting standard now.

"This is a fairly complex or challenging standard to update," he said, "probably one of the more challenging standards I've seen in decades of working in accounting."

Getting started

Implementation of the standard starts with building a team or task force to perform the work. The participation of finance and IT leaders, plus whoever handles real estate negotiation and contracts, is essential. In addition to contemplating systems requirements for reporting, IT leaders may need to provide details on equipment they are leasing.

Other functions that may need to be involved include procurement, treasury, and tax. Smaller organizations that use a third-party bookkeeper need to make sure there is a clear understanding with the contractor about who is responsible for implementing the standard, Clarke said.

While building the team, the organization will want to consider whether to use strictly internal resources or whether to contract for help from third parties, Owens said. Once the personnel involved with implementation is determined, setting a timeline with milestones and accountabilities can keep the work on schedule.

With a team in place, organizations can proceed to what may be the most challenging duty of implementation. Locating all the organization's leases and extracting the data to be reported can be extremely difficult.

It's possible that some organizations may not even be able to find all their lease contracts, especially for leases that have existed for many years. It's possible that their auditors may have the contracts if they are material leases, Clarke said, but in all likelihood only portions of the lease related to the disclosures were maintained. If they can't find contracts, organizations may need to rely on lessors to provide a copy for this accounting exercise.

Once contracts are located, extraction of data from them can begin, and there are judgments involved in this work.

Key considerations

Larger companies in particular may have to work through materiality considerations related to their leases.

"You have to go through some sort of initial inventory or initial thought process about what is material and what items are included in the scope of the new standard, and which things can you clearly say it's just inconsequential," Owens said.

After determining which leases are within the scope of the new standard, organizations need to figure out whether they can apply a portfolio approach if they have many leases of the same kind and substance. This practical expedient may help organizations account for items such as a fleet of company vehicles or leased IT equipment that may be provided to every employee.

Separating lease and nonlease components from the payments to the lessor may require a substantial amount of judgment. Many leases may include a single payment that covers the lease plus nonlease items such as maintenance of common areas, taxes, and insurance. If these items are not clearly delineated in the lease, the preparer may want to ask the lessor for an addendum that separates those items from the lease payment.

Other items preparers may need to consider include:

- **Related-party leases.** Many times smaller organizations don't have formalized leases with related parties. These arrangements will need to be spelled out in contracts so that organizations can apply the proper accounting treatment.

- **Embedded leases.** If a company is using all of a vendor's output under a supply contract, it's possible that the contract contains an embedded lease that requires lease accounting treatment. Owens said organizations may wish to analyze their supply contracts with their procurement teams and suppliers to determine whether the contracts contain an embedded lease.

- **Taxes.** The lease accounting standard may cause state tax apportionment issues in some states, especially those that are using property factors to apportion taxable business income. The standard may also trigger transfer-pricing implications associated with related-party issues. "People aren't thinking of the tax implications, but there may be some issues that they want to discuss with their tax adviser," Clarke said.

- **Lease renewals.** Under the standard, lease renewals need to be included in determining the lease term for accounting purposes if the lessor controls the lease or it is reasonably certain that the lessee will renew the lease.

- **Discount rates.** For the purposes of calculating present value, selecting an appropriate discount rate will require significant judgment.

- **Debt ratios.** Bringing more liabilities onto the balance sheet will affect debt ratios in organizations' lending covenants. A discussion of this issue with banks and other lenders can head off problems that could occur with the issuance of the organization's first financial statement under the new lease accounting rules.

- **Below-market rent leases.** Not-for-profits sometimes have leases in which a donor provides rent at a discount. The new standard requires not-for-profits to separate the contribution from the exchange in accounting for such leases.

- **Variable payments.** A step-up lease, for example, specifies that the rental price will increase by a predetermined amount in the future and requires specific accounting treatment.

- **System selection.** As companies gather data, they may want to consider what IT system they will use to handle the accounting. “Unless you only have a handful of leases, probably almost all companies are going to need some kind of a lease module embedded in their financial systems,” Owens said. “And it takes time to get that implemented.”

- **Statutory requirements.** Global companies may need to consider how to support the local requirements of their affiliates given upcoming changes under IFRS 16 (http://www.ifrs.org/issued-standards/list-of-standards/ifrs-16-leases/), *Leases*, and consideration of other accounting rules. The IFRS standard began as a convergence project with the International Accounting Standards Board and FASB, but the IFRS and U.S. GAAP rules that were developed ultimately had significant differences.

Delay at your own risk

The most important consideration of all, though, may be to get started quickly on the implementation of the leases standard.

Preparers who plan to hire third parties to locate or extract data from their leases may find that they will pay lower rates if they start now. Waiting until the last minute—especially if lots of preparers delay implementation—could mean paying a substantial premium. “It’s supply and demand, right?” Clarke said.

The effective date, more than a year away for public companies, may seem as if it’s in the distant future. But this standard may take a lot of time to implement because creating an inventory of an organization’s leases is deceptively difficult.

As a result, Clarke said companies will not want to delay the implementation process.

“Just like everything else,” she said, “the earlier you start, the easier it will be.”

Bristol-Myers Squibb started plenty early, and Owens considers the company fortunate because its financial reporting platforms do have a real estate module that the company is having updated to conform to the requirements in the leases standard. The update isn’t completed yet, but Owens is confident that the company is in good shape to finish on time.

At the same time, he is passionate about the implementation because his experience has given him a full understanding of the challenges that await his peers.

“It’s a very, very challenging rule to implement because of the wide scope of it and the broad application of it,” he said. “Although everyone has these arrangements, they were never really all pulled together as part of the normal financial reporting processes. This is going to make it very challenging for companies to implement.”

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