lease accounting

Market Readiness Two Years after the Publication of ASC 842

LEASING & OPEX RESEARCH CENTER

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LEASE ACCOUNTING PROGRESS REPORT 2018
EXECUTIVE SUMMARY

Two years have passed since the initial publication of the new ASC 842 Leases standard by the Financial Accounting Standards Board (FASB). In an effort to provide a quantitative progress report on the status of compliance efforts, LeaseAccelerator conducted a research study in late January 2018. Over 300 finance and accounting leaders from large US-based public and private companies were surveyed. A summary of the findings is outlined below:

KEY FINDINGS

Most Companies are On Track, but Prefer a One Year Extension

Two thirds of companies are on schedule or ahead of schedule with their lease accounting project, which is encouraging as the first implementation deadlines are approaching at the end of 2018. Only 6% indicated that they had completed the project. Approximately 60% of companies think that FASB should extend the compliance deadline with the majority seeking only a one-year delay. It seems the desire for additional time is not solely driven by the complexity of the ASC 842 standard, but rather the combined work effort required to comply with both the new leasing and revenue recognition standards in such close proximity.

Leasing Project More Complex than Revenue Recognition

As compared to the new revenue recognition accounting standards, 75% are finding the new leasing standards to be just as complex or more challenging. The top implementation challenge with leasing projects, cited by 50% of respondents, is finding and collecting the necessary data. Respondents also indicated that modifying business processes, policies, and controls; upgrading software applications; and project managing the overall work effort were also key implementation hurdles. Only 30% cited that the application of the accounting standards was proving to be a significant challenge. However, many suggested simplification or implementation relief for areas such as embedded leases, separating non-lease components, comparative reporting, and financial disclosures.

Embedded Leases are the Most Challenging to Analyze

Accounting organizations are finding embedded leases contained in service agreements with contract manufacturing, third party logistics, and data center outsourcing vendors to be the most challenging to find and analyze. Non-real estate leases such as IT, fleet, material handling, rail car, transportation, and other equipment leases are also proving challenging. More than half of companies have taken an inventory of their enterprise-wide lease portfolio. And 30% of companies are more than half way done with the data collection process.

Best of Breed Lease Accounting Software Applications Rising

More than one third of companies have now selected a software vendor to support the new lease accounting standards. For most companies, the historically-used, spreadsheet-based accounting approach will be replaced with a true enterprise application. Significant work remains for systems implementation as less than one third of companies have issued an RFP for lease accounting software. New, best-of-breed lease accounting vendors are the most popular option being considered. ERP and real estate administration vendors are also being widely considered.

Accounting is Taking a Formal Cross-Enterprise Role

Approximately, 80% have assigned a formal project manager from the accounting or financial reporting team to lead the initiative, which for many companies will be one of the largest accounting change initiatives in the past 50 years. Corporate Real Estate and IT are playing a strategic role in more than half of the projects. Almost two thirds of companies are planning to leverage in-house resources to complete the project. Less than 30% plan to utilize consultants from the Big Four, IT, or Business Process outsourcing organizations.

RECOMMENDATIONS

Hidden Challenges Remain for Many Project Teams

While companies are demonstrating meaningful progress in their lease accounting compliance efforts, many project teams have yet to reach the more challenging activities of the initiative. The data collection effort, not the accounting, will be the most time-consuming aspect of the project. In most cases, data will need to be collected manually by studying leasing contracts, reviewing purchase orders, and interviewing asset users. Even data sourced from enterprise systems, such as real estate administration, will need to be cleansed, reconciled, and enriched to perform the accounting. Evaluating and selecting a software application will present new challenges. Only a few vendors have mature applications that have been tested in real-world scenarios. As a result, many companies may have to undertake manual workarounds to complete the accounting until vendor product roadmaps are completed.

Take a Formal Project Management Approach

ASC 842 is more complex than most accounting change projects. The scope cannot be limited to within the four walls of the controller's organization. Participation from the day-to-day users of the leased assets, including Real Estate, Corporate IT, Fleet, Operations, and Logistics, will be required along with support from corporate functions such as Treasury, Procurement, and Accounts Payable. To mitigate the risk of project delays, we encourage accounting organizations to appoint a formal executive sponsor who will seek out budget and resource commitments across the business. We also encourage companies to assign a dedicated project manager who manages activities from a formal project plan.

Plan for Day Two and Beyond

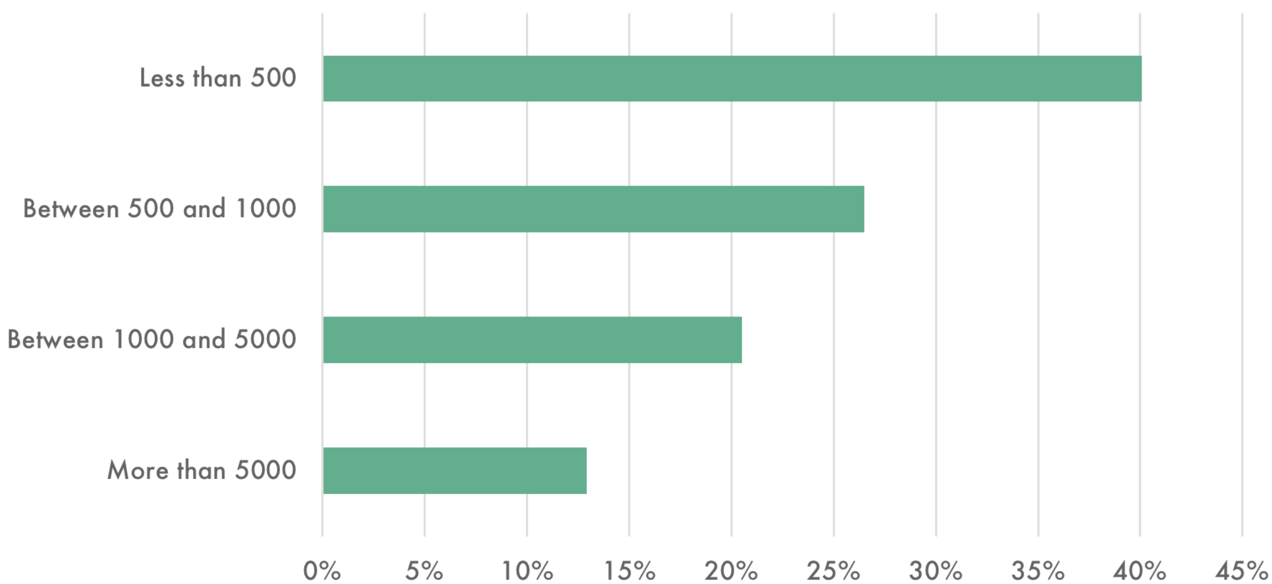
Most project teams are focused on simply complying with the new implementation deadlines. However, another set of challenges await accounting organizations on day two and beyond. Success with lease accounting will demand that companies get visibility into all new leases being signed across the business as well as the many different events that can occur within the term of a contract. Variable rent changes, equipment location changes, cost center changes, mid-term buyouts, and end-of-term renewals are just a few examples. Project teams should implement long-term business processes, policies, and controls to ensure that their lease accounting remains accurate after day one. Success will require commitment and partnerships with functions such as Procurement, Treasury, Real Estate, Corporate IT, and Operations.

RESEARCH REPORT
SURVEY DEMOGRAPHICS

The survey was conducted in January 2018 just a few weeks prior to the two-year anniversary of FASB's publication of ASC 842 (February 25, 2016). The respondents consisted of over 300 senior leaders from finance and accounting organizations at large private and public companies. Most came from companies with more than $1 Billion in annual revenues. Each of the survey participants was asked to answer 15 multiple choice questions. An incentive of a $5 online gift card was offered.

The respondents represented a diverse range of leasing portfolios - both large and small. Approximately 40% of respondents had a relatively small leasing portfolio with fewer than 500 total leases across their organization. Less than 15% had a very large leasing portfolio with more than 5000 total leases.

How many total leases do you have across your business?

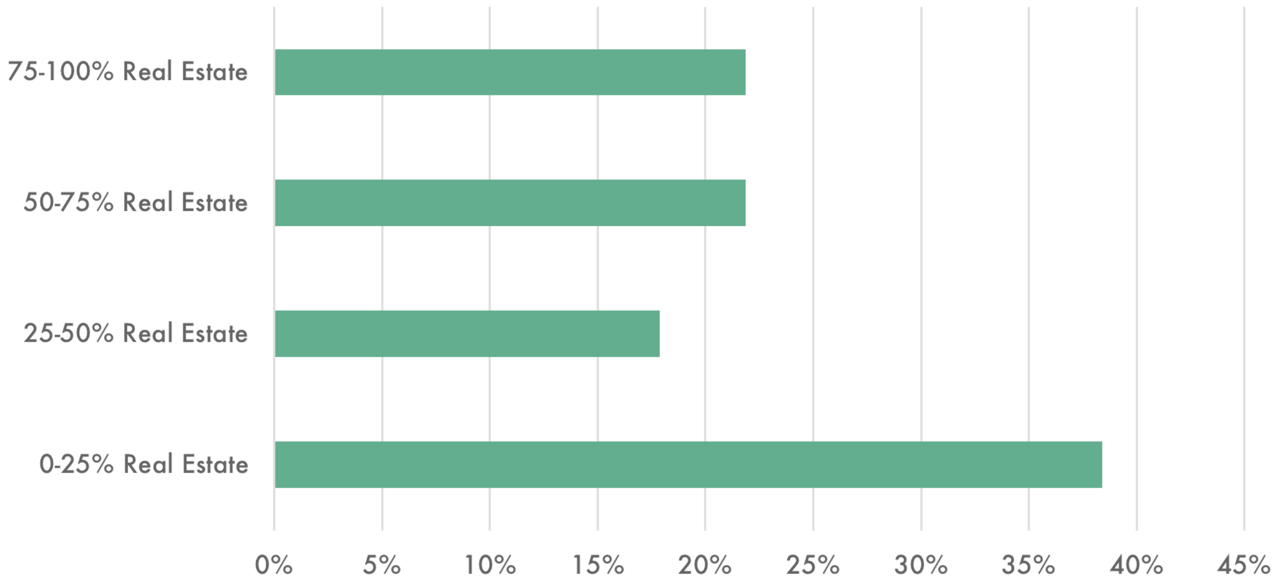


The question "how many leases do you have?" is a difficult one for many companies to answer. Under the current accounting standards, companies are required to report the total contractual obligations for their leasing portfolio. However, companies were never required to have an exact count of their leasing contracts. Large, multinational organizations have leases for a wide variety of assets including land, buildings, computers, furniture, forklifts, photocopiers, servers, trucks, rail cars, shipping containers, and aircraft. These leases are signed by managers in countries throughout Europe, Asia Pacific, and North and South America. As a result, it is not uncommon for companies to underestimate their lease population by hundreds if not thousands of leases.

One of the key benefits of the lease accounting project will be the identification of the complete population of leases across the enterprise and the tracking of all contracts in a single, centralized repository.

The composition of the lease portfolios from survey respondents was fairly diverse as well. Approximately, 60% of respondents lease a mix of different asset types including real estate, IT, fleet, and other types of equipment leases.

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



MEASURING LEASE PORTFOLIO SIZE

The size of a leasing portfolio can be measured by either the total dollar value of the lease obligations or the number of leasing contracts. When considering the new lease accounting standards, we believe that the number of contracts is often a better metric to measure the complexity of a corporate leasing portfolio and the additional compliance burden.

For example, consider two multi-billion dollar companies each with a $500M portfolio of leases.

Suppose the first company is a large retailer whose $500M in leasing obligations are concentrated in few hundred real estate leases for big box stores. Obtaining and maintaining the information necessary to comply with the ASC 842 standard will not be a significant incremental work effort. The economics of these contracts such as monthly rent, lease term, and operating expenses are well understood metrics that drive the profitability of the business. These scenarios are not limited to real estate or retail. Similar dynamics would be at play with airline operators and commercial jets, oil exploration and production firms, and offshore drilling rigs as well as several other industries.

Consider a second company who also carries $500M in leasing obligations. However, the second organization has 5000 leases across a mix of categories including real estate, material handling, rail transportation, office technology, and data center equipment. These leases are owned by many different departments, tracked in many different systems, and managed using many different processes. Due to the greater number and smaller dollar value of these contracts, there has typically been less analysis of pricing, terms, and overall economics. And as a result, there will typically be more effort required to obtain and maintain the data necessary to comply with the new standards.

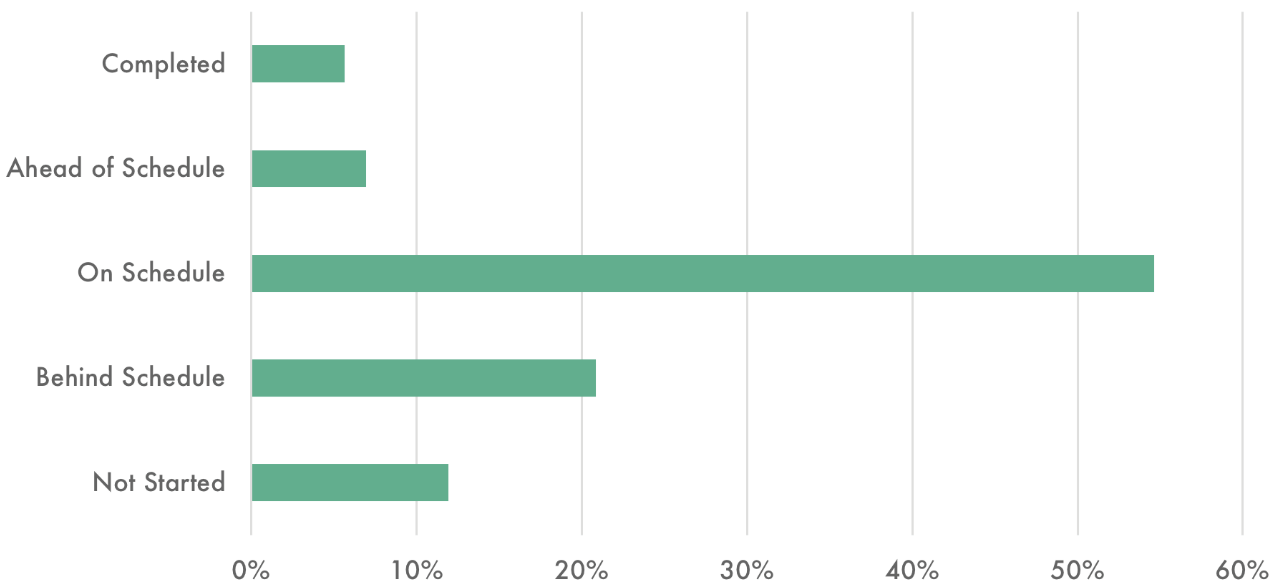
LEASE ACCOUNTING READINESS

AVOIDING LEASEPOCALYPSE

At the time of publication of this report, only 10 months remain before the first implementation deadlines. Public, calendar-year filers will need to need to begin adopting the new standards at the end of 2018. In most cases, private companies will have an additional year to comply.

The good news is that the industry appears to be largely on track with their lease accounting projects. We will likely avoid what many were worried might turn into "leasepocalypse" at year end.

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



Two thirds of survey respondents indicated that their projects were on schedule or ahead of schedule. The level of readiness is impressive when you consider that many of the finance organizations tasked with these types of accounting change and compliance initiatives are busy wrestling other mega-projects in their organizations such as:

- **Revenue Recognition** - The initial ASC 606 and IFRS 15 implementation deadlines were just a few months ago. Many non-calendar year public filers are still racing to finish the last mile of rev rec. And many private companies still have another year to comply.
- **Tax Reform** - The US recently enacted a massive corporate tax reform which is creating new opportunities for finance organizations. Treasurers are busy developing strategies for repatriating offshore earnings. Procurement and finance groups are rethinking capital expenditure strategies to take advantage of new, accelerated depreciation schedules. And accounting groups have been busy adjusting the tax treatment on income statements and balance sheets.

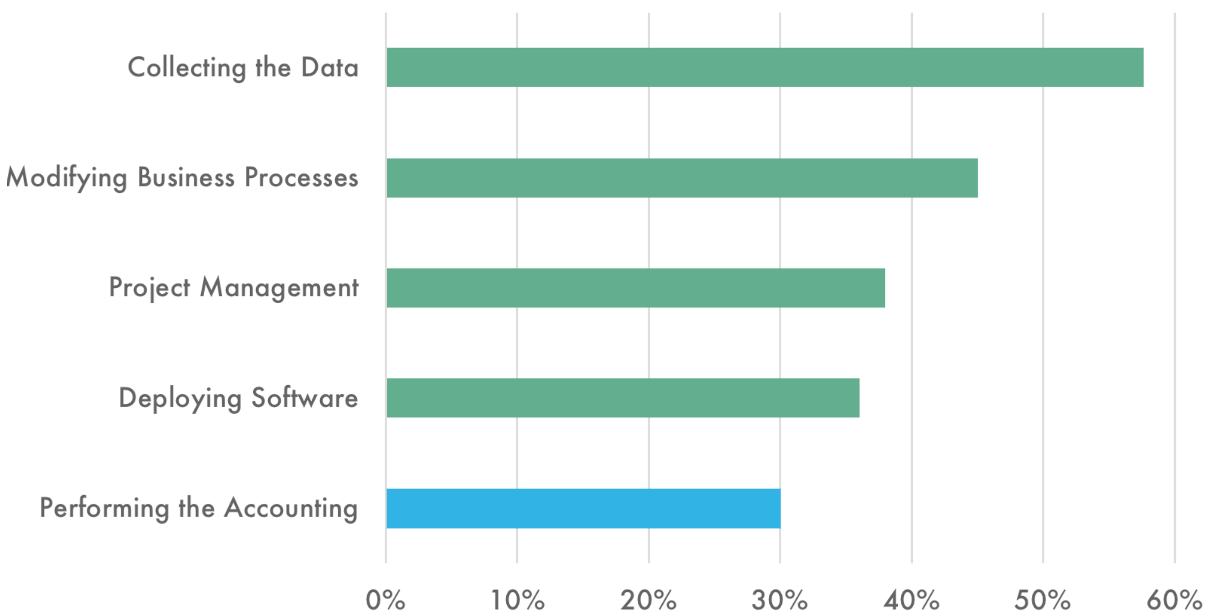
- **Digital Transformation** – Finance organizations are amongst the early adopters of a new wave of digital technologies. Back office processes stand to gain the most from the productivity benefits of robotic process automation, machine learning, and artificial intelligence. As a result, many finance teams are busy evaluating the business case for adoption of these disruptive technologies.

Only six percent reported having completed the lease accounting project, which is not surprising given the level of effort and the time period remaining before the deadline. Approximately, 12% have not started, which may not be a big cause for concern if the companies are privately held or have a fiscal year that ends later in the year.

APPLICATION OF THE ACCOUNTING STANDARDS

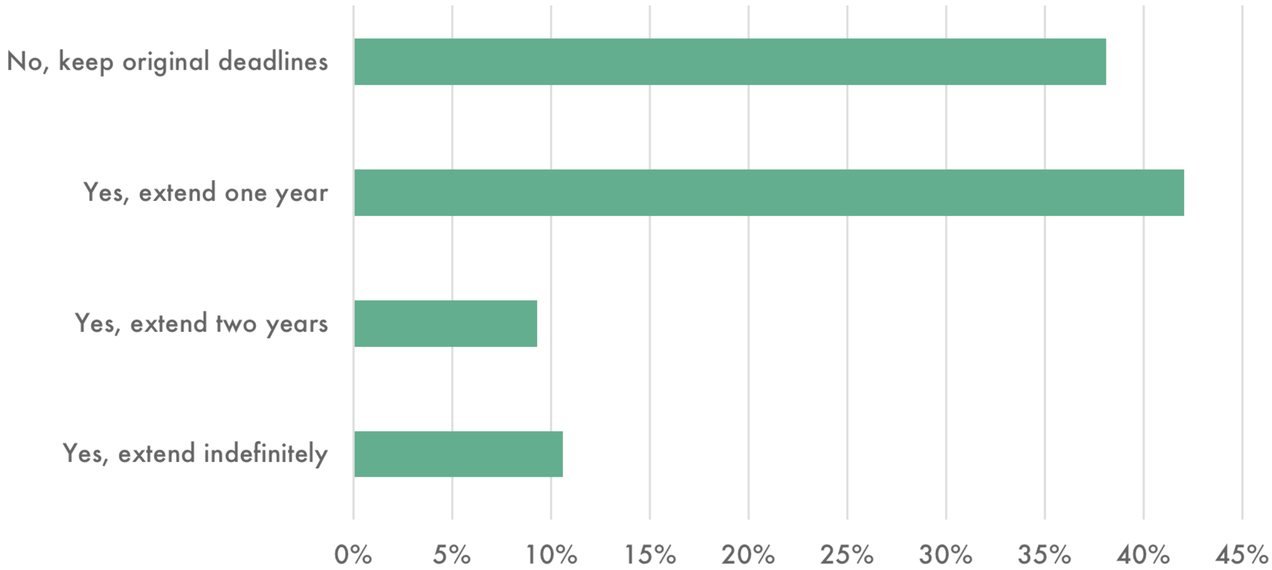
The new leasing standards represent a significant accounting change, arguably one of the largest in history. However, most project leaders will tell you that the accounting changes are not the most significant challenge of the project. Less than one third of companies are finding the process of applying the new accounting standards to be a significant implementation challenge. Far more companies cite activities such as finding and collecting the data; modifying processes, policies, and controls; upgrading and deploying software; and project managing the overall work effort as greater obstacles to compliance. Each of these activities will be discussed in detail later in the report.

Which of the following do you view as posing a significant implementation challenge? (Select all that apply)



Although two thirds of organizations report being on schedule or ahead of schedule, over 60% think that FASB should extend the deadline for implementation. Most of the survey respondents (70% cited) seeking an extension indicated that one year would be sufficient. The desire for time is not driven solely by the complexity of the ASC 842 standard, but rather the combined work effort required to comply with both the new leasing and revenue recognition standards in such close proximity.

Do you think FASB should extend the deadline for the standard?



Another common theme amongst survey respondents was the request for FASB to ease the transition burden for compliance. As originally published, ASC 842 required companies to provide three years of comparative reporting for the income statement and two years for the balance sheet. The three-year look-back period was intended to enable investors, lenders, and others to perform comparisons of financial statements with and without the lease accounting standards applied. In recent months, the FASB has indicated that relief will be provided for the transition accounting requirements.

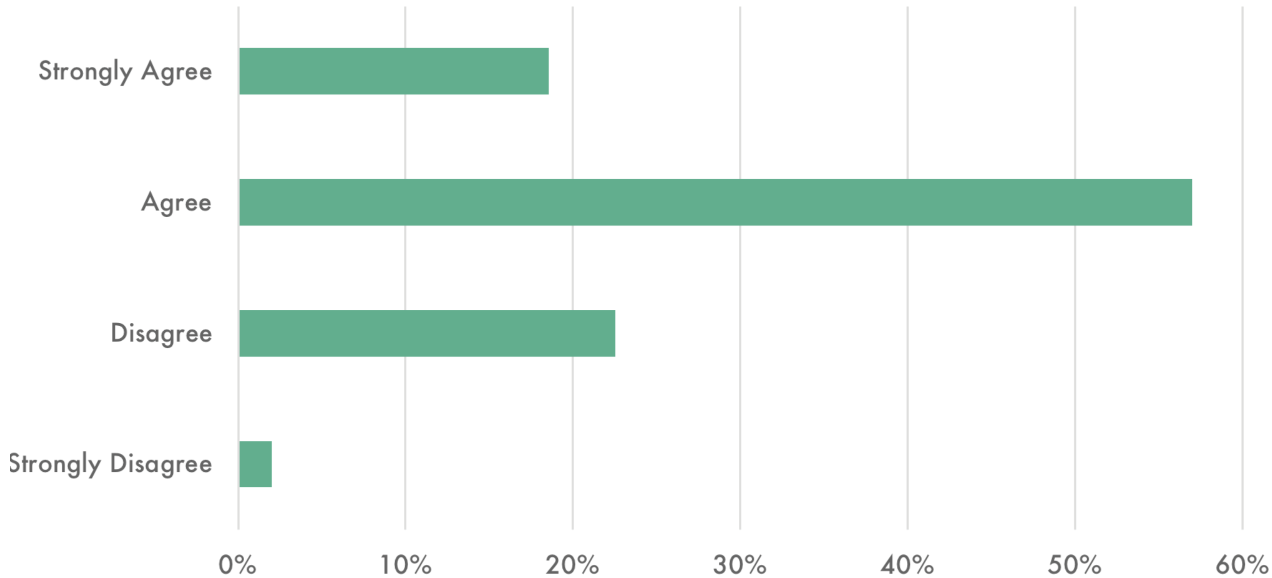
Survey respondents indicated that they are experiencing a significant challenge with identifying and analyzing embedded leases. Under ASC 842, many contracts that a banker or a lawyer would not consider a lease are now considered leases for accounting purposes. To comply with the standard project, teams must identify all service and outsourcing contracts that may contain right-of-use assets to identify potential embedded leases. A complex series of assessments must be performed 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.

Another key challenge of the new accounting standards involves the effort to separate the products and services included in the contracts into lease and non-lease components. Non-lease components might include common area maintenance services for real estate, property taxes, and insurance fees. The consideration for each must be measured, separated, and allocated between lease and non-lease components.

PROJECT COMPLEXITY

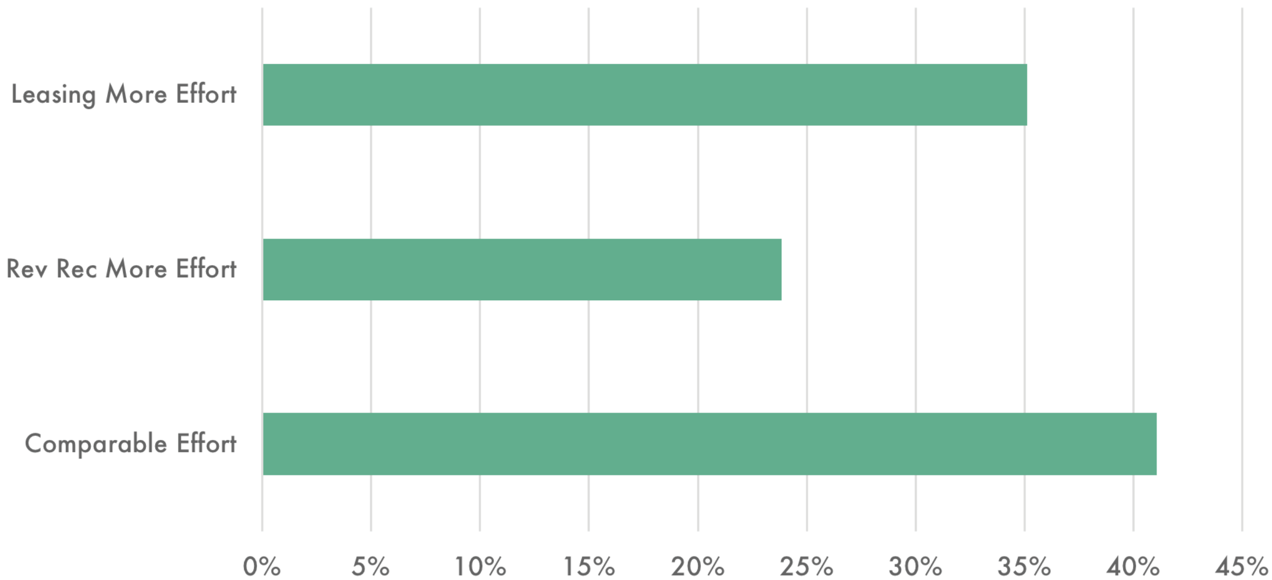
Almost 75% of respondents have found the lease accounting project to be more complex than originally anticipated.

Our lease accounting project is more complex than we originally anticipated? (Select all that apply)



When asked about the level of effort to comply with the lease accounting project as compared to the revenue recognition standard, the market is split. Approximately 35% of those surveyed are finding the lease accounting project to be more burdensome. About 25% disagreed, stating that the revenue recognition standard was more complex. The remaining 40% are finding a comparable level of effort is required for both projects.

How does the level of effort for lease accounting compare to the level of effort for revenue recognition? (Select all that apply)



The difference of opinion is not surprising when you consider the impacts that each standard is having on different cross-sections of industries. Revenue recognition focuses on the sell-side or customer-facing part of the business whereas leasing focuses primarily on the buy-side or supplier-facing part of the business.

Several of the industries most impacted by revenue recognition have comparatively simple leasing portfolios. Consider the Internet services and software sectors. These companies have complex pricing, contractual, and delivery models such as the software-as-a-service paradigm. However, most software and Internet companies have less complexity in their leasing portfolios, with office space being the predominant asset category.

Lease accounting complexity seems to be greatest in asset-intensive industries such as electrical utilities, oil and gas, chemicals and materials, transportation and logistics, aerospace and defense, automotive, and heavy industrial products. These sectors tend to lease a diverse range of asset categories that are managed in decentralized operating companies. As a result, a significant amount of work will be required to inventory the leasing contracts, centralize the systems, and standardize the business processes.

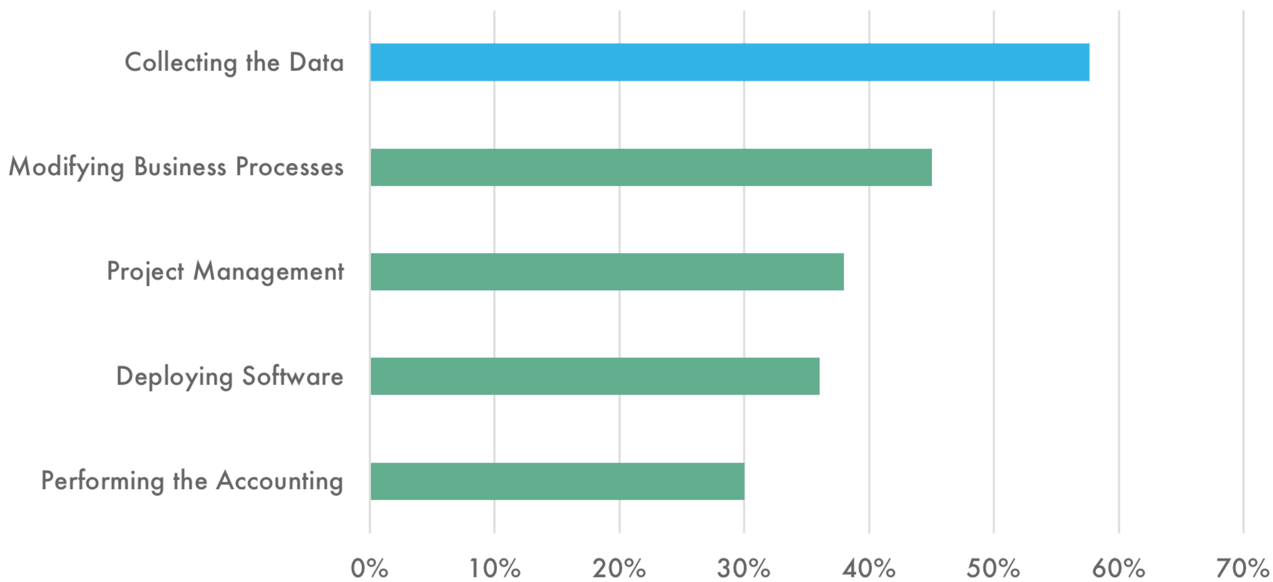
Some industries are significantly impacted by both standards. For example, the telecommunications industry not only has complex revenue recognition issues with products such as mobile phone service, but also carries diverse lease portfolios that include shared fiber optic cables, large corporate vehicle fleets, global networking, and data center assets.

DATA COLLECTION

THE TOP DAY ONE IMPLEMENTATION CHALLENGE

The top challenge being faced amongst companies implementing the new lease accounting standards is finding and collecting the data (cited by 60% of survey respondents). A handful of companies have undertaken projects to centralize leasing data and automate business processes over the past few years. However, the vast majority of companies have not collected the various leasing data and documentation required for the new standard. And most do not have a system to manage their leasing business processes.

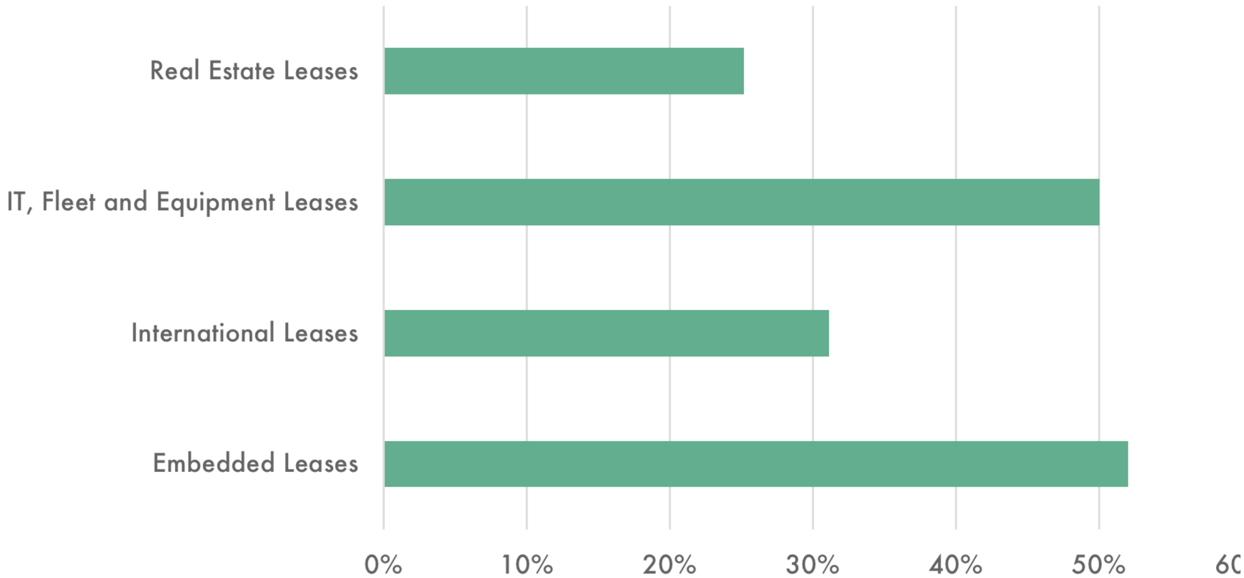
Which of the following do you view as posing a significant implementation challenge? (Select all that apply)



TYPES OF LEASES

Embedded leases are proving the most challenging to find and analyze (cited by 52% of respondents). Project teams will 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 is less challenging than analyzing them. Electronic discovery technologies can be used to crawl corporate file repositories to identify the contracts. Unfortunately, no artificial intelligence or automated data abstraction tools are available on the market to support the analysis of embedded leases.

Which of the following categories of leases are proving the most challenging to find and analyze? (Select all that apply)



Project teams are experiencing the fewest challenges with finding and analyzing real estate leases (cited by only 25% of respondents). Most companies have a real estate administration system that stores basic information about leases for office buildings, retail stores, and industrial properties. Although the real estate leases are less challenging to find, obtaining a complete set of data does create complications. Project teams are finding that the data in real estate systems is often incomplete or out-of-date. Lease data is entered into the real estate system following commencement, but is not kept up-to-date as rent adjustments, floor space expansions, end of lease renewals, or other modifications are made to the lease.

Beyond the real estate system, what little leasing data does exist is typically scattered across the enterprise in various procurement, asset management, and financial applications. The data used to provide the contractual obligations reporting required by the current lease accounting standards in the footnotes disclosure of annual fillings is typically maintained in a series of spreadsheets. At most companies, the only reliable source of data for leases is the accounts payable system. And the only field that can be relied upon to be accurate is the payment amount.

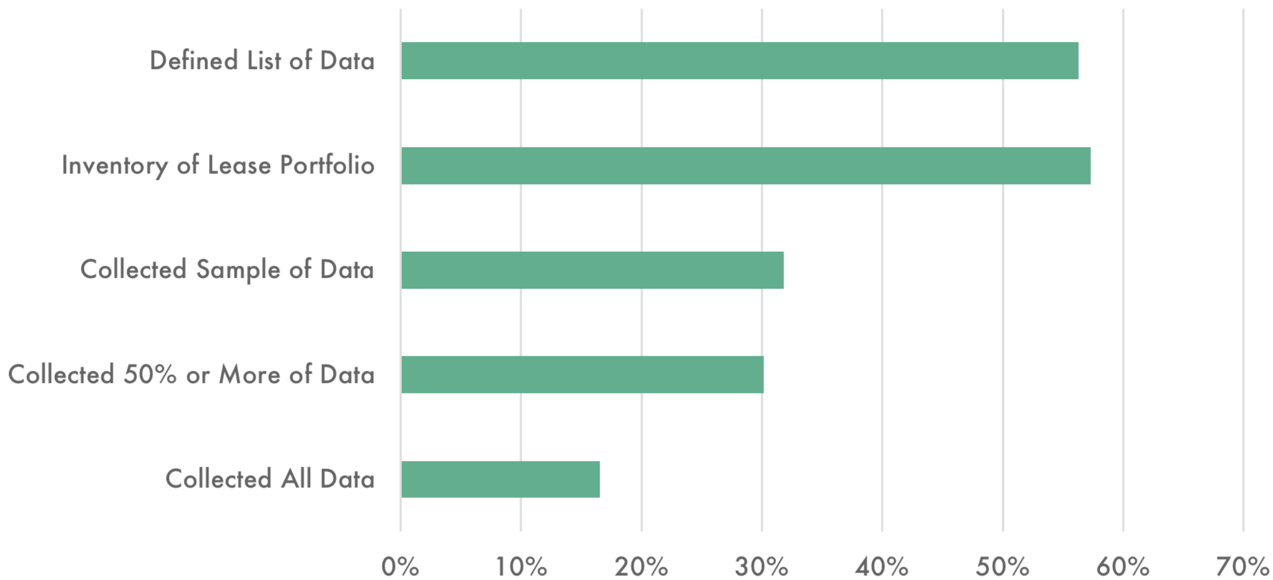
As a result, companies are struggling to locate information about non-real estate leases such as IT, fleet, and other equipment leases (cited by 50% of respondents). At most companies, the ownership of non-real estate leases is distributed across a large number of stakeholders in a large number of organizations around the world. Corporate IT might own leases for laptops, servers, switches, and data center equipment. Supply Chain might own leases for material handling equipment, rail cars, shipping containers, and delivery vehicles. Fleet Management might own leases for company cars, commercial vans, and delivery trucks. Each of these organizations will need to be contacted to identify the population of leases and to locate the documentation.

The complexities outlined above only grow in magnitude with international leases. Many of these leases are written in local languages with rents in local currencies. There are two options for international leases. The data from international leases can be abstracted by local accounting teams or the contracts can be translated into a common language then forwarded onto the project team for analysis.

COLLECTING THE DATA

A little more than half of companies have been able to define the list of fields required to perform the accounting, which is typically the first step in the data collection process. To perform the necessary accounting calculations, judgments, and policy elections, over 100 different data elements will need to be collected for each lease. Examples include base and variable rents, payment frequency and timing, contract options and clauses, estimated residual values, and holding periods. Much of the data can be abstracted from the leasing contracts. However, some data will need to be sourced from purchase orders, invoices, and certificates of acceptance. And a few fields can only be obtained by interviewing the actual users and owners of the leased assets.

How far have you progressed in collecting your lease accounting data? (Select all that apply)



Approximately 60% of companies have conducted an inventory of their enterprise lease population. With no centralized system to track leases in place at most companies, the project teams must conduct a time and labor-intensive discovery process. Typically, the accounts payable team is leveraged to identify all the vendors with recurring expense profiles that might represent leases. 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 products and services being provided under each contract. The list of confirmed leases is then presented to the procurement, treasury, and legal teams for assistance with locating the associated contracts, purchase orders, and supporting documentation.

Under the new standards, leases will be listed as right-of-use assets and liabilities on the balance sheet, which will invite additional scrutiny from external auditors. Consequently, most project teams are taking additional measures to ensure that they have identified the complete population of leases across the enterprise. Some project teams are reviewing maintenance records from manufacturing plants to ensure that all equipment assets that may be leased have been identified. Others are reviewing insurance policy statements to ensure that all company cars and other property assets that might be leased have been identified.

The data collection process will be the most time-consuming aspect of the lease accounting implementation project. Abstracting the leasing data, researching the missing fields, and applying the new accounting standards can take four to eight hours per lease. Automated data abstraction and artificial intelligence tools can be leveraged to reduce the time required in some scenarios. However, most companies are relying on contract analysts to perform the data collection and analysis manually.

Despite the considerable work effort, project teams are making noteworthy progress with almost 30% citing that they have collected more than half of the data. Approximately 16% indicated that they had collected all of the necessary leasing data and moved onto the software implementation, testing, and deployment phases of the project.

BUSINESS PROCESSES

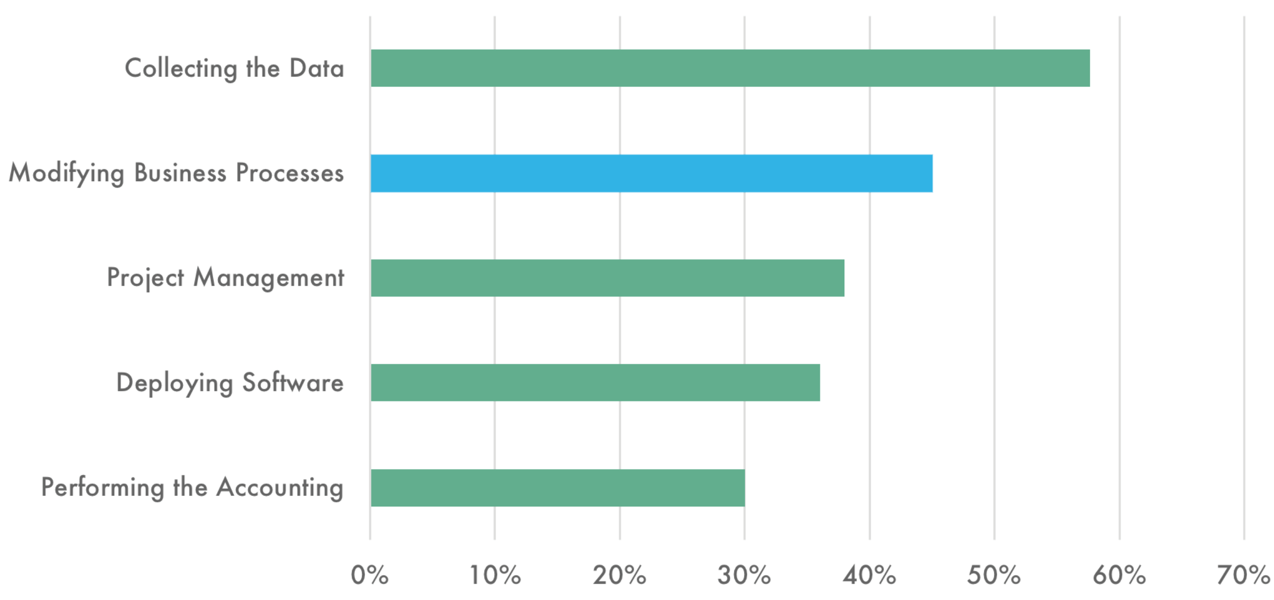
THE TOP CHALLENGE FOR DAY TWO AND BEYOND

The second biggest challenge to achieving day one compliance with the new standards, cited by 45% of respondents, is modifying business processes, policies, and controls. If the question had been asked differently, focusing on compliance for day two and beyond, it's likely that modifying business processes would have topped the list of concerns. Updates to business processes will be critical to ensure that the accounting and leasing data remains accurate after the implementation date.

LEASING AS A PAYABLES ACTIVITY

At most companies, leasing has never been considered a formal business process. It is viewed by most financial professionals as an accounts payable activity. Most business units view leasing as a financing mechanism used to circumvent annual budget ceilings. Rarely have organizations defined standardized leasing practices for business processes such as procure-to-pay, acquire-to-retire, and record-to-report. As a result, the processes used to track and manage real estate leases in North America might be different than those in Europe or Asia. And the business processes used for end-of-term management might be very different between asset categories such as real estate, material handling, office equipment, and data center technology.

Which of the following do you view as posing a significant implementation challenge? (Select all that apply)



LEASING AS A BUSINESS PROCESS

The new accounting standards will require businesses to adopt a new level of rigor and discipline in their enterprise leasing business processes. Accounting organizations will need to ensure that they maintain complete, accurate, and up-to-date records of all leases across the business not only at commencement of the contract, but also throughout the term of the agreement. New business processes will need to be put in place to ensure all the necessary data required for accounting is collected at the start of the lease. Controls will be required to ensure that any contractual updates or business plan changes resulting in a modification or reassessment are relayed to the accounting organization. Asset management procedures will need to be put in place to ensure that the cost center, physical location, and employee assigned to each leased asset is kept up-to-date. Managers in business units may be required to attest to the accuracy of leasing records on a quarterly or semi-annual basis. Decision makers may be required to notify accounting of end-of-term decisions to renew, terminate, or purchase leased assets or face internal chargebacks.

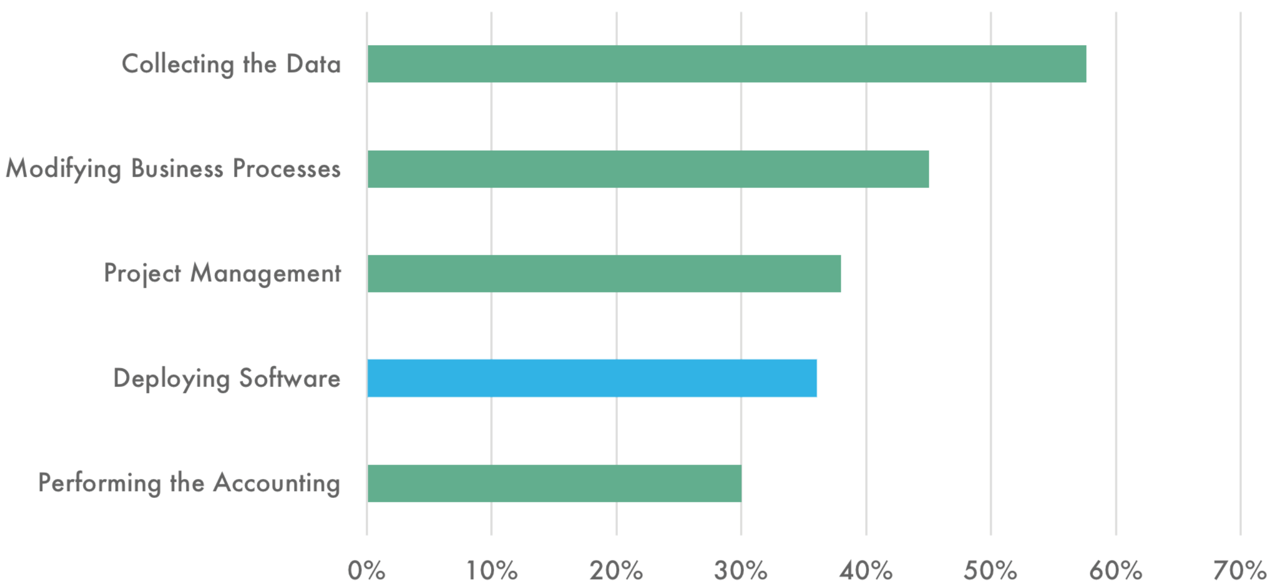
With leases representing a significant set of assets and liabilities on the balance sheet, many companies may adopt additional best practices to ensure that leasing portfolios are being optimized. For example, some may institute standardized lease versus buy analysis programs for all new capital expenditures. Others may lower the thresholds for senior level approvals of new leases, renewals, and end-of-term buyouts. Best-in-class companies will establish a set of key performance indicators to measure the efficacy and economics of leasing that are reported regularly to senior leadership.

SOFTWARE DEPLOYMENT

A NEW CATEGORY OF APPLICATIONS EMERGING

Historically, most companies have performed lease accounting and financial reporting under the current standards using a collection of spreadsheets. Since the introduction of ASC 842, a number of commercial, off-the-shelf software packages have been released to the market specifically designed to support the new lease accounting requirements. These applications feature dedicated leasing subledgers that track all the necessary journal entries, accounting engines to perform multiple set-of-book reporting, and algorithms to automatically classify contracts as operating or finance leases.

Which of the following do you view as posing a significant implementation challenge? (Select all that apply)



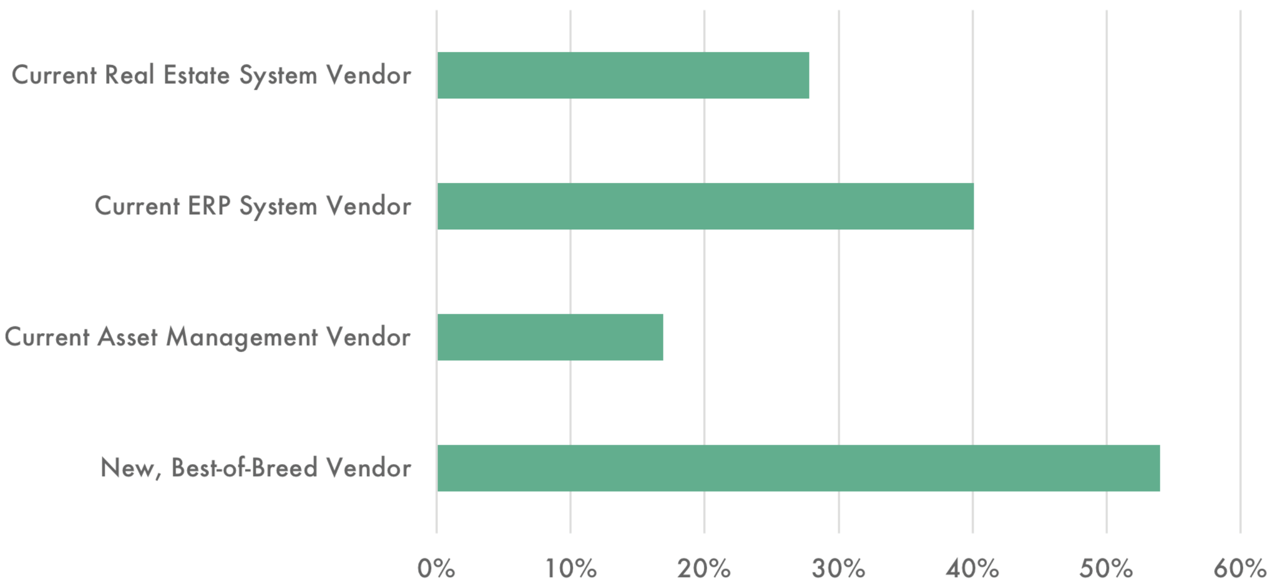
Approximately 35% of respondents cited the need to upgrade and/or deploy software as one of the top implementation challenges. Although software challenges ranked fourth amongst implementation challenges, they are perhaps the most significant. Software readiness has been the focal point of numerous recent public letters to the FASB. The American Petroleum Institute[1], the FEI Committee on Corporate Reporting[2], and a group of pharmaceutical manufacturers[3] have each submitted letters to the FASB expressing concerns about the readiness of software vendors to comply with the new standards.

With only 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 challenge, most of the lease accounting vendors do not have a historical background in financial accounting or reporting. Most of the vendors come from the real estate, data services, or human resources sectors. As a result, they not only have had to climb the learning curve with ASC 842 and IFRS 16, but also have been required to hire new personnel into their product development, customer support, and professional services teams with finance and accounting experience. As a result, most of the applications on the market are relatively immature, having undergone limited testing cycles and real-world scenarios.

SOFTWARE VENDOR SELECTION

Therefore, it is not surprising that specialized, best-of-breed vendors such as LeaseAccelerator and LeaseQuery are the most popular type of software option being considered (cited by 50%). The core business of these vendors is developing lease accounting and management applications, which allows them to concentrate the bulk of their research and development, technical support, and implementation resources into programs supporting ASC 842 compliance.

Which of the following type of software vendors are you considering? (Select all that apply)



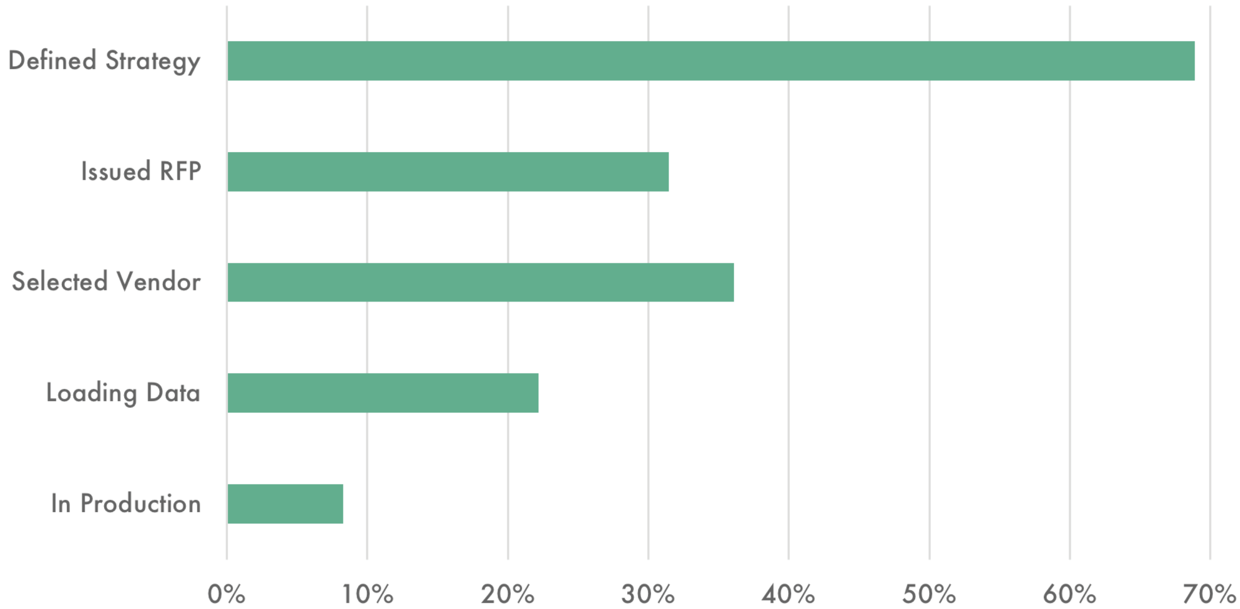
ERP vendors are the second most widely considered option for lease accounting software (cited by 40% of respondents). However, the number of companies considering ERP declined by more than 25% compared to our 2017 survey. Market leaders such as Oracle, Microsoft, Workday, and Infor have yet to announce a clear product strategy to the market. SAP has introduced several lease accounting solutions, including its own real estate administration application as well as partnerships with Nakisa and Bramasol.

Approximately 25% of companies are considering their current real estate system vendor to fulfill their lease accounting needs. Although there are twenty or more well established real estate administration and integrated workplace management systems on the market, only a handful, such as IBM's Tririga and ProLease, have made the leap to accounting. For companies whose leasing portfolios are primarily buildings and land, their existing real estate administration application is a natural candidate to consider.

SOFTWARE IMPLEMENTATION

Companies are making noteworthy progress on their software selection, implementation, and deployment projects. Almost 70% of respondents indicate that they have defined a systems strategy for lease accounting. About one third have issued an RFP seeking a formal proposal and pricing from multiple software vendors. As lease accounting is a new type of software, companies are having to climb the learning curve to understand the key requirements and evaluation criteria by which to compare vendors.

How far have you progressed in collecting your lease accounting software strategy? (Select all that apply)



Only 36% of respondents indicated that they had selected a vendor thus far. Once a software application is selected, the heavy lifting of locating, abstracting, and populating the data begins. Customers will not only need to identify the data related to leases, but also configure the chart of accounts, upload depreciation schedules, and define leasing policy thresholds. Key financial variables such as the incremental borrowing rate, weighted average cost of capital, and federal tax rates will need to be inputted as well. Slightly less than 25% of companies have progressed to the stage of implementing the software and loading the necessary data.

Another important aspect of software implementation is the need to build interfaces between systems. To minimize the number of additional headcount required on day two and beyond, companies are seeking to establish automated interfaces between their lease accounting applications and other financial systems. Most are starting with the upload of debits and credits from the leasing subledger to the general ledger. Interfaces with the accounts payable system and real estate administration applications are being widely considered as well.

After the software configuration, data upload, and financial systems interfaces are completed, companies will need to go through a testing and deployment phase. Companies will need to ensure that they can automatically generate the necessary journal entries and quantitative disclosures required for the new standards. Additionally, project teams will need to ensure that the software supports the diverse range of payment structures and contract terms within their lease population. Test scenarios will include variable rents tied to performance, usage, and market indices payable in arrears or advance at monthly, quarterly or annual intervals. Accounting organizations will want to "stress test" vendor software with complex permutations of sale-leaseback transactions, real estate subleases, and partial end-of-term equipment buyouts. Less than 10% of companies have finished these testing cycles and deployed to production, which is not surprising considering that such activities represent the last mile of compliance.

THE PROJECT TEAM

BEYOND THE FOUR WALLS

Unlike many other accounting change initiatives, which could be managed within the four walls of the accounting organization, ASC 842 will require a cross-functional, enterprise-wide project.

The users and owners of leased assets span almost every function in the business. Corporate IT owns laptops, servers, and data center gear. Real estate owns buildings, factories, and warehouse leases. Logistics owns material handling, railcar, and ocean container leases. Fleet owns company cars, repair trucks, and delivery vans. These functions are distributed across different business units, operating companies, and legal entities around the world.

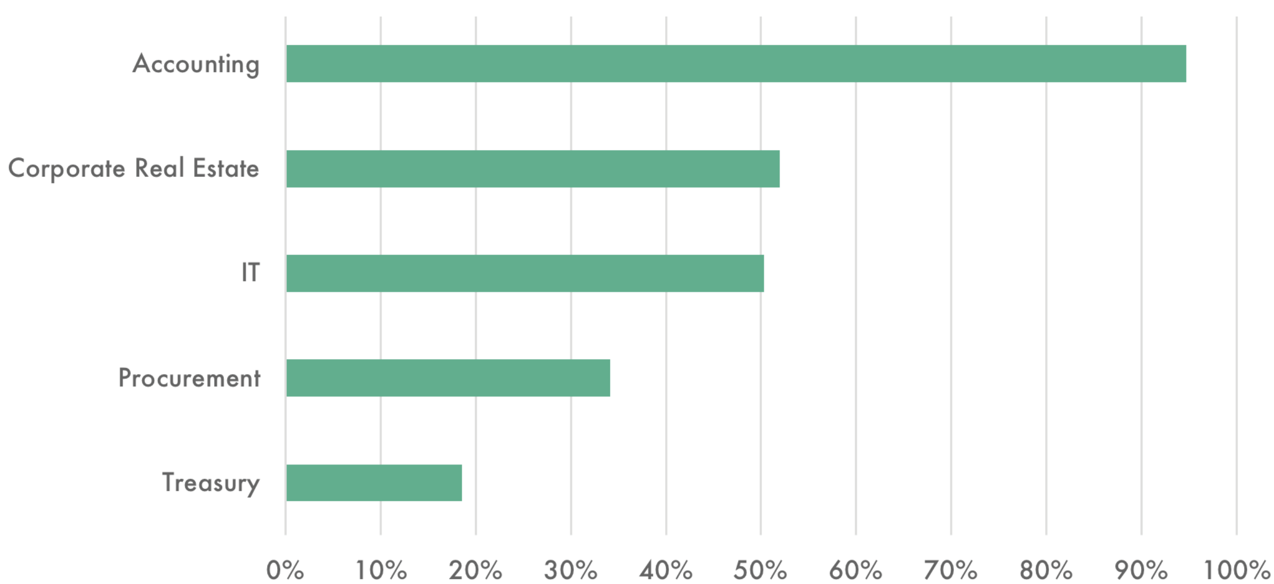
The organizations touching leases throughout their lifecycle represent almost every corporate function in the business. Legal and Procurement negotiate the pricing and terms for new leases. Treasury manages credit relationships with lessors and the insurance policies for leased assets. Accounting owns invoice processing, sublease collections, and financial reporting. Finance owns budgeting, planning, and forecasting for leasing programs. Tax is responsible for state, local, and federal property obligations for leased assets.

Investor Relations will be required to communicate the impact of the new right-of-use assets and liabilities on the balance sheet. Human Resources will be required to evaluate the impact of executive compensation agreements based upon impacted financial metrics. Internal audit will be required to review the policies, controls, and governance aspects of the compliance effort.

FINANCE AND ACCOUNTING

Leadership of the project typically sits within the finance or accounting team. In some cases, an assistant controller is the lead. In other cases, director level leaders in financial reporting, technical accounting, or accounting programs are running point.

Which of the following groups are playing a strategic role in your lease accounting project? (Select all that apply)



REAL ESTATE

The Corporate Real Estate team is playing a strategic role in more than half of companies (cited by 52%). Real estate represents the largest asset category in most leasing portfolios by dollar value. In addition, the processes, systems, and controls for managing real estate leases tend to be much more mature than for other categories such as material handling, data center, or transportation leases. 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.

Participation by Real Estate will be critical to project success as the accountants perform assessments of complex real estate contracts. Support will be needed to understand the complex payment structures associated with leases including performance-based variable rents, long term security deposits, and multi-stage tenant improvement allowances. Real estate leases are also more likely to be the byproducts of sale-leaseback transactions, which will require assessments both of revenue recognition and lease accounting. Finally, many companies sublease or assign space to other tenants, in effect becoming lessors with regular billing and accounts receivable cycles.

CORPORATE IT

The corporate IT organization is also taking a leadership role. At half of all companies (cited by 50%), IT has a dual-role in most lease accounting projects. The financial systems group within IT will be a critical player in the evaluation, selection, and implementation of lease accounting software. Although the accounting team may have the experts in defining the business requirements, IT organizations will be accountable for the day-to-day operations related to the software. As with any financial application, there are information security and regulatory compliance concerns for lease accounting software. Additionally, there are on-going maintenance, upgrades, and technical support requirements to ensure that the lease accounting system is up and running, especially at month end close.

At many companies, the IT organization may also play a secondary role as the owner of a multi-million dollar portfolio of desktop and data center technology leases. Whereas Real Estate is often the organization with the highest dollar value of leases, corporate IT is often the department with the greatest number of leased assets. Think employee laptops.

PROCUREMENT

Approximately one third of companies have engaged the supply chain, procurement, or sourcing organizations to play a strategic role in the project. At most companies, Procurement is assisting in the identification and location of potential lease contracts. While project teams may be able to get a list of vendors with recurring payments from Accounts Payable, there is a critical dependency on Procurement to assist with scoping the list of service and outsourcing contracts that may contain embedded leases.

Perhaps more important than securing Procurement's involvement in the original compliance project will be ensuring that Procurement maintains an active role in lease accounting on day two and beyond. The first step in any leasing contract workflow should be a purchase requisition for the desired 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. Additionally, Procurement can provide visibility into the renewal of existing lease contracts and the end-of-term buyout of assets.

TREASURY

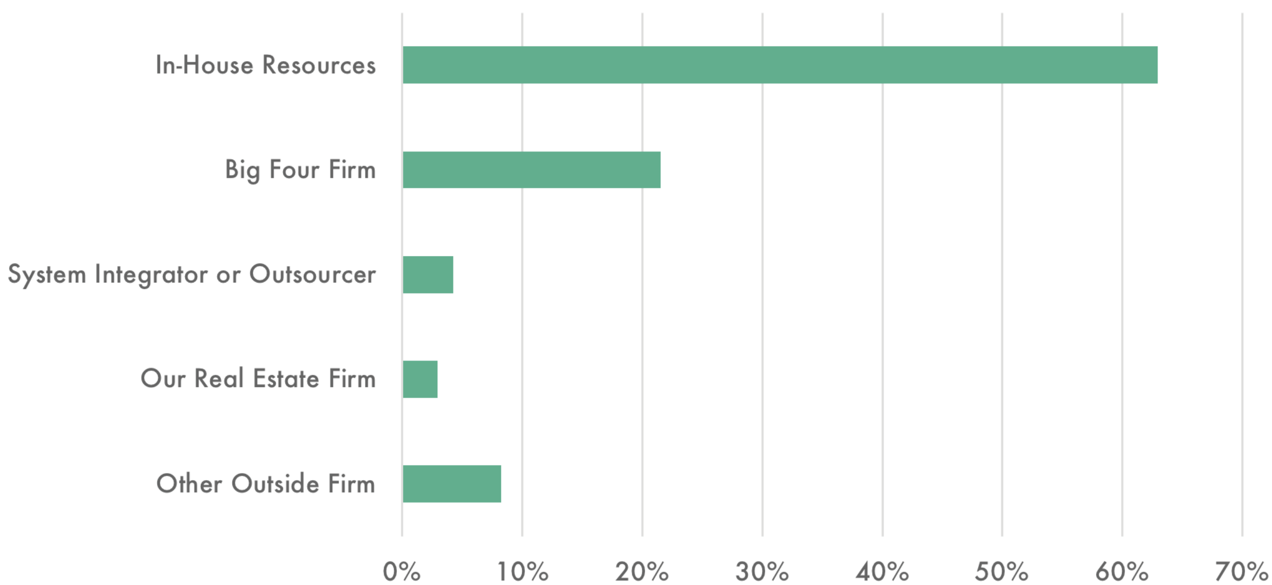
Less than one in five companies have engaged the corporate treasury function in their lease accounting project. Treasury may not typically play a day-to-day role in the sourcing, management, or accounting for leases, but Treasury owns the balance sheet and the leasing strategy in most organizations. Treasury sets the policies on when to buy assets versus when to lease them. And Treasury often manages the credit relationships with commercial banks, independent leasing companies, vendor captive finance organizations, and other lessors.

Consequently, more companies should consider strategic participation from Treasury in the lease accounting project, especially for day two and beyond. As the owner of lease versus buy analysis, Treasury can ensure that many of the necessary details needed to make accounting judgments are captured upfront before a lease is sourced. For example, Treasury could require "reasonably expected holding periods" and end-of-term plans to be stipulated by business units. Additionally, Treasury wields tremendous influence over lessors as the owner of credit relationships. Treasury could simplify on-going compliance efforts by requiring all leasing companies to standardize contract terms and provide electronic feeds of the data required for lease accounting.

EXTERNAL RESOURCES

Given the shrinking timebox companies are operating under, support from external resources may be equally as important to the success of a lease accounting project 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 skill sets. The challenges are multiplied by the relatively short time period remaining before the compliance deadline.

What approach will you take to implementing the new lease accounting standards? (Select all that apply)



Given these challenges, we were surprised that more than 60% of companies are depending largely on in-house resources to complete the project.

Only 21% of companies are enlisting the help of consultants from a Big Four firm. The Advisory practices of the major accounting firms offer a range of services to help companies implement the new standards. These firms can perform an initial diagnostic to assess the impacts of changes to financial statement metrics as well as the impact to debt covenants and compensation arrangements. Additional consulting services include assessing the current state of readiness, development of new policies and procedures, and advising on tax exposure strategies. PwC, Deloitte, KPMG, RSM, and others have developed full lease accounting solutions that include not only the consulting and implementation services, but software as well.

Only 4% of companies have engaged a system integrator or outsourcing firm. The finance and accounting practices of Business Process Outsourcing firms would seem to be a natural candidate to assist with leasing projects. Firms such as Genpact, Capgemini, and Accenture manage the entire back office for multinational companies including the record-to-report, procure-to-pay, and order-to-cash processes. As a result, the BPO firms will be likely to inherit lease accounting operations on day two and beyond. A few firms, most notably Genpact, have defined a strategy for lease accounting and are assisting customers with the transition.

Only 3% of companies are leveraging a real estate property management firm to support their lease accounting project. Firms such as CBRE, JLL, Cushman, and Wakefield manage the corporate real estate functions, including space planning, facilities management, and lease administration, for many multinational firms. These property management organizations will be likely to inherit lease accounting operations for real estate assets on day two and beyond.

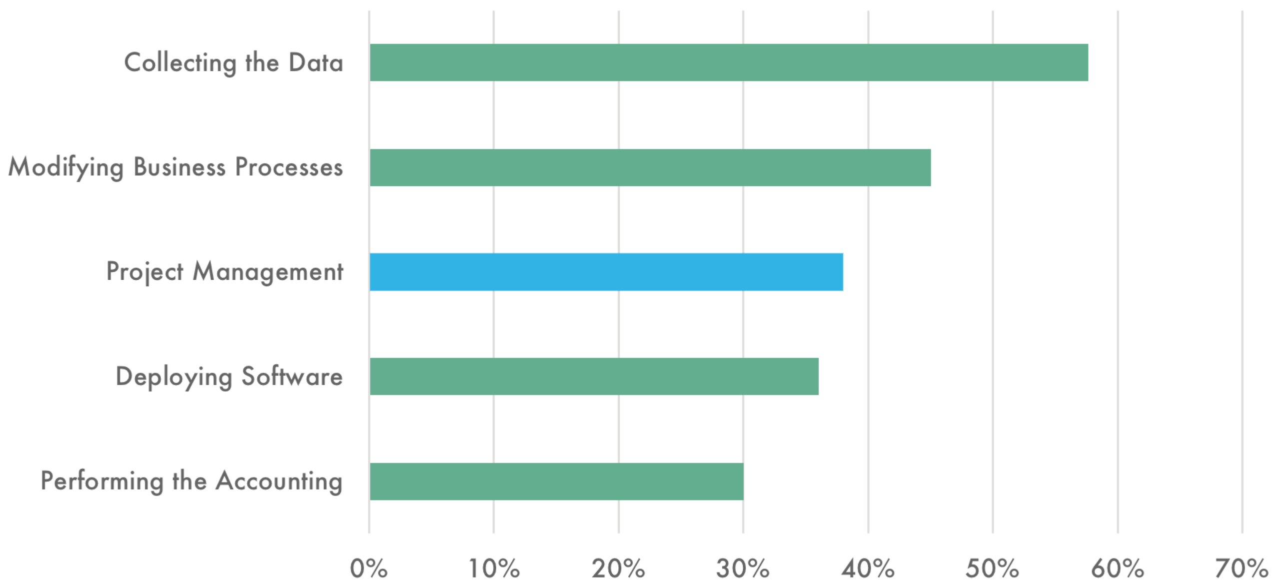
As the deadline for compliance approaches, it is likely that the use of external firms will increase. Some companies will realize that they have underestimated the level of effort required to perform data collection, software implementation, and business process changes. As a result, many project teams could be making the proverbial "911 call" for external support.

PROJECT GOVERNANCE

A GLOBAL, CROSS-ENTERPRISE INITIATIVE

As a result of the diverse range of internal and external constituents involved, the leasing project is far more complex than most accounting change initiatives. An unusual set of project management challenges are emerging for accounting leaders who often are not accustomed to driving transformational projects across the business. Not surprisingly, more than one third of survey respondents indicated that project managing the overall work effort was one of the most significant implementation challenges.

Which of the following do you view as posing a significant implementation challenge? (Select all that apply)

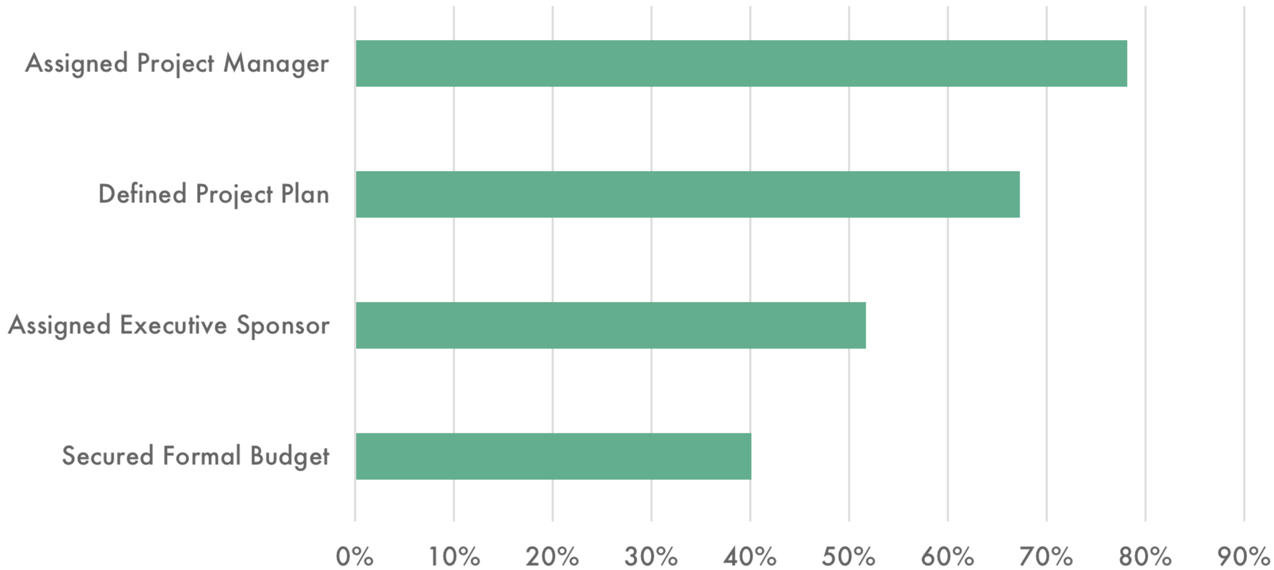


To ensure success with such a global, cross-enterprise initiative, companies are adopting best practices in project management such as hiring a dedicated project manager, developing a formal project plan, and appointing a C-Level executive sponsor.

PROJECT MANAGEMENT

For example, two thirds of respondents have developed a formal project plan for the lease accounting initiative. Such a high percentage is an encouraging sign and suggests that organizations are taking the program seriously, allocating resources and tracking milestones. Creating a project plan for an initiative such as lease accounting is a challenging endeavor for most companies. Since lease accounting has never been done before, estimating work efforts, understanding required resources, and predicting potential obstacles is a difficult, if not impossible, task. Many projects have used the expression "we don't know what we don't know" as a guiding theme for the project effort.

Which of the following steps have you completed in your lease accounting project? (Select all that apply)



One of the best practices communicated by organizations further along in the implementation lifecycle is to formally assign a full-time project leader. We are encouraged to see that almost 80% of survey respondents have assigned a formal project manager to lead the lease accounting initiative. 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 technical accounting issues and should not easily be scared off by discussions of incremental borrowing rates and guaranteed residuals.

EXECUTIVE SPONSOR

More than half of the survey respondents 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 executive stakeholders. At most companies, the chief accounting officer or controller is the de facto executive sponsor of the project. 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. As discussed earlier, success with day one compliance efforts and day two on-going efforts will require participation from asset owners in the real estate, corporate IT, logistics, and operations teams. Corporate functions such as Procurement, Treasury, Tax, Legal, and Finance will be required as well. Many of these organizations will view accounting change projects as outside of their scope of responsibility. The executive sponsor will be challenged to sell the business on the need for active participation.

SUMMARY

There has been a dramatic shift between the first and second year of lease accounting compliance. Despite other major initiatives related to revenue recognition, tax reform, and digital finance transformation, most companies are making significant progress in executing formal project plans, collecting leasing data, and evaluating software applications. As companies enter the second half of their compliance journey in 2018, project teams should focus not only on day one requirements but also on long-term success. Maintaining compliance on day two and beyond will demand the implementation of new processes, policies, and controls; integration between lease accounting, the general ledger, and accounts payable systems; and formal partnerships with Procurement, Treasury, and business units.

ADDITIONAL RESOURCES

For more best practices and recommendations on how to implement the new lease accounting standards, please review the following articles:

How to Get Started with Your Lease Accounting Project
http://www.leaseaccelerator.com/lease-accounting-executive-guide/

Hiring a Great Lease Accounting Project Manager
http://www.leaseaccelerator.com/hire-lease-accounting-project-manager/

How to Budget for Your Lease Accounting Project
http://www.leaseaccelerator.com/lease-accounting-budget-line-items/

Selecting Your Lease Accounting Project Team
http://www.leaseaccelerator.com/lease-accounting-project-team/

How to Conduct an Inventory of Your Leases
http://www.leaseaccelerator.com/what-do-we-lease/

What Data to Collect for Your Lease Accounting
https://www.leaseaccelerator.com/lease-accounting-data-fields/

Evaluation Guide for Selecting Lease Accounting Software
http://www.leaseaccelerator.com/lease-accounting-software-evaluation-guide/

Sample RFP for Lease Accounting Software
https://www.leaseaccelerator.com/lease-accounting-software-rfp/

REFERENCES

END NOTES

1. Stephen Comstock, letter to Wesley R. Bricker and Russell G. Golden, July 11, 2017.
2. Mick Homan, letter to Russell G. Golden, October 6, 2017.
3. Pharmaceutical Industry Members, letter to Russell G. Golden, January 11, 2018.

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