lease accelerator

PRIVATE COMPANIES AND LEASE ACCOUNTING

A 2019 PROGRESS REPORT

Market Readiness Three Years
After The Publication Of ASC 842

LEASING & OPEX RESEARCH CENTER

ASC 842

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Executive Summary

Over three years have passed since the initial publication of the new lease accounting standard (ASC 842) in February 2016. Some have called the new standard the biggest accounting change ever as some $3 trillion worth of assets transfer onto corporate balance sheets in the coming years. It is not often that new line items are added to the balance sheet. As a result, the new right-of-use assets and liabilities will be heavily scrutinized by shareholders, debt holders, external auditors, and independent board members following adoption. In the US, public companies began adopting the new standard at the start of 2019. All remaining public companies will transition to ASC 842 throughout the duration of the year. A similar wave of adoption will occur next year as the implementation deadlines for private companies commence starting in January 2020.

In an effort to provide a quantitative progress report on the status of compliance efforts for private companies, LeaseAccelerator conducted a research study in late January 2019.

Key Findings

40%

of Private Companies Have Not Started the ASC 842 Project

Approximately 40% of private companies surveyed are behind schedule or have not started their ASC 842 project - a concerning metric as the first implementation deadlines are quickly approaching. However, 12% indicated that they had already completed the project. Those that have completed include private companies who are planning IPOs in the near future or are in the process of being acquired by a public company. There are also some privately held companies that have registered securities or are SEC filers and so must follow the deadlines for public companies.

- Planning IPOs in near future
- Acquired by public company
- SEC filers or registered securities
- Early adopters

The remaining 48% of private companies surveyed indicated that they were on schedule or ahead of schedule. However, some of these companies may be underestimating the work effort remaining before Day One compliance, much like their public company counterparts did.

75%

Find Leasing Project More or As Complex as Revenue Recognition

Overall, 55% of private companies are finding the lease accounting implementation to be more complex than anticipated. The top implementation challenge cited by more than 40% of respondents was identifying the population of leases and abstracting the data needed for the accounting calculations. Other top challenges cited included modifying existing business processes, project managing the enterprise-wide work effort, and applying new accounting policies. Compared to the revenue recognition accounting standard (ASC 606), 75% are finding the new leasing standard to be just as much effort or more effort.

Equipment Leases are the Most Challenging to Find and Analyze

Although real estate leases represent the largest spend category at most private companies, project teams are not finding these contracts to be the most complex to locate and analyze. Instead, equipment leases, such as IT, vehicles, plant, machinery, and transportation assets are proving more challenging. Equipment leases have historically been tracked in spreadsheets with few defined business processes around management. As a result, companies, have to search through vendor invoices, contract repositories, and maintenance records to identify the universe of equipment that is being leased and may need to be transitioned onto the balance sheet. By contrast, real estate leases are typically centrally managed in a business application and are therefore easier to locate.

Almost 80% of Private Companies Have Yet to Select a Software Provider

Enterprise lease accounting software applications from both ERP and new best-of-breed vendors are the most popular choice amongst software applications. Only 10% of private companies are considering real estate administration software vendors as an option. Regardless of vendor preference, significant work remains for private companies as almost 80% of those surveyed have yet to select a lease accounting software vendor. Also noteworthy is that more than 50% of private companies currently are planning to use spreadsheets to perform the accounting calculations which is likely to change post-adoption. While spreadsheets are often the application of choice for financial power-users, they are typically challenging to test, track, maintain, and control over a longer period of time.

ASC 842 is Not an Accounting Project, but an Enterprise-Wide Initiative

More than 60% of private companies have assigned a formal project manager. Unlike other accounting change projects that can be accomplished within the four walls of the Controller's organization, ASC 842 requires a truly cross-enterprise effort. Corporate functions such as Procurement, Treasury, Accounts Payable, Tax, and Legal will touch almost every lease throughout its lifecycle. Support from the business units and functions that use the leased assets, such as Operations, Logistics, IT, and Corporate Real Estate will be critical as well. One out of four project teams have the Corporate Real Estate and IT teams playing a strategic role. Gaining support from the business will be a key challenge for most companies as the additional oversight, policies, and governance for leasing will not be welcomed by the users of the leased assets. Over 40% of companies have appointed an executive sponsor to help solicit participation from different stakeholders as well as secure budget and resources for the project.

Recommendations

Private companies will undoubtedly benefit from having one extra year to adopt after public companies. Software applications will be much more mature by early 2020, consultants will be much better versed in leasing processes, and auditors will be more prepared to provide guidance. However, private companies should be careful to avoid the pitfalls that many public companies encountered in their journey towards compliance, especially the three below.

Many Private Companies are Underestimating the Complexity Associated with Implementation

Approximately 50% of private companies indicated that they were either ahead of schedule or on schedule with their lease accounting projects. A similar optimistic sentiment was offered by last year's survey respondents with 60% of public and private companies indicating they were ahead or on schedule. However, at the time of the publication of this study, hundreds of publicly traded companies are closing the books on their first quarter reporting under ASC 842. Very few of these public companies are indicating that the project is anywhere near complete even though they are a few months past the implementation deadline. Most are indicating that a concerted effort will continue to be required throughout most of 2019. Private companies should not underestimate the level of complexity that will be required prior to transition and in the first year after adoption.

Private Companies Should Invest Time in Last Mile Activities such as Testing, Training, and Talent Development

Collecting data, implementing systems, and modifying business processes will be the largest work efforts required prior to Day One. However, there are many additional activities that need to be completed as well which many public companies underestimated. Most of these fall into the "last mile" of the project in the final 90 days before transition. Testing the accuracy of the accounting is proving to be a formidable challenge for many large public companies. There are over 100 billion combinations of use cases that can exist under ASC 842 when considering the different payment structures and events that can occur throughout the leasing lifecycle. In addition to developing a strong test plan, project teams will need to train end-users and communicate policy changes throughout the organization. Perhaps, most importantly, companies will need to staff a team of lease accountants to perform the ongoing analysis of changes to the portfolio. Some may need to build centers of excellence specifically focused on leasing.

Accounting Teams Should Not Focus on Day One, but Rather Year One Readiness

Although most private companies currently are focused on getting ready for the deadline, the project is not over once the new standard is adopted. In fact, many have described the implementation process as "a race to the starting line." Public companies in the first quarter of adoption are struggling with issues such as proving the accuracy and completeness of their lease population. Perhaps the greatest challenge, however, is the need to track changes to the lease portfolio. A company with 300 leases will have to track an average of 230 events in a single year as assets come off lease, new leases are signed, and changes occur throughout the term. Real estate leases have frequent rent changes as well as expansion clauses, tenant improvement allowances, and early renewal options that can be executed at various points in a 10-year lease. Equipment assets under lease can be lost, stolen, damaged, purchased, returned, renewed, or upgraded during the relatively short term of a three-year lease. Tracking these activities with spreadsheets and emails will prove challenging even to the most organized of accountants.

SECTION 1

Survey Firmographics

The survey was conducted in January 2019. Approximately 350 senior finance and accounting leaders at US-based private companies responded.

The 2019 survey is the third in our annual series of lease accounting implementation readiness studies. The first survey was conducted in January 2017 approximately one year after the introduction of FASB's ASC 842 standard with a mix of both public and private companies. The second survey was performed one year later in January 2018, also with public and private companies.

We did not ask survey participants about annual revenues. However, only companies with $1 billion in revenue were invited to participate. We also did not elect to ask the survey respondents questions about their vertical industry because we have not seen any correlation between the level of effort required for lease accounting implementation and a company's business sector. Instead, the complexity of the ASC 842 project is more correlated with the size of a company's lease portfolio and diversity of the asset population which we did include the scope of the survey.

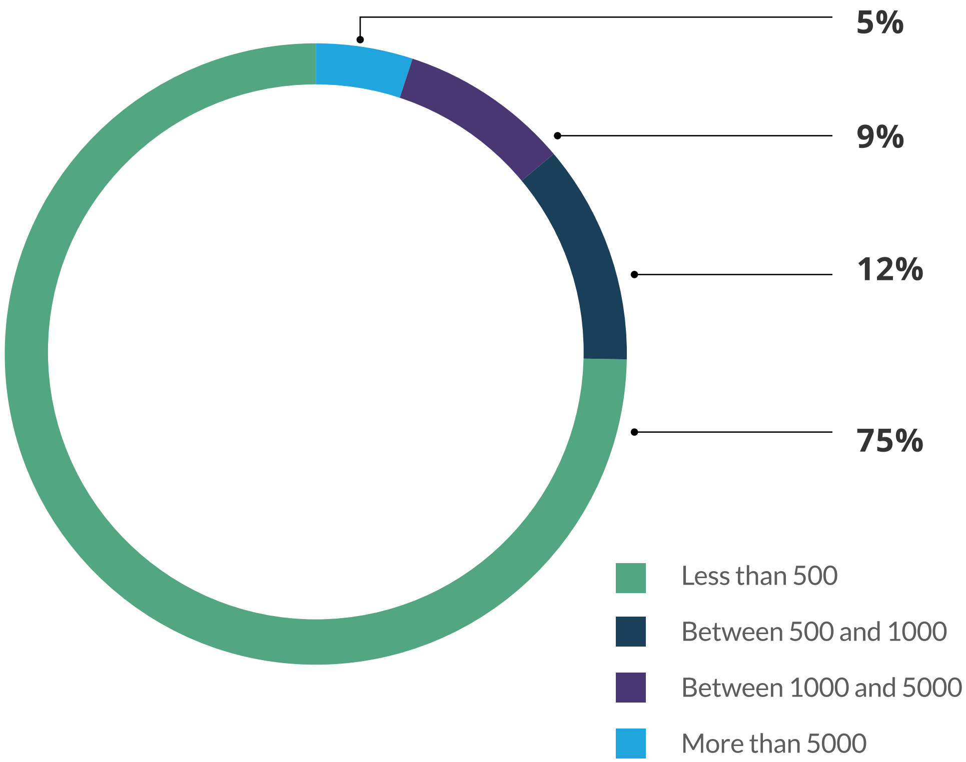
Size Of Lease Portfolio

Private Companies Report Fewer Leases Than Public Companies, but Those Early in the Project Lifecycle may be Underestimating.

The private companies surveyed have much smaller lease portfolios than publicly listed companies. Approximately 75% reported having 500 or fewer leases. In last year's survey of public and private companies, only 40% reported having 500 or fewer leases. However, there may be a fair degree of inaccuracy in the lease counts of many private companies that are still early in the project lifecycle. Under current GAAP, companies are required to report the total dollar value of their lease portfolio, but there is little focus on identifying the number of leases.

How many total leases do you have across your business?

The question of "how many leases do you have?" is a hard one for some companies to answer – especially for those that lease a diverse mix of asset types. The industry typically divides leases into two categories – real estate and equipment. Real estate includes buildings such as offices, factories, warehouses, and call centers as well as the land they are located on. Equipment is defined as everything that is not real estate. Examples of equipment leases include laptops, servers, photocopiers, furniture, forklifts, trucks, company cars, rail cars, shipping containers, and corporate aircraft.



Mix Of Leased Assets

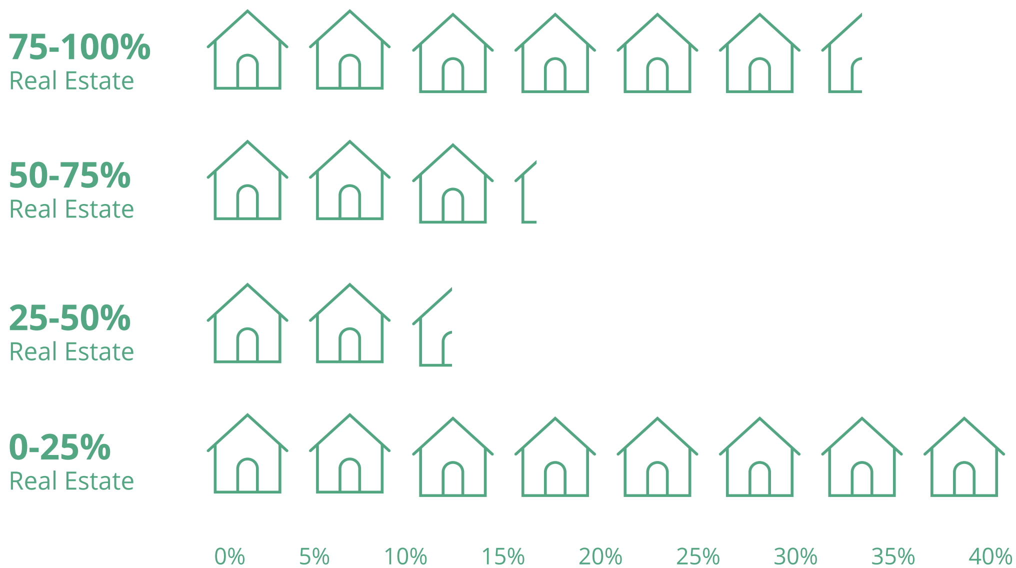
Private Companies Lease More Than Real Estate. Most Lease a Diverse Mix of Assets That Includes IT, Fleet, and Other Types of Equipment.

Some companies limit their leasing portfolios to a single asset category such as real estate. For example, one third of private companies surveyed had a lease portfolio heavily concentrated in real estate (75% or more of the leases) whereas the remaining two thirds of private companies surveyed had a more diverse mix of assets. Although these assets might all be grouped together into the category of equipment by analysts and consultants, they are rarely managed that way by the companies actually using the assets.

Equipment leases are typically managed in a highly decentralized fashion by various different business units and geographic regions around the world. The supply chain group might manage the leases for forklifts, rail cars, trucks, shipping containers, and marine vessels. The corporate IT group might manage the leases for laptops, printers, servers, and data center equipment. The real estate group might manage the leases for buildings, land, furniture, and office equipment such as photocopiers, water coolers, and coffee machines.

Due to the de-centralized nature of lease administration, it is common for companies to not have an accurate count of their equipment lease portfolio. There are numerous examples of companies in the later stages of their ASC 842 implementation finding out that their actual lease portfolio was three to four times larger than the original estimate.

What percentage of your total leases are real estate (versus IT, fleet, equipment, etc)?



SECTION 2

Implementation Progress

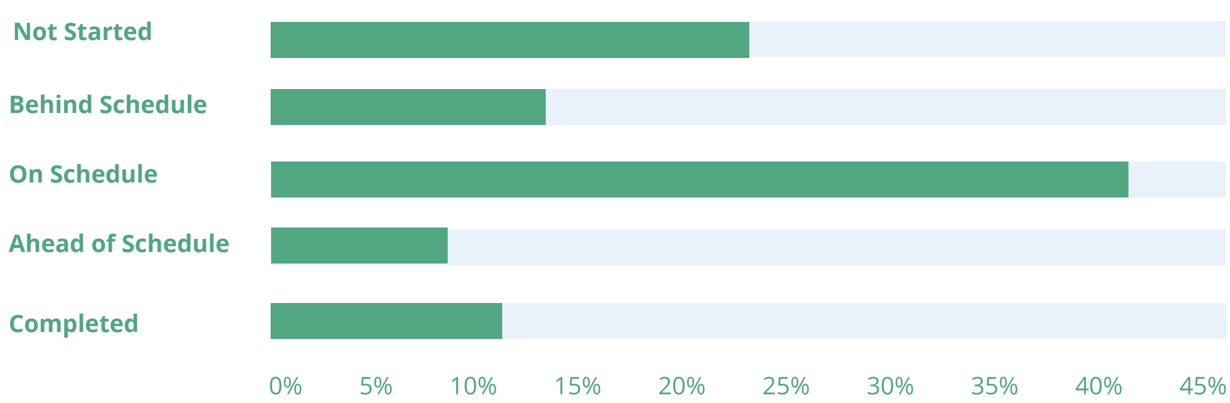
Implementation Completed

12%

of Private Companies Have Completed the Project Including Those With SEC Filing Requirements and Those Planning IPOs

Most private companies will not have to adopt ASC 842 for financial reporting until 2020. The first deadlines for non-public business entities are for companies with fiscal periods starting after December 15th, 2019. However, there are exceptions. For example, some private companies fall under the FASB's definition of a public business entity as they have publicly traded securities (e.g. debt) or requirements to be an SEC filer. Other private companies are planning initial public offerings or forms of public capital raising in the near future. Still others may be in the process of becoming a public entity if they are being acquired by a larger organization whose shares are already traded on a public exchange. Finally, there are a few that may have chosen to early adopt the leasing standard at the same time they transitioned to the new revenue recognition standard.

Which of the following best describes the current state of your lease accounting project?



Implementation in Progress

50%

Report Being "On Schedule" or "Ahead of Schedule," but Some Private Companies May be Underestimating the Level of Effort Required Remaining.

Approximately 50% of private companies indicated that they were either ahead of schedule or on schedule with their lease accounting projects. The responses are encouraging given that less than eleven months remained (at the time of the survey) until the initial implementation deadlines for private companies. A similar optimistic sentiment was offered by last year's survey respondents with 60% of both public and private companies indicating they were ahead or on schedule.

However, companies tend to overestimate their actual progress and underestimate the level of effort remaining to complete the project. At the time of publication of this study, hundreds of publicly traded companies are closing the books on their first quarter reporting under ASC 842. Very few of these public companies are indicating that the project is anywhere near complete even though they are a few months past the implementation deadline. Most are indicating that a concerted effort will continue to be required throughout most of 2019.

Implementation Not Started

25%

of Private Companies Have Not Started the Project, Lease Accounting Will be Important for Owners, Debtholders and Other Users of Financial Statements.

Almost 25% of companies indicated that they had not started the project, which is twice as many as we saw in last year's surveys. We suspect that the lease accounting project has a lower sense of urgency amongst private companies as these organizations are not under the spotlight of Wall Street analysts and quarterly earnings announcements. While some private entities have requirements to be an SEC filer, most private companies do not have the same level of visibility on their financial statements as public companies. As a result, most private companies do not have to worry about the scrutiny of large activist institutional investors, debt ratings agencies, or regulatory agencies. Nonetheless, private companies likely will commit a substantial effort towards their ASC 842 projects to ensure that their accounting satisfies the needs of private equity firms that may have considerable ownership stakes, debt holders that may have restrictive covenants, and banks that provide other credit facilities. All of these stakeholders rely upon accurate financial statements reported under US GAAP.

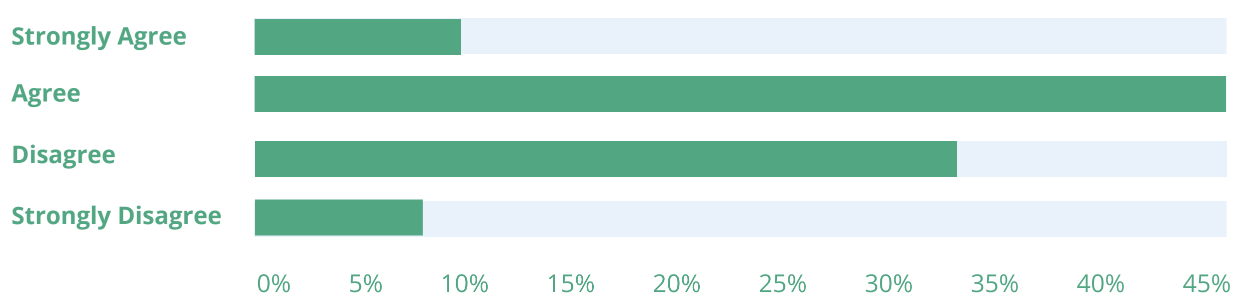
Level Of Implementation Complexity

75%

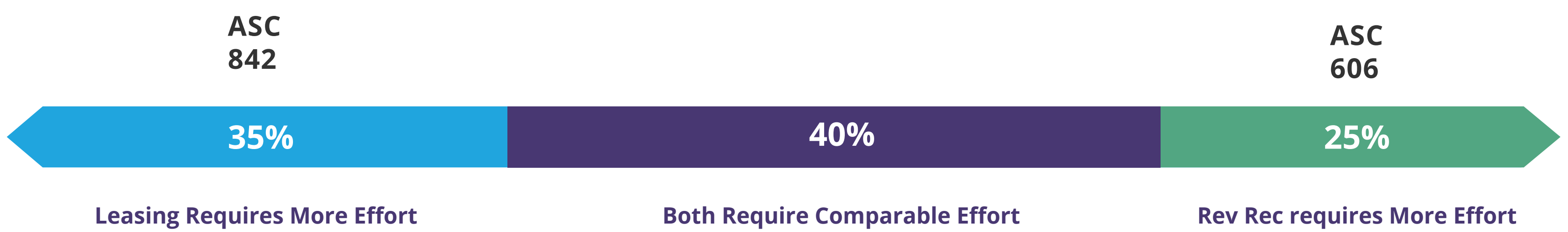
of Companies are Finding Lease Accounting (ASC 842) to be "As Complex" or "More Complex" Than the Recent Revenue Recognition (ASC 606) Changes.'

Almost, 25% of companies indicated that they had not started the project, which is twice as many as we saw in last year's surveys. We suspect that the lease accounting project has a lower sense of urgency amongst private companies as these organizations are not under the spotlight of Wall Street analysts and quarterly earnings announcements. While some private entities have requirements to be an SEC filer, most private companies do not have the same level of visibility on their financial statements as public companies. As a result, most private companies do not have to worry about the scrutiny of large activist institutional investors, debt ratings agencies, or regulatory agencies. Nonetheless, private companies likely will commit a substantial effort towards their ASC 842 projects to ensure that their accounting satisfies the needs of private equity firms that may have considerable ownership stakes, debt holders that may have restrictive covenants, and banks that provide other credit facilities. All of these stakeholders rely upon accurate financial statements reported under US GAAP.

Our lease accounting project is more complex than we originally anticipated?



How does the level of effort for lease accounting compare to the level of effort for revenue recognition?



The top implementation challenge cited by more than 40% of respondents was identifying the population of leases and abstracting the data needed for the accounting calculations.

Other top challenges included modifying existing business processes, project managing the enterprise-wide work effort, applying the new accounting policies, and upgrading software applications. In the remainder of the report, we will delve into greater detail on each of these five key areas of challenges.

The Accounting Challenge

Applying Asc 842 Accounting

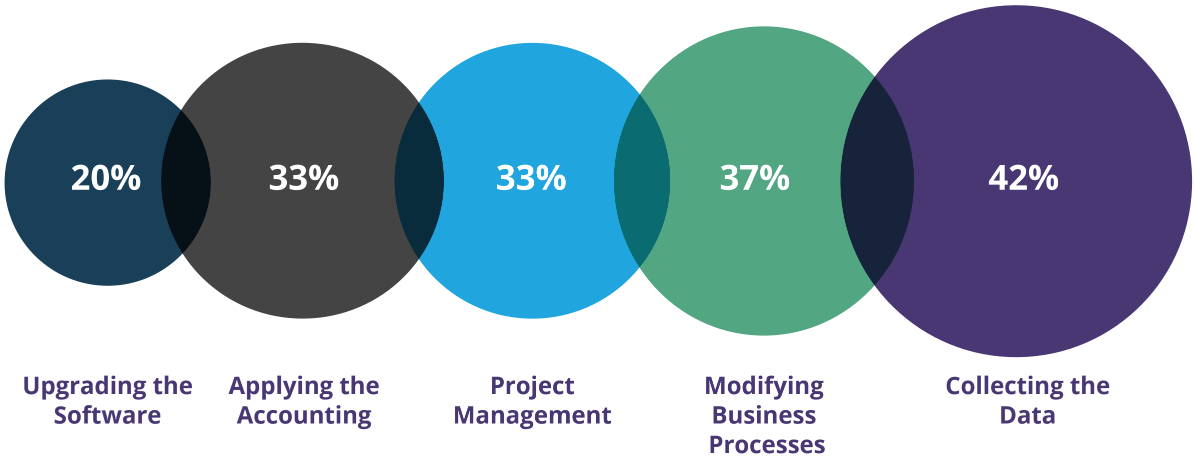
33%

of Companies are Finding Applying the ASC 842 Accounting Standards to be a Significant Challenge.

The new leasing standards represent a significant accounting change, arguably one of the biggest in history when you consider the $3 trillion worth of leases moving onto corporate balance sheets. However, most project leaders do not consider the application of the technical accounting principles to be the most complex aspect of the implementation. Only one third of private companies surveyed indicated that applying the accounting was posing a significant implementation challenge.

Although the accounting may not be as challenging as data collection or process design, there are definitely areas that project teams are struggling with such as embedded leases, discount rates, and sublease arrangements.

Which of the followign do you view as posing a significant implementation challenge?*



*Multiple responses accepted

Embedded Leases

One of the Key Challenges is Identifying Embedded Leases That May be Present in Outsourcing and Service Contracts Historically Not Considered Leases.

One of the most commonly cited accounting challenges is testing contracts to determine if they meet FASB's definition of a lease. Under ASC 842, many contracts that a banker or a lawyer may not consider a lease are considered leases for accounting purposes. Some outsourcing and service contracts may contain "embedded leases" that need to be reported as right-of-use assets and liabilities on the balance sheet. For example, a consumer products brand might outsource production of its products to a contract manufacturer. Under certain circumstances, the factories, machinery, and equipment used by the contract manufacturer may be considered embedded leases. Similar leased assets might be found in IT outsourcing contracts, third party logistics contracts, and billboard advertising contracts. To comply with the standards, project teams must review contracts and then perform a complex series of assessments to determine if there is an identified asset within the contract, the scope of the customer's right to use the asset, and the types of economic benefits the customer obtains from the asset.

Contract Manufacturing

IT Outsourcing

Third Party Logistics

Billboard Advertising

Subleases

Many Companies are Finding That They are Not Only Lessees, but Also Lessors Due to Subtenant Arrangements in Real Estate Contracts.

Most public and private companies are approaching the project initially as a lessee (or end user of leased assets). However, many are finding when analyzing their lease portfolios that they are also a lessor. Companies with relatively large real estate portfolios often encounter situations where they occupy too much space in a building. A typical example is consolidating office space following a merger or acquisition. In these scenarios, the company may have signed a long-term lease for the building for which it must pay rent regardless of the occupancy levels. To recover some of the costs, the company will often sublease space to another tenant. However, the sublease creates a situation in which the company then effectively becomes a landlord and a lessor for accounting purposes. As a result, the company must now adopt ASC 842 principles for lessor accounting, which could require additional systems changes as well as new policies and controls.

Discount Rates

Identifying the Discount Rates to Use in Accounting Calculations is One of the Top Challenges.

One of the biggest challenges for many public companies has been determining the discount rates to use in accounting calculations. Few, if any, leasing companies share the financing rates used for their products in an effort to mask the level of profitability they are realizing. As a result, most companies will need to use incremental borrowing rates (IBRs) for their discount rates instead. In other words, the financing rate that would be needed to acquire a similar asset. Determining the appropriate IBR is challenging for organizations as some companies that lease extensively may not have any debt to use as a reference point. Even those that do have debt may not have the kind of secured debt backed by fixed assets that would be required for a true comparison. As a result, project teams will have go through a complex process considering a mix of variables including government bonds, yield curves (think LIBOR), lease term, and the economic environment.

Learning From Public Companies

Private Companies Will Benefit From an Additional Year to Adopt ASC 842 by Learning From the Disclosures, Audits, and Reviews of Public Companies Who Have Already Adopted.

The good news is that private companies should benefit from the experiences of public companies who are one year ahead of them in the lease accounting journey. Throughout 2019 and 2020, as private companies go through their implementation projects, they will have the benefit of being able to consult public SEC filings for their peer group to see real-world examples of quantitative and qualitative disclosures. Most 2018 filings from public companies included comments on the materiality of impacts to the balance sheet, income statement, and cash flow statements in SAB 74 disclosures and the Management Discussion & Analysis of annual reports. Throughout 2019, a rich set of examples will be published in 10-Qs and 10-Ks for private companies to study. SEC comment letters and additional revisions to ASC 842 by the FASB will also provide clarity on how to apply the principles in the standard.

Some companies will likely begin to take proactive measures to simplify their lease accounting. Some will rewrite policies to de-scope entire asset categories or individual leases whose dollar values fall below certain thresholds. Others will begin to renegotiate leasing contracts with vendors upon renewal to eliminate certain pricing structures and terms that drive complexity in the accounting. A handful of pioneers have standardized their leasing contracts with a consistent set of terms for all commercial banks, vendor captives, and independent equipment finance vendors. Contract standardization reduces the time to process a lease and lowers outside counsel fees. It can also reduce accounting complexity by ensuring that the pricing structures and terms that drive complexity are eliminated across the portfolio.

The Data Challenge

Taking An Enterprise-Wide Inventory Of Leases

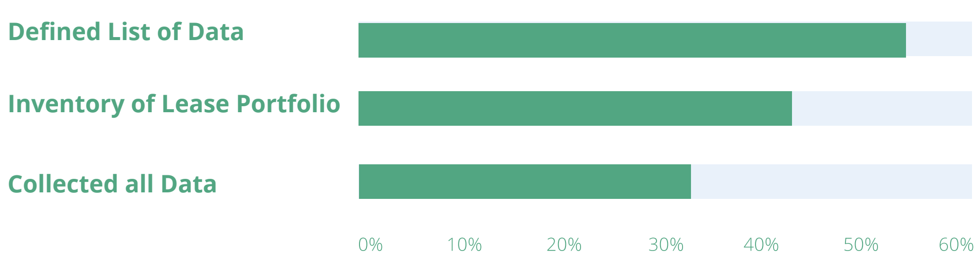
50%

of All Private Companies Have Completed an Inventory of Their Lease Population and One Third Have Begun the Data Collection Process.

For the third year in a row, data collection was cited as the most significant implementation challenge for lease accounting. Historically, most companies have not tracked their leases or the associated data in a centralized system. The best leasing data is often found in real estate administration systems that store details such as monthly rent, renewal date, and square footage for office buildings, retail stores, or industrial properties. Beyond the real estate system, what little leasing data does exist usually is scattered across the enterprise in various procurement, asset management, and financial applications. At most companies, the only reliable source of data for leases is the accounts payable system. And the only field that can be consistently relied upon to be accurate is the payment amount. As a result, a significant undertaking is required to track down the leases and abstract the necessary data.

Approximately, one third of survey respondents indicated that they had completed the data collection effort. The process typically takes between one to three months. The first step is usually to take an enterprise-wide census of the lease population. For most companies, this is a relatively low-tech process accomplished via email surveys and manual reconciliations between systems. There has been much hype about the promise of electronic discovery technologies, which could potentially crawl through the enterprise content systems and file shares to "automagically" identify leases. However, in practice there have been few examples of success with this approach. Although many assets are tagged electronically with RFID tags, sensors, or other industrial Internet technologies, there are few if any real-world case studies of utilizing these newfound technologies to inventory the lease population.

How far have you progressed in collecting your lease accounting data?



Follow The Money

Most Companies Are Finding That The Best Place To Start Identifying Leases Is Reviewing The Disbursement Activity In Accounts Payable Systems.

Instead, most companies start by tracing the money trail. With no centralized leasing system to query, lease accounting project teams start with their accounts payable records. A list of the past twelve months of disbursements can be reviewed to identify patterns such as recurring payments or other expense profiles that might resemble a lease. Armed with a list of lease candidates, the project team then consults the business sponsors who approve the invoice payments to gather more specifics about the line items being billed under each contract. The output of the process is a confirmed list of leases, which is then presented to the procurement, treasury, and legal teams for assistance with locating the associated contracts, purchase orders, and supporting documentation.

Ensuring Completeness

Ensuring Completeness Of The Lease Population Will Be A Significant Challenge Both Before And After Adoption.

Auditors have stated that the completeness of the lease population will be a significant focus of year one reviews. As a result, most companies are not simply relying on the accounts payable disbursements as a definitive source for identifying all leases. Project teams are cross-checking the list discovered from payment transactions with records in various asset management systems for real estate, vehicle fleets, and IT management. Some teams are getting more creative in their quest for completeness. For example, one food manufacturer is reviewing maintenance records on forklifts and trucks to ensure that all leased equipment assets have been identified. An advertising conglomerate is reviewing commercial insurance policy records to ensure that all of its company cars under lease have been identified.

Identifying The Data To Be Collected

100+

Different Data Elements May Need To Be Collected For Each Leased Asset And Some Are Not Documented Anywhere.

Once the universe of leases is identified, project teams will confront another challenge as they attempt to collect the data necessary to perform the accounting. For most companies, over 100 different data elements will need to be collected for each individual asset being leased. Examples include:

- Base and variable rent
- Payment frequency and timing
- Contract options and clauses
- Estimated residual values

At public companies, obtaining the list of data attributes necessary to perform the accounting was a significant challenge. Project teams had to dig through FASB's 200-page ASC 842 standard to identify all the attributes used in calculations. By the time most private companies begin the bulk of their data collection efforts in the second half of 2019, the list of required data attributes should be well-understood. Some of the data required is not actually on the leasing contract but will have to be identified by interviewing the stakeholders responsible for the assets. For example, the new lease accounting standard requires an estimate of the "reasonably certain" holding period for real estate and equipment leases. These details often are best sourced from the line-of-business manager charged with making decisions about the plans for renewing or terminating a lease at end of term.

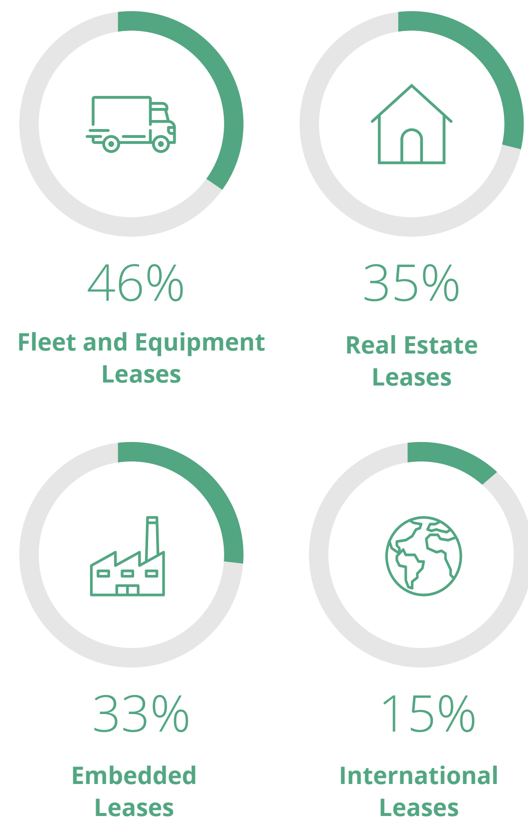
It, Fleet, Plant, Machinery, And Equipment Data

Finding And Analyzing Equipment Leases Is More Challenging Than Real Estate Leases.

Data about IT, fleet, plant, machinery, and other equipment leases is proving most challenging to locate as indicated by just under 50% of survey respondents. The ownership for equipment leases is distributed across a large number of stakeholders and the data is typically fragmented across a number of different asset management systems and spreadsheets. Therefore, project teams must go on what effectively amounts to a scavenger hunt to collect all the data from various teams, records, and systems across the business.

The complexity is compounded by the fact that many companies rely on external service providers and outsourcers to manage some of their IT, fleet, and other equipment assets. As a result, the system of record might be an external application managed by a third-party vendor. Although the dependency on an external vendor for data might create a challenge during implementation, we expect it will prove to be a benefit in the long term. As outsourcing and leasing companies gain more experience with their customer's accounting requirements, they will start bundling documentation and data sets into their service offerings. Fleet vendors will begin to send a monthly report of all the vehicles being leased along with all the necessary data attributes for easy upload into the accounting system. IT outsourcing vendors will send a report with all the desktop, network, and data center assets.

Which of the following categories of leases are proving the most challenging to find and analyze?



Real Estate Data

Lease Accounting Requires A Broader Set Of Data Than Has Traditionally Been Captured In Real Estate Administration Systems.

In theory, locating data for buildings and land should be relatively straightforward as most large companies have a dedicated real estate administration system. However, the survey data indicates that more than one third of private companies are encountering challenges finding and analyzing real estate leases. Although companies do have real estate systems, the information about leasing contracts is often incomplete or out-of-date. Lease data is entered into the real estate system following contract signature, but is rarely kept up-to-date as rent adjustments, floor space expansions, end of lease renewals, or other modifications are made to the lease. Even if the real estate system is properly updated, the new lease accounting standards require a broader set of information to perform the calculations than most facilities teams have historically tracked. For example, to perform the accounting, companies need to know not only that a monthly rent payment changed, but also the reason why it changed. Accountants need to know not only what the contractual end date for an office lease is, but also whether the business is reasonably certain that it will renew (or terminate) the lease at the end of term.

Embedded Leases

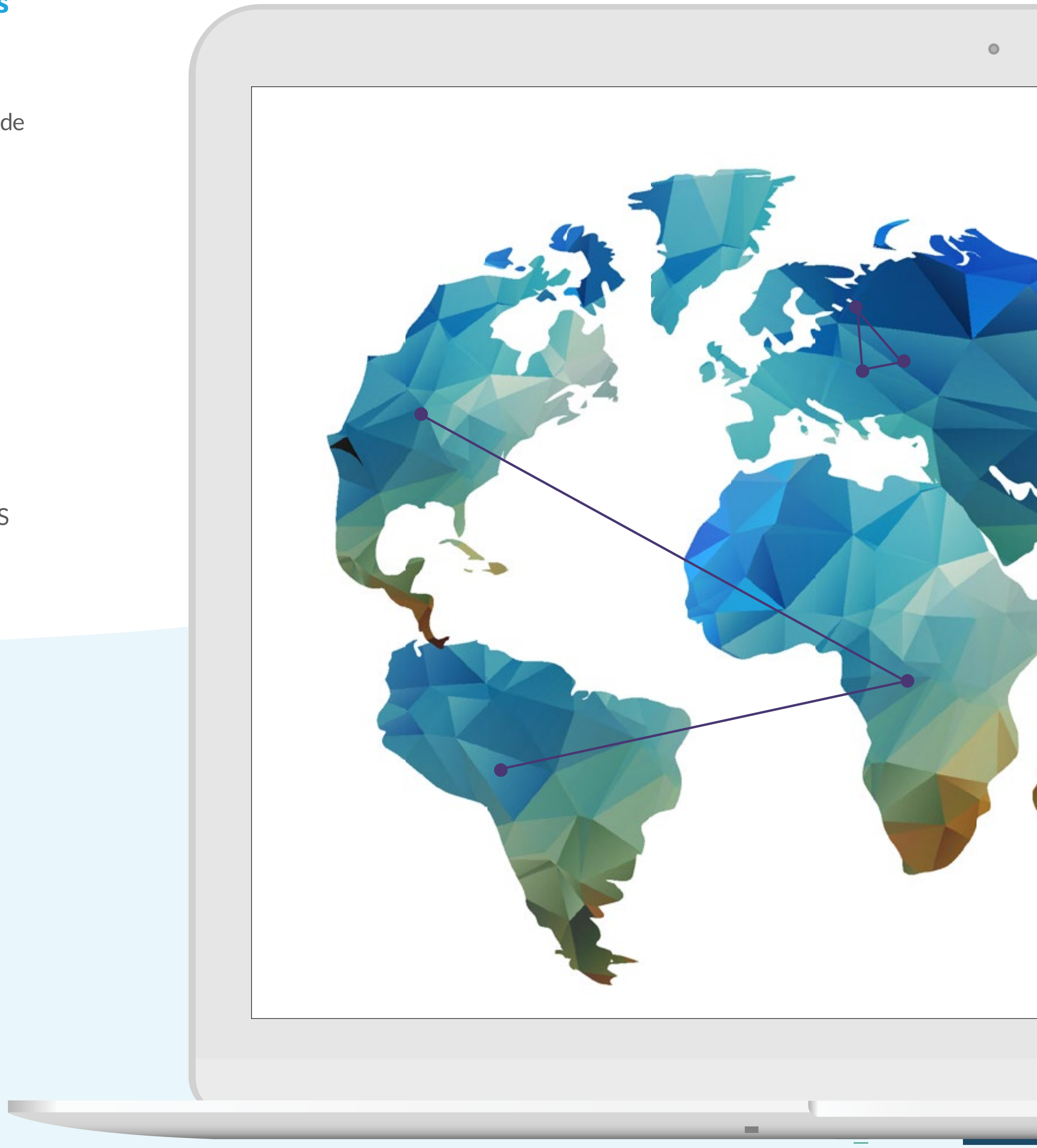
Some project teams are spending significant times reviewing contracts for evidence of embedded leases.

In our prior surveys, embedded leases have been cited as the most challenging to find and analyze. However, less than one third of private companies surveyed this year are finding challenges with this category. This could be because many companies have not yet reached the stage of the project at which embedded leases become problematic. Project teams will eventually need to identify the population of outsourcing and service agreements that exist with vendors performing services such as contract manufacturing, third party logistics, and data center outsourcing. Finding the legal documents for these contracts is far less challenging than analyzing them. No artificial intelligence or automated data abstraction tools have been invented to scan these contracts for evidence of implicit assets. Instead, project teams will need to rely on contract analysts to manually review each agreement and follow FASB's flow chart for identifying whether an embedded asset meets the definition of a lease. However, the struggle to identify embedded leases will likely become less challenging in upcoming years. Accounting organizations are teaming up with procurement groups to rewrite these service contracts as they come up for renewal with new terms that ensure they will not meet FASB's definition of a lease.

International Leases

International Leases Are Presenting Challenges With Language Translation, Currencies, And Terminology To Some Project Teams.

The complexities of finding and analyzing leases only grow in magnitude with international leases. First, the term “lease” carries a different definition in many different countries. Project teams are finding that South American counterparts will indicate that they do not lease any assets, but they do rent quite a few. Once the language barriers are overcome, project teams will need to overcome the hurdles of analyzing contracts in foreign languages with local currencies. In some cases, the local country finance teams will be tasked with abstracting the necessary data from these leases. In other cases, the leases may be translated (often by Google Translate) and analyzed by the headquarters project team. The issues with gathering data from international leases will become less problematic as regional finance teams come to better understand their local lease portfolios with IFRS 16 adoption.



The Process Challenge

Leasing As A Business Process

Future State Design Is Proving To Be A Significant Challenge As Most Companies Historically Have Not Developed Standardized Procure-To-Pay Or Record-To-Report Processes For Leased Assets.

The second most significant challenge cited by almost 40% of survey respondents was the need to modify business processes which is encouraging for several reasons.

Historically, most companies have not viewed leasing as a business process. Instead it has been viewed by most as a financing mechanism or an accounts payable activity. While many companies have standardized their corporate real estate processes, few companies have identified formal business processes for the acquire-to-dispose lifecycle of IT, fleet, machinery, and all the other equipment they lease. Going forward, success with financial reporting will demand a more formalized record-to-report process.

In fact, modifying business processes will be the most critical success factor for maintaining accurate lease accounting on Day Two and beyond. Companies will need to develop processes, policies, and controls to track changes to the lease portfolio. Specifically, accounting organizations will need to be informed of:

New Leases – Many companies are instituting controls to ensure accounting teams are notified in advance of contract signatures for new equipment and real estate leases. Accounting teams will also need to review service contracts and outsourcing arrangements that may qualify as embedded leases. Sale-leaseback transactions and subleases will also need to be flagged to perform the appropriate accounting.

Lease Changes - The new standards require modifications, reassessments, and re-measurements when certain triggers and conditions are satisfied. As a result, accounting teams will need to be informed of changes to variable rent payments; floor space expansions; early terminations; and lost, stolen, or damaged property that might result in impairments.

Expiring Leases - Accounting teams will need more timely reporting on decisions related to end-of-term renewals, buyouts, and terminations of leased assets. To perform the proper accounting, companies will need to identify not only when a renewal of a contract is performed, but also when the business stakeholder changes their plans about whether they plan to renew a contract.

New Policies And Controls

With Leases Moving On Balance Sheet, Private Companies Will Need To Establish Stronger Financial Controls To Ensure The Accuracy And Completeness Of Their Accounting.

To ensure that these changes to the lease portfolio are being identified, accounting teams are enacting new financial controls. For example, many companies are considering instituting lease versus buy analysis policies that would provide early identification of any lease candidates in advance of a contract signature. Others are putting periodic attestation processes in place to regularly survey the user community about the existence, status, and planned holding periods for leased assets.

Even post-adoption, public companies continue to struggle with instituting processes, policies, and controls for their leasing programs. The challenges stem from not only the historical lack of focus on management of the lease lifecycle, but also the highly decentralized nature of the organizations involved in the processes. Over the next few years, the financial advisory firms will begin to publish maturity models for leasing processes. Best-in-class organizations will begin to measure KPIs and metrics for leasing processes such as the number of reconciliations required during the close period and the percentage of end-of-term events recorded on time.

SECTION 6

The Systems Challenge

Spreadsheets

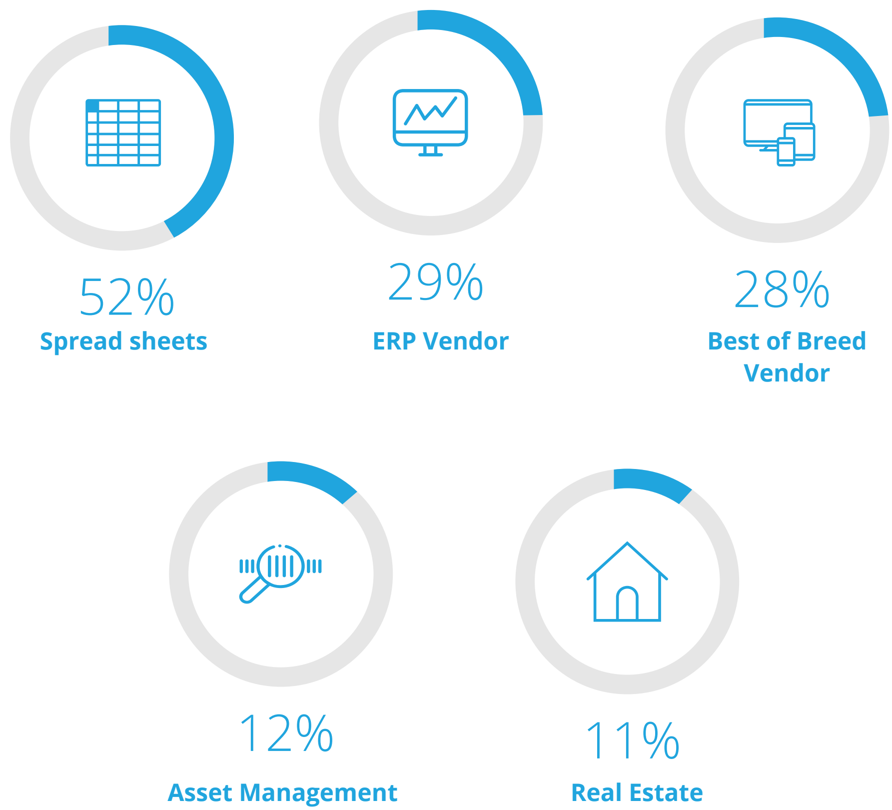
50%

Of Companies Are Planning To Use Spreadsheets As Part Of Their ASC 842 Systems Strategy.

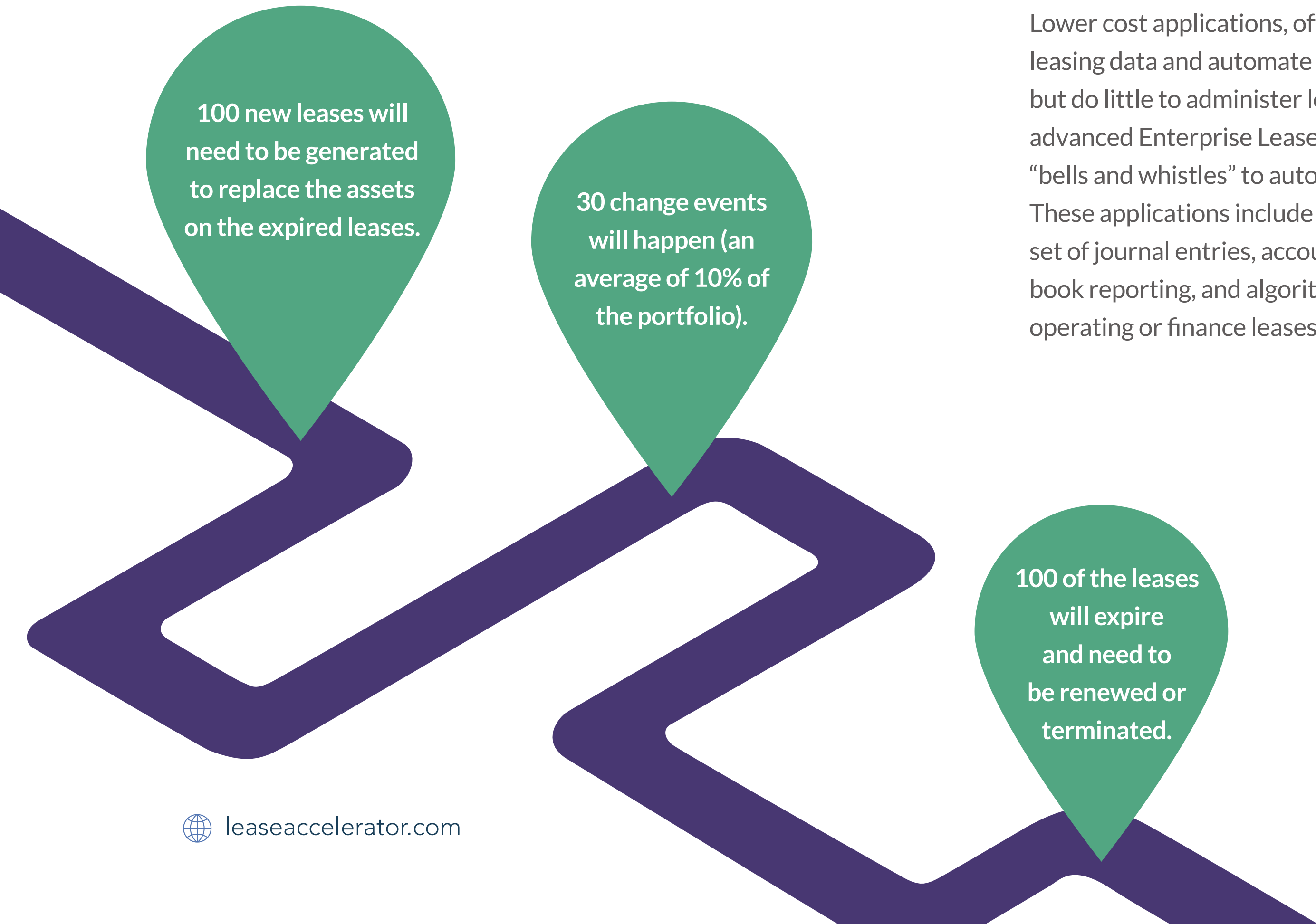
20%

of private companies viewed software upgrades as a significant implementation challenge which is a much lower level of concern than expressed by respondents in prior surveys. The lack of concern is likely correlated with the view that more than half are planning to continue using spreadsheets for lease accounting. While spreadsheets are fast and easy to implement, they often present challenges in audits and ongoing operations. Spreadsheets are often criticized for having weak version control, poor functional testing, and frequent calculation errors.

What approach will you take to implement the new lease accounting standards?



However, the biggest challenges with using spreadsheets, emails, and manual processes for lease accounting may not be with the calculations, but rather with the need to track changes to the lease portfolio on Day Two and beyond. For example, a portfolio of 300 leases with an average term of 3 years will have an average of 230 events occur within a single fiscal year:



Tracking all of these changes manually across a broad range of stakeholders will be quite a challenge even for highly organized accountants.

The focus on spreadsheets differs considerably from public companies, most of which have elected to purchase a specialized lease accounting application to support the new standards. There are over 25 vendors offering the applications in the newly formed lease accounting category, representing a wide range of functionality and price points.

Lower cost applications, often called "spreadsheets on steroids," centralize leasing data and automate the core calculations required for ASC 842, but do little to administer leases or handle complex use cases. More advanced Enterprise Lease Accounting applications come with additional "bells and whistles" to automate the full record-to-report lifecycle. These applications include dedicated subledgers that track a complete set of journal entries, accounting engines that perform multiple set-of-book reporting, and algorithms that automatically classify contracts as operating or finance leases.

A Maturing Software Market

Private Companies Will Benefit From The Additional Year To Adopt ASC 842, By Gaining Access To More Mature Software Products That Have Been Tested In Real-World Scenarios With Public Companies.

Although most public companies elected to purchase specialized lease accounting software packages, many have experienced considerable challenges during implementation. Described by many customers as “Public Betas” and “version 1.0” software releases, these applications were rushed to market often with incomplete functionality. Many companies that historically focused on the real estate sector lacked functionality for equipment leases and asset-level journal entries. Others were primarily designed for ASC 842 and could not report in IFRS or frozen GAAP (ASC 840). Some handled lessee scenarios well but were not able to accommodate subleases or intracompany transactions that required lessor accounting. As a result, many public companies needed to use spreadsheets and manual processes to close their books during the first few months post-adoption.

Just as significant as the functionality challenges were the lack of support services available from many vendors. Some vendors lacked any end-user documentation or training, forcing corporate IT departments to develop their own curriculum of learning materials for the vendor products. Other vendors lacked quality assurance processes, forcing the customers to perform testing on new code releases that were pushed to production. Others struggled with performance tuning issues that slowed down test environments and frustrated users.

The root cause of the issues is that, with a few exceptions, most lease accounting software vendors did not start developing their applications until after the publication of ASC 842 in February 2016. To compound the challenges, most of the lease “accounting” vendors had relatively little experience with accounting prior to 2016. Instead, they came from the real estate or human resources sectors. Not only did these vendors have to climb the learning curve with ASC 842 and IFRS 16, they also had to hire a new layer of personnel in their product development, customer support, and professional services teams with finance and accounting experience.

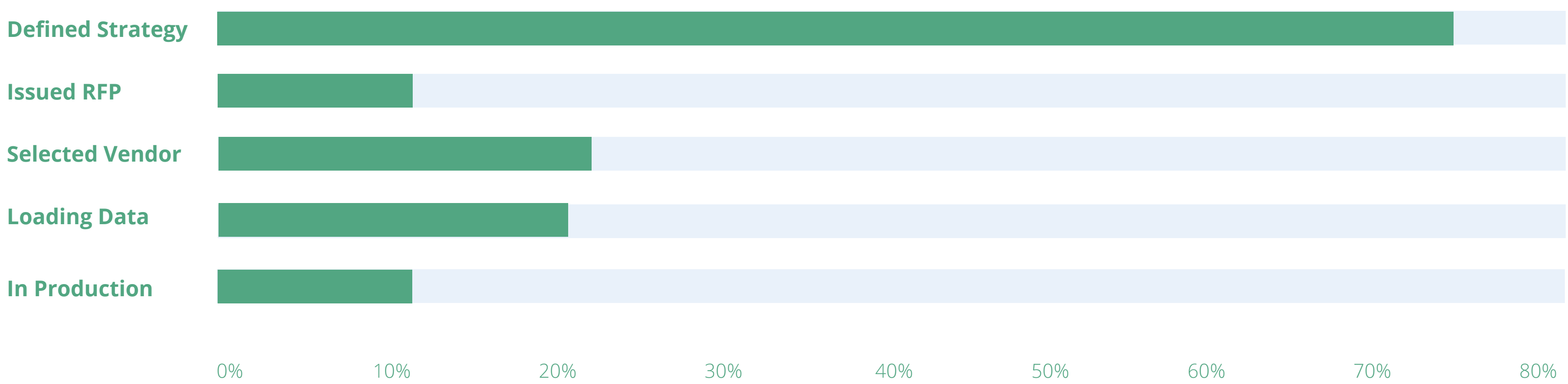
The good news is that by the time most private company software implementations “go live” in late 2019, the lease accounting software applications should have reached a much higher level of maturity. Real-world testing of a broader set of use cases with public companies will help to ensure complete functionality is available to most private companies. Furthermore, with each passing month there is a larger and larger community of experienced professionals at Big Four and financial advisory firms that know how to implement these software packages. These firms can not only make recommendations about which software vendors are the best fit for a particular type of lease portfolio, but also accelerate the implementation process with trained consultants who have already deployed the applications for other clients.

Status Of Software Implementations

Most Private Companies Are Still In The Early Stages Of Their System Strategies With Just Over 20% Having Selected A Lease Accounting Software Package.

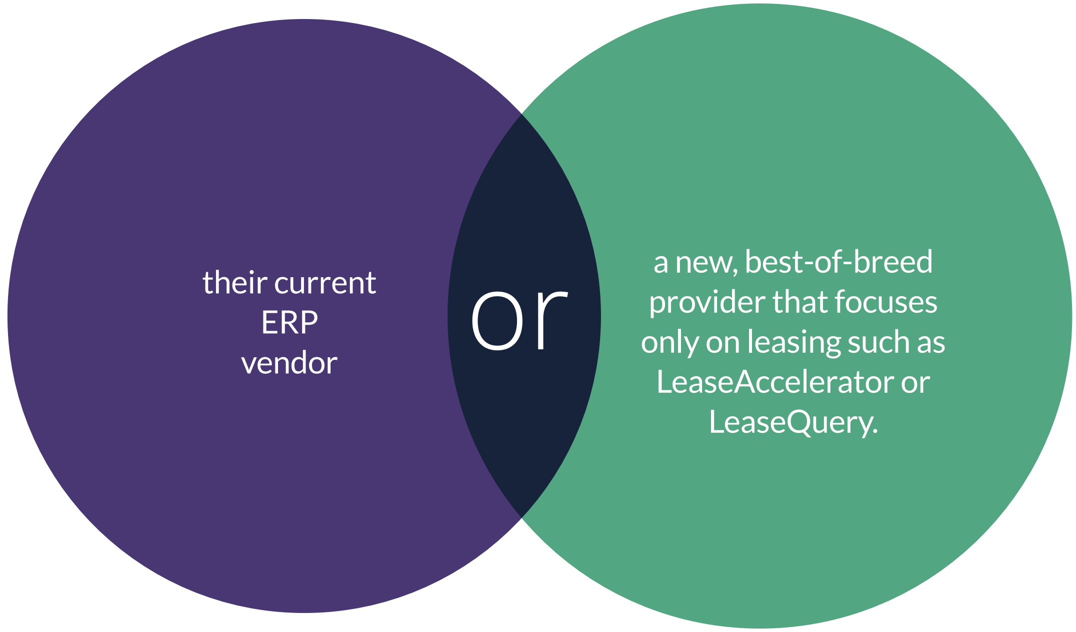
Most companies are still early on in the systems aspect of the project. However, there are exceptions. Approximately 10% of private companies have lease accounting software in production which correlates closely with the number of companies indicating they have completed the project.

How far have you progressed in collecting your lease accounting software strategy?



20%

have already selected a vendor, many without going through a formal RFP process. Amongst private companies, the highest concentrations
are planning to buy from either:



SAP has introduced several lease accounting solutions both from its own product portfolio and in conjunction with its partner network. Oracle recently announced a new offering. Additionally, legacy products owned by Oracle, such as PeopleSoft and JD Edwards, each have a lease accounting module for their install base. At the time of publication, Microsoft, Infor, and Workday have not published any information about their strategy in the space.

Only approximately 10% of private companies plan to use their current real estate lease administration system vendor for lease accounting, perhaps because most of these players have not introduced a solution. Although there are over 20 well established integrated workplace management system and real estate administration vendors, only a handful, such as IBM Tririga and Planon, have made the leap to accounting. For companies whose leasing portfolios are primarily buildings and land, their existing real estate administration is a natural candidate to consider.

The Organizational Challenge

The Cross-Functional Project Team

Unlike Many Other Accounting Change Initiatives Which Could Be Managed Within The Four Walls Of The Controller's Organization, ASC 842 Will Require Participation From The Asset Users Across The Business And Many Corporate Functions.

The users and owners of leased assets span almost every function in the business.

Corporate IT owns laptops, servers, and data center leases.

Real estate owns buildings, factories, stores, and warehouse leases.

Logistics owns material handling, railcar, and ocean container leases.

Fleet owns company cars, service vehicles, and delivery van leases.

The organizations touching leases throughout their lifecycle represent almost every corporate function in the business:

Procurement runs the vendor selection process and negotiates the pricing and terms for new leases.

Treasury manages credit relationships with the lessors and insures the property.

Accounting owns invoice processing, sublease collections, and financial reporting.

Finance owns budgeting, planning, and forecasting.

Tax is responsible for state, local, and federal property obligations.

Other functions that need to understand leasing include:

Investor Relations which will communicate impact of new balance sheet assets and liabilities.

Human resources which will need to rewrite executive compensation programs impacted by the new financial metrics.

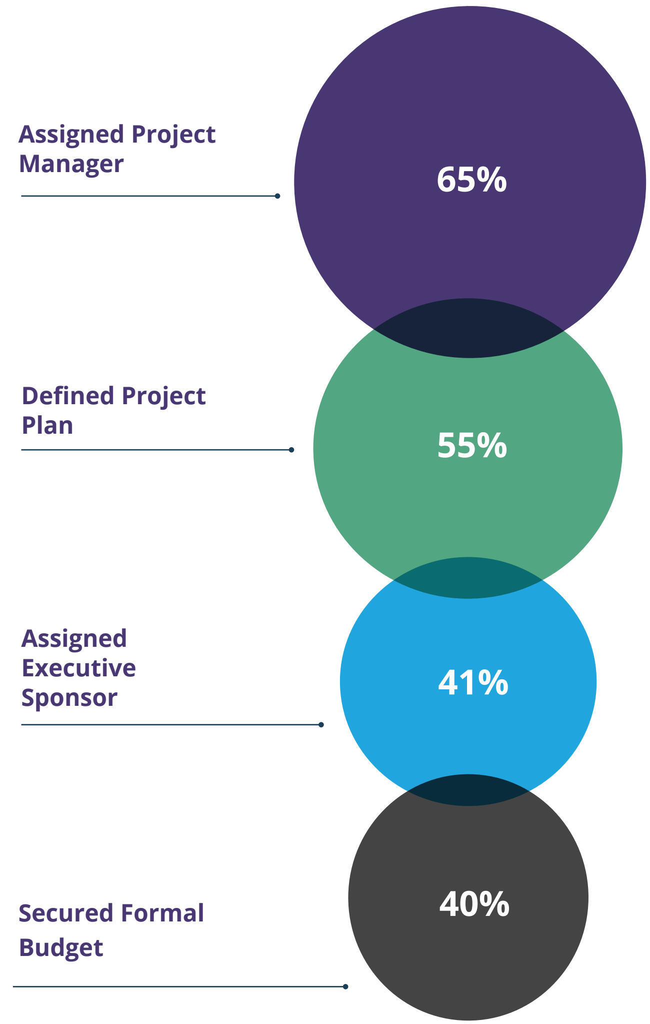
Internal audit which will review the policies, controls, and governance aspects of the compliance program.

Corporate development which will need to understand accounting implications for potential acquisitions.

Due to the breadth of business units and functions involved, an unusual set of project management challenges will emerge for accounting leaders who are not accustomed to typically driving transformational projects across the business. Not surprisingly, one third of the private companies we surveyed cited project management as a significant challenge for implementation.

To ensure success with this cross-enterprise initiative, companies are adopting best practices such as hiring a formal project manager, developing a formal project plan, and appointing executive sponsors.

Which of the followign steps have you completed in your lease accounting project?



Executive Sponsor

Many Private Companies Are Appointing An Executive Sponsor That Will Liaise With The Board And Help To Secure Budget, Resources, And Attention For The Project.

40%

of the private companies surveyed indicated that they had appointed a formal executive sponsor for the project. While the greatest volume of work will fall on the shoulders of the project manager and extended team, the executive sponsor will take on perhaps the most challenging tasks such as securing budget and resources. The sponsor will also provide updates to the senior management team, audit committee, and other stakeholders. At most companies, the chief accounting officer or controller will become the de facto executive sponsor. However, a handful of companies have enlisted the chief financial officer, treasurer, or chief operating officer as the lead.

Perhaps the greatest challenge for many executive sponsors will be soliciting the participation of the various organizations across the business. Success with both Day One compliance and Day Two operations will require participation from the teams that own the assets such as Real Estate, Corporate IT, Logistics, and Operations. Support from corporate functions such as Procurement, Treasury, Tax, and Finance will be required as well. Some of these organizations will be supporters of the project while others will passively resist changes to the additional policies, controls, and governance of the leasing program that will be required under ASC 842. It will be the executive sponsor's role to overcome these challenges.

Project Manager

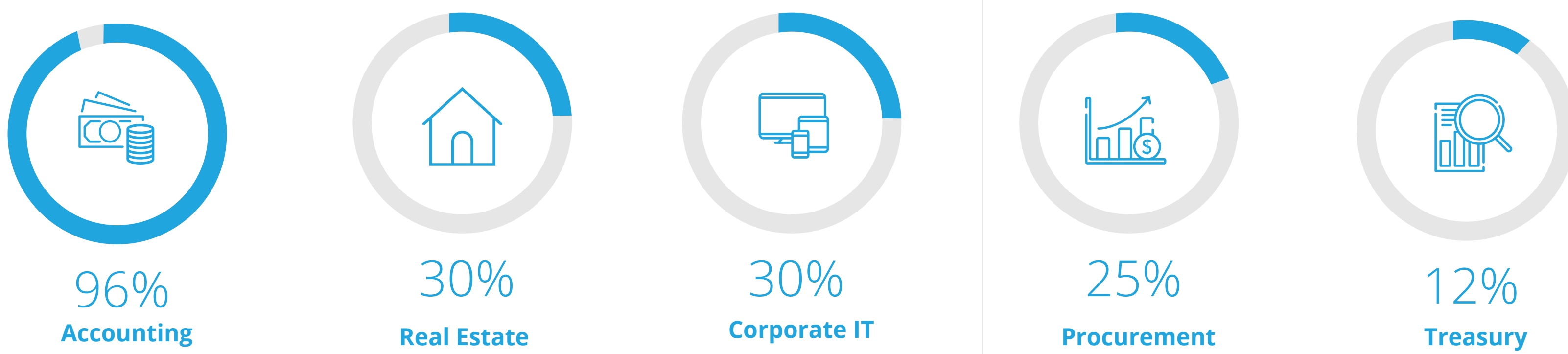
66%

Of Companies Have Appointed A Project Manager To Lead The Cross-Functional Work Effort.

Day-to-day leadership of the project is typically not performed by the executive sponsor, but by the project lead. Two thirds of the private companies surveyed have appointed a project manager. Arguably the most important person on the lease accounting team, the project manager will be responsible for managing key milestones, understanding project risks, and escalating potential showstoppers to the executive team. The best project managers will not only have strong leadership and teamwork skills, but also be well-versed in finance and accounting functions. Project managers will be immersed in discussions about incremental borrowing rates and guaranteed residuals so they should not be easily scared off by technical "accounting speak."

In addition to accounting, Real Estate and Corporate IT are the groups that most frequently play a strategic role in the lease accounting project.

Which of the following groups are playing a strategic role in your lease accounting project?



Real Estate's Role In The Project

Corporate Real Estate Teams Are Playing A Strategic Role In 30% Of Projects—Helping With Complex Transactions Such As Sale-Leasebacks, Build-To-Suit Arrangements, And Subleases To Other Tenants.

Corporate Real Estate is playing a strategic role at 30% of the private companies we surveyed. Real estate represents the largest asset category by dollar value at most companies. Therefore, it is natural for the corporate real estate team to not only have a seat at the table, but also demonstrate a leadership role in the project. In fact, participation will be critical for project teams to interpret the specifics of complex transactions such as sale-leasebacks, build-to-suit arrangements, and subleases to other tenants. Real estate leases also have variable rents that can be tied to inflation, union wages, or retail sales, which are handled differently in IFRS than US GAAP. Invoices often include landlord operating expenses and non-lease expenses which may need to be separated from rent to avoid inflating right-of-use assets and liabilities on the balance sheet.

IT's Role In The Project

Corporate IT Teams Are Playing A Strategic Role In 30% Of Projects—Helping With Systems Upgrades And New Software Implementations.

Since new systems typically have to be deployed to perform lease accounting, the Corporate IT organization is playing a strategic role at many companies. Although the accounting team may be the experts in the financial reporting requirements, IT organizations are responsible for the day-to-day operations of software, including lease accounting software. Approximately, 30% of the private companies we surveyed have involved IT in defining system requirements, evaluating vendors, and implementing software applications. We suspect this percentage will increase substantially as more companies progress further into the project lifecycle.

Procurement's Role In The Project

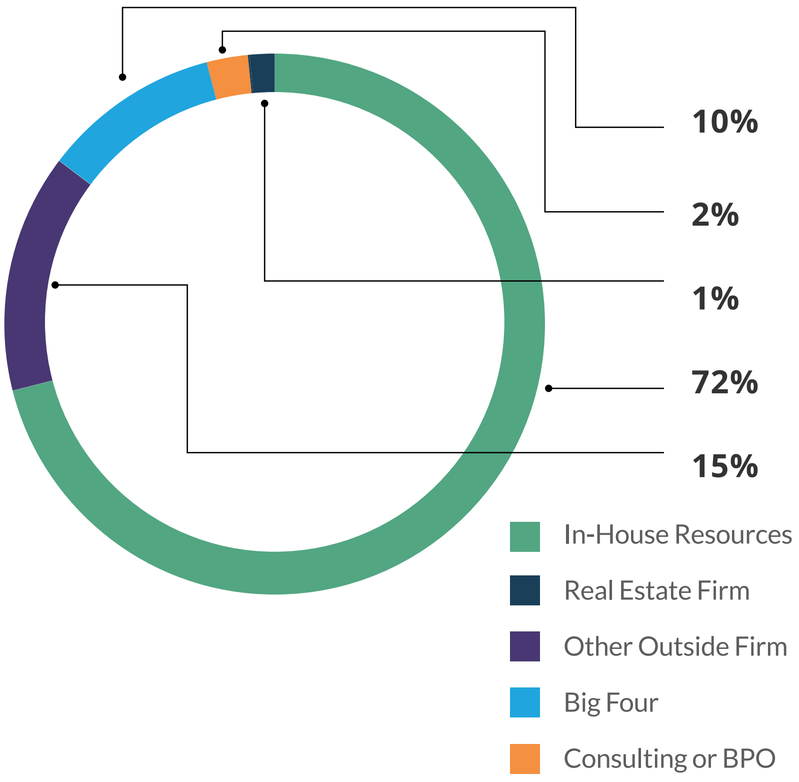
Procurement Is Playing A Strategic Role In 25% Of Projects, Typically With A Heavy Effort On Identifying Embedded Leases Contained Within Service Contracts And Outsourcing Arrangements.

Approximately 25% of private companies surveyed have the supply chain, procurement, or sourcing organizations playing a strategic role in the project. At most companies, Procurement is assisting in the identification and location of potential lease contracts, specifically embedded leases. The buyers who negotiated the agreements are in the best position to help dissect complex outsourcing contracts and service arrangements for potential right-of-use assets. Procurement will also need to play an active role on Day Two and beyond. The first step in any well-designed leasing contract workflow should be a procurement-initiated requisition for the asset. As the originator of all leases, Procurement is in an excellent position to ensure that Accounting remains aware of any new equipment and real estate leases as well as any contracts with embedded lease candidates.

External Resources

Most Private Companies Are Planning To Resource The Lease Accounting Project With Internal Staff Rather Than Consultants From Advisory And Technology Firms.

What approach will you take to impleneting the new lease accounting standards?



Given the shrinking time box companies are operating under, support from external resources may be just as important as internal stakeholder participation. The level of effort required to collect data, configure software, and modify business processes will require a significant number of resources with highly specialized skills sets. The challenges are multiplied by the relatively short time period remaining before the compliance deadline.

It's surprising to see that more than 70% of the private companies surveyed indicated that they had planned to implement the lease accounting project primarily with in-house resources. As private companies get further into the project lifecycle, many may rethink their resourcing strategies and make the proverbial "911 call" for external support.

Some have already engaged outside firms. Approximately 25% indicated that they were engaging a Big Four or financial advisory firm for support. Advisory practices of the major accounting firms can perform an initial diagnostic to assess the impacts of changes to financial statement metrics. Additionally, they can provide experts to help assess the current state of readiness, develop new financial controls, and advise on tax accounting strategies. All of the top ten accounting firms have lease accounting practices as do independent advisory firms such as RGP, Vaco, Armanino, Pine Hill, and others.

Relatively few companies have engaged a business process outsourcing (BPO) firm or real estate management services provider for assistance. The participation of these firms may grow substantially post-adoption. The finance and accounting practices of BPO firms, such as Genpact, Capgemini, and Accenture, would be excellent candidates to run an outsourced leasing center of excellence for private companies as they already perform the record-to-report, procure-to-pay, or order-to-cash functions at many of these companies. Companies with large real estate portfolios often outsource day-to-day management to CBRE, JLL, Cushman and Wakefield, or other IWMS. Lease accounting is a natural extension of the lease administration and facilities management functions that these firms already provide.

Additional Recommendations

Late-Stage Project Activities Can Present Risks

As indicated by the survey results, collecting data, implementing systems, applying accounting policies, and modifying business processes will be the largest work efforts required prior to Day One. However, there are many additional activities such as testing, training, and talent development that were not addressed in the survey. These "last mile" activities were not areas of focus for most public companies, but they emerged as major challenges in the last 90 days of the project. Private companies should get a head start on these activities to minimize late-stage project risks:

Test Planning Could Be Complex As There Are Potentially Over 100 Billion Combinations Of Lease Accounting Scenarios That Could Emerge.

There are over 100 billion combinations of use cases that can exist under ASC 842. Payments can be fixed or variable; paid in advance or arrears; due monthly, quarterly, or annually; and so on. At the end of term, the lease could be renewed, terminated, bought out, or automatically extended month-to-month. Project teams will need to develop test plans to ensure the accuracy of their accounting outputs for each of these different scenarios and others.

Few Companies Have Historically Maintained In-House Expertise In Leasing And Will Need A Concerted Effort To Recruit, Develop, And Retain Talent.

Most companies have few, if any, experts at lease accounting and administration. There has never been a reason to invest in building expertise until the publication of ASC 842. As a result, companies will need a strategy to train the business on processes, policies, controls, and systems required for accurate lease accounting. A combination of online and classroom training will be required with different levels of detail for various groups across the organization.

A substantial work effort will be required to maintain accurate and complete lease accounting beyond the deadline. Private companies will need to build small teams to manage the record-to-report cycle. Some are building centers of excellence specifically focused on administering and accounting for leases.

SECTION 9

Summary

The bulk of the focus on lease accounting readiness since FASB released the standard in early 2016 has been on public company implementations. With more than three quarters of public companies already past the effective date, the attention will now turn to private companies as they quickly approach their 2020 deadlines. In almost every area of project readiness, from data and systems to process change and project management, private companies are reporting a lower state of readiness than the survey population from last year.

As private companies race to meet the implementation deadline, they should be mindful not just of Day One considerations, but also of the need to set up scalable business processes for Day Two and beyond. Perhaps the biggest challenge for private companies will be tracking the ongoing changes to the lease portfolio. Each month new leases are being signed, expiring leases are being terminated or renewed, and existing leases are being modified. These changes will need to be promptly communicated to the accounting team before month-end close to ensure accurate calculations. Success with lease accounting will demand an enterprise-wide effort to regularly communicate changes to the portfolio across business units, corporate functions, and the accounting team.

About LeaseAccelerator

LeaseAccelerator offers the market-leading Software-as-a-Service (SaaS) solution for Enterprise Lease Accounting, enabling compliance with the current and new FASB and IFRS standards. Using LeaseAccelerator's proprietary Global Lease Accounting Engine, customers can apply the new standards to all types of leases including Real Estate, fleet, IT, and other equipment at an asset-level as required by FASB and IASB. On average, LeaseAccelerator's Sourcing and Management applications generate savings of 17 percent with smarter procurement and end-of-term management.

The 2019 Progress Report was produced sponsored by LeaseAccelerator and produced by the OPEX and Leasing Research Center to help financial controllers at private companies benchmark their progress towards adoption of ASC 842 against their peer group.