Lease accounting insights for private companies

Host: • Rich Paul, Audit & Assurance partner and Consumer industry leader

Guests: • Jeanne McGovern, Audit & Assurance partner and Lease Accounting leader
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Rich Paul (Rich): Hi, it's Rich Paul, the leader of our Consumer industry Audit & Assurance business of Deloitte & Touche LLP. Welcome to our Consumer Speaks podcast series, where you'll hear from leaders as they share their perspective and insights on emerging topics impacting financial reporting in the consumer industry. Today I have with me Jeanne McGovern and Lauren Pesa, who will be discussing five lessons learned from the public company adoption of the FASB's lease accounting standard and considerations for private companies in the consumer industry. Jeanne is an Audit & Assurance partner and the Accounting and Reporting Advisory Lease Accounting leader with Deloitte & Touche LLP. Lauren is an Accounting and Reporting Advisory senior manager with Deloitte & Touche LLP, also leading our efforts regarding lease accounting. Thank you both for joining us. Jeanne, let's start with you. Can you please provide top-line overview of the lease accounting standard?

Jeanne McGovern (Jeanne): Sure, Rich. January 2019 marked a turning point. The Accounting Standards Codification topic 842, the Financial Accounting Standards Board's new and long-awaited standard on accounting for leases, took effect for public companies with calendar year-end. When all is said and done, the standard is expected to bring some $3 trillion of lease liabilities onto public traded companies' balance sheets. ASC 842 fundamentally changes the way companies across all industries account for their leases and is intended to provide investors with a clearer picture of what companies owe through their lease obligations, including those for equipment and real estate. And in 2021, two years after the public company adoption thanks to a one-year delay provided by the FASB, the rule goes into effect for private companies as well. The relief provided by the FASB should not be taken for granted. One of the reasons for its issuance was the experiences garnered

by public company adopters. Implementations took greater resources and time than was expected. As we talk about some of the lessons learned from public company adoptions, we really need to underscore that private companies should get started sooner rather than later. We're eager to share what we believe are the top five lessons that we've learned from public lease adoptions.

Rich: Lauren, welcome. Given what we've seen related to public-company implementation of the lease accounting standard, what would you say was the biggest lesson learned?

Lauren Pesa (Lauren): One of the biggest lessons learned is that many public companies struggle to answer what may seem like a pretty basic question, but turned out to be not so basic after all, and that question is "Where are my leases?" Many public companies learned finding leases may not be straightforward. Now, it's important to remember that failure to appropriately identify a complete population of leases has a more significant financial statement impact under ASC 842 than it did under legacy US GAAP because most leases are now reflected on companies' balance sheets. As public companies kicked off their ASC 842 implementations, they soon realized that the decentralized processes releases that were sufficient for legacy GAAP reporting, which was largely disclosure-only, would become a significant implementation hurdle. Often a company's leases were tracked and maintained in disparate spreadsheets or databases by many different individuals. In addition, gathering the original contracts and various lease amendments to abstract the incremental data required for ASC 842 was no small task.

Beyond finding contracts that are clearly leases, another fundamental challenge is that not every lease is labeled as one. Just because a contract is labeled as a service contract doesn't mean it's not a lease or it doesn't contain a lease. From an accounting standpoint, a lease is a contract that conveys the right to control the use of a specified asset—for example, a plant or a piece of equipment—over a period of time in exchange for consideration. This type of agreement can be embedded in many other types of contracts, such as transportation service agreements, IT service contracts, and contract manufacturing arrangements. Finding and documenting these embedded leases can involve considerable time and judgment; therefore, it's important to take a close look at all operations, identify areas where embedded leases are more likely to exist, and meet with relevant stakeholders to understand whether assets are deployed as part of service contracts. We've found that it often takes a unique skill to understand the technical implications of embedded leases and be able to articulate to non-accounting stakeholders what it is you may be looking for as you conduct an embedded lease search.

Rich: Jeanne, what would you say is your, other than what Lauren just said, obviously, what would you say was your top lesson learned by the public company adoption of the lease standard?

Jeanne: Rich, another one of the key lessons learned from public company implementations of the standard was not to underestimate the time it takes to collect, organize, and maintain lease data. Even if you identify the appropriate population of leases, as Lauren just discussed, or if you've got technology that can perform accurate and complete lease calculations, if you don't get the data right, it's a classic case of garbage in, garbage out. ASC 842 requires companies gather many different data points. For instance, the critical dates in a lease term, the amounts being paid under a lease, and other relevant information about the right of use conveyed under the lease contract. Many lease agreements contain complex provisions. Some may be in foreign languages, and some may reflect the nuances of a local market. Additionally, it's not uncommon for leases to have numerous amendments, making identification of the appropriate source document or the relevant data fields another source of complexity.

ASC 842 also significantly increases the disclosure requirements for leases and mandates that companies collect and monitor certain relevant lease data, including both quantitative and qualitative information. Yet many leases don't contain all the necessary data to comply, since some of the data required is based on management judgment. For example, companies should identify discount rates or fair market values, both of which rely on management judgements and estimates. To the extent that systems are currently maintained to support lease operations, the existing data in the system may be stale or of unsuitable quality for use in reporting or migration to a company's new ASC 842 technology solution. If suitable lease data does not currently exist, companies will need to abstract required data from the underlying lease contracts, which can be a significant and labor-intensive task.

Rich: So, Lauren, over to you for our third lesson learned.

Lauren: So another lesson learned is that systems and processes may require more attention than expected or, frankly, even desired. ASC 842 requires significantly more data and calculations to produce accounting journal entries, and the very expansive disclosure requirements, such as weighted average calculations like going to weighted average remaining lease term or weighted average discount rate. All of this prompted many public companies to acquire new technology solutions or modify existing systems for lease accounting. Their experience underscores the importance of confirming up front that a proposed technology solution has the measurement and disclosure reporting functionality that the organization needs. Public companies also discovered that it often takes longer than expected for a new tool to be fully operational. Now, while we've seen some public companies get through day one adoption in a spreadsheet solution, we've seen some realize that it's unsustainable and impractical for tracking lease modifications,

modeling different valuations scenarios, and preparing financial disclosures, and not only that, responding to other compliance and management reporting needs. And thus, for those that didn't necessarily expect to have to implement a technology solution, many are beginning to gravitate in that direction.

Rich: So, Jeanne, could you talk about the fourth lesson learned from the public company adoption of the lease standard?

Jeanne: You bet, Rich. A fourth lesson learned is that the incremental borrowing rate can be a really complex issue. ASC 842 requires lessees to use their incremental borrowing rate (IBR) to record a lease on the balance sheet. Determination of an appropriate IBR involves multiple inputs and judgments, which can vary significantly from one business to the next and change over time. What's more, companies may need to consider a variety of IBRs for different lease terms and different lease currencies. Private companies do have an alternative. Instead of using their incremental borrowing rates, they can elect to use a risk-free rate. Although this is a simpler way to record lease liabilities, bear in mind that the election becomes invalid if a company goes public. In other words, a company would have to go back and calculate IBR and restate its financial statements under public company GAAP, which could be a very challenging undertaking.

Rich: Important considerations for private companies. Jeanne, thank you. So, with no further ado, Lauren, you want to talk about the fifth lesson learned?

Lauren: So the last lesson learned is that lease adoption requires more cooks in the kitchen than just accounting. In other words, spread the word early about implementation. Other departments may be affected, and they need to understand the changes that may be required. For example, the IT department should be involved in planning and making modifications to an existing lease accounting solution. Or if a new system is being considered, providing input on vendor selection or system integrations and testing. The lease project management function may need to solicit legal review of the lease contracts to clarify a company's obligations, for instance, and the procurement function will likely need to be involved in explaining the contracts under its purview to help identify a complete lease population. So to summarize, public companies learned that involving other departments up front is critical, not only for ASC 842 planning and implementation, but also to help identify opportunities for ancillary benefits. For example, enhanced analytics, modeling, and forecasting capabilities can help different departments make more informed business decisions and improve the leased asset performance. Meanwhile, new lease accounting processes can jump-start related initiatives like procurement optimization, real estate management and optimization, contract management and compliance, and contract digitization. Given such a broad impact, it makes sense for affected groups to work on ASC 842 adoption in parallel.

Rich: Jeanne, any final considerations?

Jeanne: Yes, Rich. ASC 842 dramatically increases the number of leases that companies may need to record on their balance sheets. The standard will likely have far-reaching implications affecting areas such as accounting, real estate, legal, procurement, and technology. But private companies don't need to start from scratch. They can learn from their counterparts in the public arena becoming aware of the potential pitfalls and turning a compliance exercise into an ongoing business advantage.

Rich: Jeanne and Lauren, I really appreciate your time and your insight related to the FASB lease accounting standard and the lessons learned for private companies in the consumer industry to consider and help them understand what the early adopters did to prepare and the challenges they encountered along the way. If you have any questions about today's topic, please feel free to contact me, Rich Paul, at rpaul@deloitte.com, Jeanne McGovern at jmcgovern@deloitte.com, or Lauren Pesa at lpesa@deloitte.com. Thanks, and talk to you next time.