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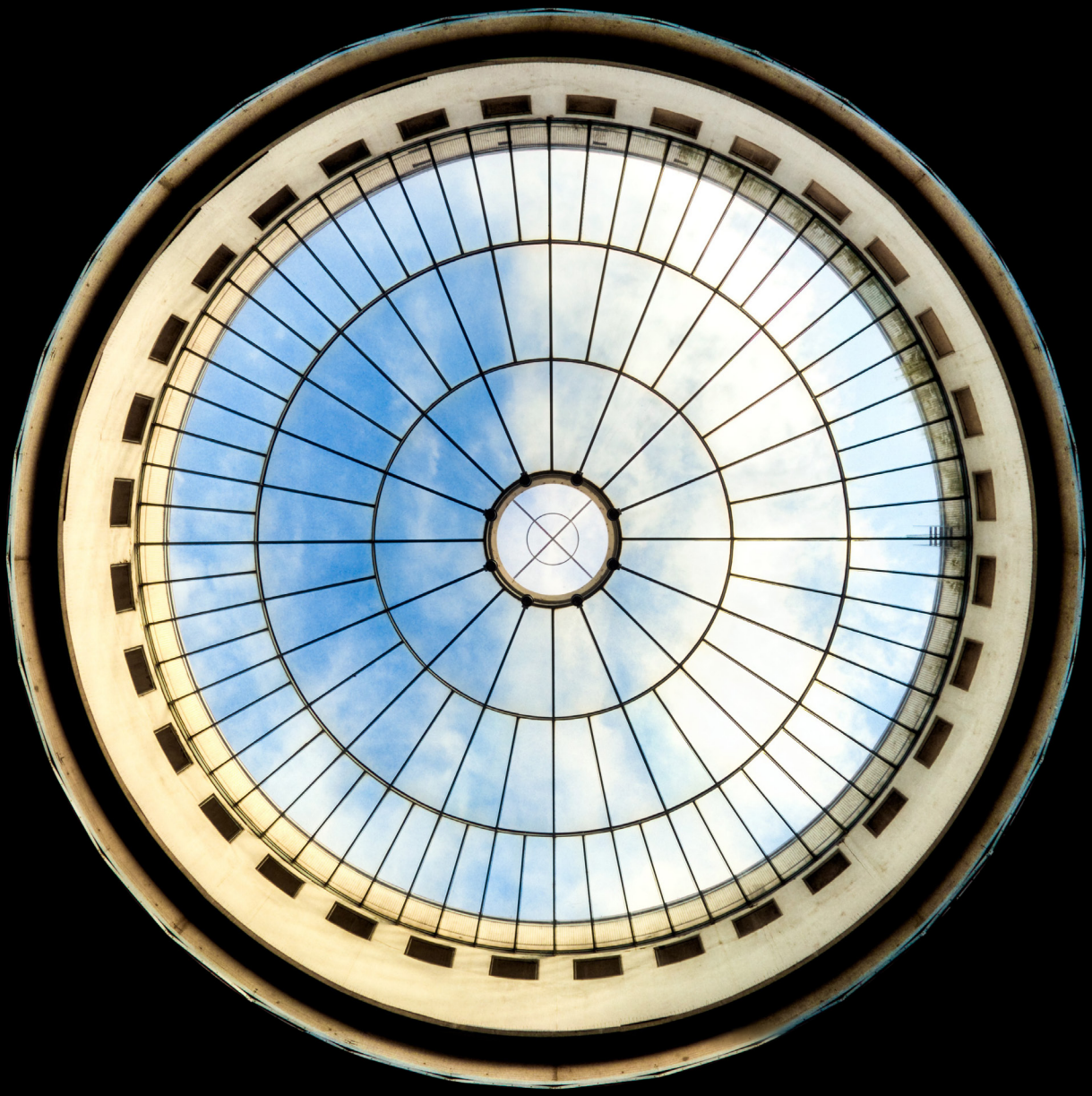


Lease accounting

Five questions PE firms should ask now

The fast-approaching deadline for public companies to comply with the new U.S. lease accounting standard is a call to action for private equity firms. Effective January 1, 2019, Financial Accounting Standard Board (FASB) ASC 842, *Leases*, requires public companies with calendar year-ends to categorize leases as either operating or finance leases and to record virtually all leases exceeding one year in length on their balance sheet. The standard applies a year later for non-public companies.

ASC 842 should be of interest to PE firms now for its impact on portfolio companies due to the potential investment and resources required to comply with the standard. Additionally, management can benefit from considering the potential affects, if any, to financial performance and underlying valuation. Such impacts could have implications for any of those companies if they are being considered for divestitures, M&A, joint ventures, or other deals.

Likely of foremost importance to PE firms is what the standard means for the valuation of their portfolio holdings. Bringing off-balance-sheet leases that were previously treated with a footnote, if at all, onto the books as liabilities may have some impact on a company's valuation. For example, the total liabilities- to-equity ratio is likely to reflect an increased amount of liabilities with no changes in equity. That matrix probably appeared to look better prior to issuance of the new leasing standard because the lease commitments disclosed in the footnote may not have previously been considered to be a real liability.

Implementation of the standard can require significant investment and attention, both during and after the transition period. ASC 842 compliance is likely to involve new technology or upgrades to existing systems, extensive abstraction of existing lease agreements to capture specific data, and close coordination among portfolio company senior executives in corporate real estate, procurement, and IT, with third-party advisers involved where necessary. The new standard requires lessees to establish a liability for each of their leases, including operating leases exceeding 12 months, and an accompanying right-of-use asset. Many organizations historically have not captured, at the required level of detail, the variables necessary to make these calculations and related disclosures.

PE firm executives who want to determine the readiness of their portfolio companies for ASC 842, or anticipate the standard's potential impact, can gain valuable insights by posing five questions to the CFOs, chief accountants, or head of the finance team (hereafter CFOs) of those portfolio companies.

QUESTION #1

Is your portfolio company adjusting business models, processes, and behaviors to comply with ASC 842?

Many leading enterprises are adopting a centralized model for lease administration and accounting. This is a departure from the decentralized structure found in many large organizations, which is typically driven by tax considerations and defined by geographical borders. The benefits of this shift are expected to accrue more to operations than to finance. Companies can be more strategic about their real estate and equipment leases using accurate and complete data, along with sophisticated data analytics, to generate economies of scale and negotiate more effectively with vendors.

That's not to say finance and accounting are out of the picture, however. In fact, the new standard has far-reaching implications for tax, accounting, and reporting. For example, in the past, a business unit renewing a lease, perhaps for an office building, often cared primarily about the new rental cost and payments, giving it little reason to reach out to finance and accounting. With ASC 842, finance and accounting teams and the business units engaged in negotiating and renewing leases will want to stay in close contact. This will allow the accountants to assess the impact of leasing decisions on the balance sheet, potentially including impacts to debt covenant requirements, future financing, and fund-raising activities of the portfolio companies.

New accounting realities will also factor into business unit leasing decisions. In the past, for example, many companies carefully structured lease arrangements, including sale leasebacks, so they could be considered operating leases and hence remain off the balance sheet. Under the new standard, most leases will be on the balance sheet regardless of how the transaction is structured, which means those transactions may make less financial sense.

QUESTION #2

Has your company begun to implement new technology or modify existing systems to meet the requirements of the standard?

Having systems, processes, and people in place is essential for ASC 842 compliance, as well as for assuring current and potential investors of a company's stability. The new standard presents organizations with data collection and aggregation challenges across multiple locations, in multiple currencies and languages, and across various technology platforms, many of which are not able to easily share information.

Portfolio company CFOs will want to make sure their organizations have lease accounting software and systems in place that can store lease data from across the enterprise and perform the necessary lease accounting calculations. The more processes are automated using these systems, the less likelihood of mistakes that lead to errors in the financial statements.

Ideally, systems designed to facilitate compliance should go live early in the year ASC 842 becomes effective (again, 2019 for public companies, 2020 for all other entities with calendar year-ends) to enable quarterly reporting under the new standard by March 31 of that year. To allow for testing, that may mean they should be operational at least by the end of September or early October of the previous year.

Accounting-only solutions are relatively inexpensive and allow for shorter implementation times. More-robust, more-costly lease administration packages can be integrated more easily with other enterprise systems, and—among other advantages—may be able to assist in lease-versus-buy decisions, manage lease payments and renewal options, and facilitate operating analysis of leased assets.

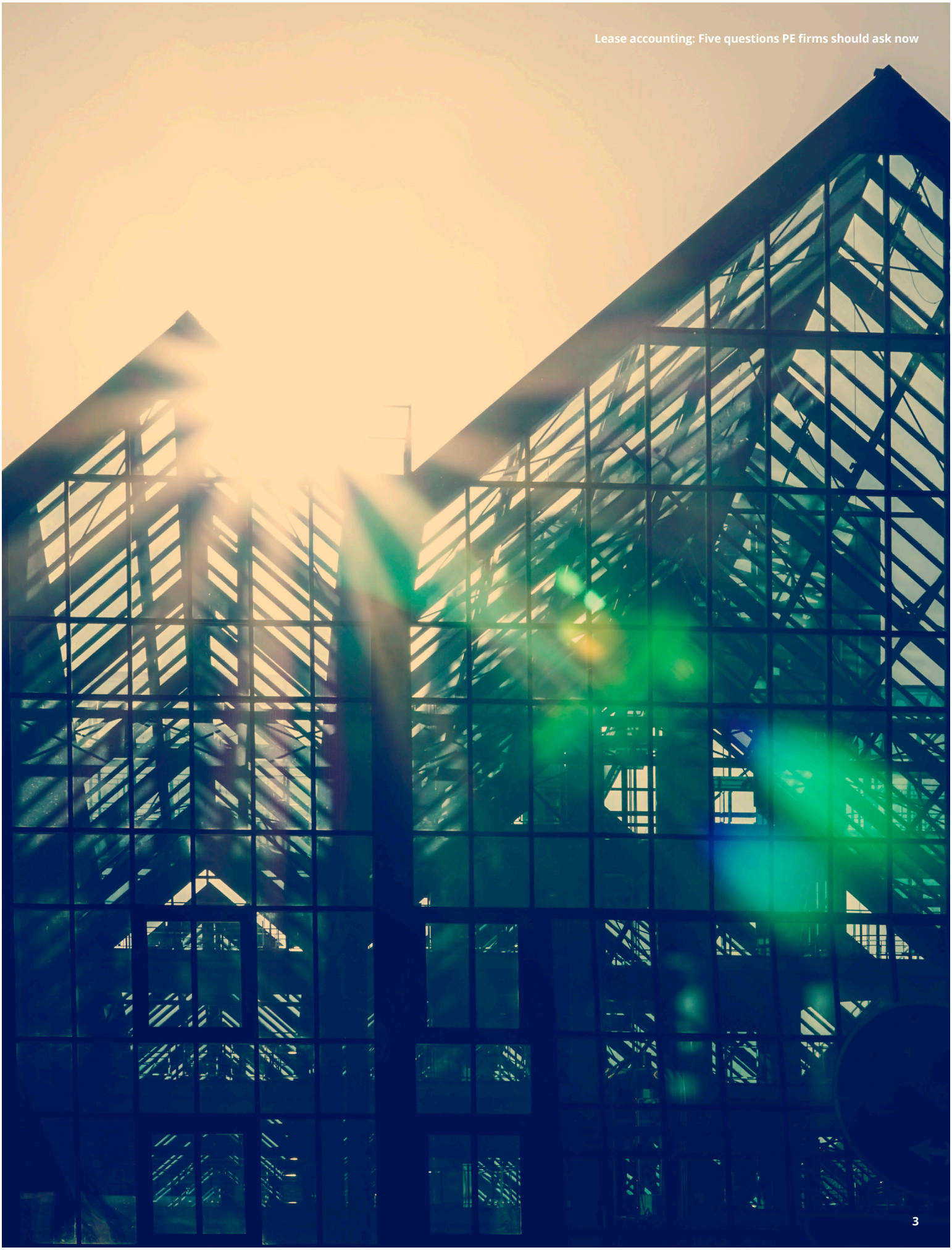
QUESTION #3

Have you identified data gaps and developed a remediation plan?

Gathering accurate, complete data early in the ASC 842 compliance effort can help avoid complications and distractions as the process unfolds. Some of the many quantitative data points required by ASC 842, such as the market value of a leased asset, may have been managed manually and not regularly tracked in existing lease management systems. Other data points may not have been captured technologically in a manner that facilitates calculations now required under ASC 842. For example, under the new standard, the term of a lease may include not only the initial term but also any renewal options that are reasonably certain to be exercised. Companies should have a process to identify what data they are missing and how they are going to obtain such data efficiently.

PE firm executives can ask their portfolio CFOs whether their organizations have designated an in-house lease accounting specialist to commission and oversee the lease abstraction process or instead outsourced the work to a qualified third party. Companies whose lease portfolios are mostly homogeneous can perhaps use internal resources to handle the abstraction process. Those with more varied portfolios may seek outside help to address challenging accounting determinations.

Notably, some companies have been outsourcing lease administration programs already, especially those pertaining to real estate. Companies that have reduced the number of data points, or fields, they track to reduce costs may now need to populate many new data fields with data previously not abstracted.



QUESTION #4

Does your company have the resources to do this work on its own?

Some organizations may have the in-house bandwidth and knowledge to oversee the migration to the new lease accounting standard. Others might not, especially during the implementation phase, which can be especially daunting.

PE firm executives will want to understand if and how their portfolio companies may be using external resources to assist in the adoption of the standard. Many companies are turning to third parties to handle lease abstraction activities, implement new technology solutions, and manage their real estate portfolios. The quality and experience of these parties are critical to effective accounting. Of course, what resources need to be brought to bear is contingent on the size and complexity of a company's lease portfolio.

QUESTION #5

Has your company initiated discussions with its external auditors to discuss significant judgments, policy decisions, and auditor expectations around accounting and internal controls?

A portfolio company that considers itself thoroughly prepared for the new standard can nonetheless benefit from knowing the expectations of its auditors. Whatever new processes and technology the business is implementing, the auditors need to be comfortable with the approach. They'll want to know, for example, that they'll be able to come in after the fact and find that your organization has captured the required details. Portfolio companies are encouraged to engage their auditors early and in advance of their proposed implementation for timely feedback.

Championing ASC 842 compliance

PE firm executives can help accelerate and streamline ASC 842 implementation by directing portfolio company CFOs to designate a project management office (PMO), which can coordinate and take responsibility for the effort. PMO stakeholders should include representatives from the portfolio company's accounting, tax, corporate real estate, procurement, and IT functions, along with external auditors. The PMO can develop a detailed project plan in coordination with the external auditor, then work to ensure that data collection and validation and software implementation remain on schedule. Portfolio company CFOs also may want to appoint a lease liaison—a lease accountant to be responsible for the new accounting and reporting requirements on an ongoing basis.

The clock is ticking

The new lease accounting standard is expected to increase transparency, but implementing it will be a big undertaking for many companies. For PE firms that might have been monitoring their portfolio companies' progress on adoption only sporadically, this is the time to put it higher on the agenda.

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