Lease accounting for private companies:

Lessons learned from public company implementations
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Introduction

For public companies, January 2019 marked a turning point. It was then that Accounting Standards Codification (ASC) Topic 842, the Financial Accounting Standards Board’s (FASB’s) new standard on accounting for leases, took effect for public companies with calendar year-ends. It could bring some $3 trillion of lease liabilities onto publicly traded company balance sheets.¹

ASC 842 changes the way companies across all industries account for their leases and provides investors with a clearer picture of what companies owe through their lease obligations, including those for equipment and real estate. And in 2020, the rule goes into effect for most private companies as well.

This gives private companies an opportunity to learn from their counterparts in the public realm. What did earlier adopters do to prepare? And what stumbling blocks did they encounter along the way? Here are five takeaways to help private companies prepare for the first major update to lease accounting in nearly 40 years.

LESSON 1:
Finding leases is not straightforward

Failure to appropriately identify a complete population of leases can have a more significant financial statement impact under ASC 842 than it did under legacy US GAAP. As public companies kicked off their ASC 842 implementations, they soon realized that the decentralized processes for leases that were sufficient for legacy GAAP reporting would become significant implementation hurdles. Often, a company’s leases were tracked and maintained in disparate spreadsheets or databases by 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.

We expect private companies will face similar challenges, so they should undertake careful planning upfront to identify a complete population of leases and to establish appropriate procedures as new leases and lease amendments are executed.

Beyond finding contracts that are clearly leases, another fundamental challenge is that not every lease is labeled as one. A lease is a contract that conveys the right to control the use of a specified asset (e.g., 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, information technology (IT) service contracts, and contract manufacturing arrangements.

Finding and documenting these embedded leases can involve considerable time and judgment, including a close look at all operations, identifying areas where embedded leases are more likely to exist, and meeting with relevant stakeholders to understand whether assets are deployed as part of service contracts. An examination of expense activity may also be required, as well as a physical inspection and a legal review to highlight contracts for further evaluation. For other embedded lease considerations, lessons learned, and effective practices, see our recent publication, “Identifying embedded leases: Are leases hiding in your contracts?”

LESSON 2:
Required lease data can be a challenge to abstract, migrate, and maintain

ASC 842 requires companies to identify 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, and some may be in foreign languages and reflect the nuances of local markets. Additionally, some leases have numerous amendments, making identification of the appropriate source document for relevant data fields a further 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 lease agreements do not contain all the necessary data to comply, since some of the data required is based on management judgment. For example, companies must identify discount rates or fair market values, both of which are premised on management judgments and estimates.

To the extent systems are currently maintained to support lease operations, the existing data may be stale or of unsuitable quality for migration to the company's new ASC 842 solution. If suitable lease data does not currently exist, companies will need to abstract required data from the underlying lease contract(s), which can be a significant and labor-intensive task. Artificial intelligence (AI) tools exist to assist in abstraction and should be considered wherever possible, but the technology has limitations, especially when dealing with older lease contracts. As such, AI generally can aid human effort, but not replace it altogether. People must still review the output, execute quality control procedures, and consider additional fields to abstract outside the lease contract.

Once the initial data abstraction or migration effort is completed, companies may soon need to pivot to lease data maintenance. Many organizations with larger lease portfolios frequently modify, cancel, and renew leases. Management should consider an operationally efficient approach to ongoing lease accounting data maintenance.

The lessons? Don’t underestimate what it takes to collect, organize, and maintain lease data. Private companies can achieve efficiencies by developing robust plans, implementing data quality checks and controls, and leveraging technology in combination with suitably trained and skilled data specialists.
LESSON 3:

Systems and processes may require more attention than expected—or desired

ASC 842 requires significantly more data and calculations to produce accounting journal entries and disclosures. At the same time, it makes manual processes less practical for tracking lease modifications, modeling different valuation scenarios, preparing financial disclosures, and responding to other compliance and management reporting needs.

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 upfront that a proposed technology solution has the measurement and disclosure reporting functionality the organization needs. They also discovered that it often takes longer than expected for a new tool to be fully operational.

Nevertheless, a longer adoption runway gives private companies more time to think through their approach, including the ongoing monitoring and maintenance aspects. To make use of this longer runway, private companies should consider effective project management practices to efficiently use project resources and to manage timeline risk, particularly in areas such as business requirements development, application integration, system testing, and user training.

Furthermore, because compliance and reporting must be done regularly, effective internal controls and processes are important. In particular, controls and processes around reversing current ASC 840 accounting, impairment accounting, modification accounting, and the reconciliation between actual and contractual cash flows are all key elements of an effective lease accounting program.
LESSON 4:
Incremental borrowing rate is a complex issue

Under some circumstances, ASC 842 requires lessees to use their incremental borrowing rate (IBR) to record a lease on the balance sheet.\(^3\) Determination of an appropriate IBR involves multiple inputs and judgments, which can vary significantly from one business to the next and even change over time. What’s more, companies may need to consider a variety of IBRs for different lease terms and different lease currencies.

However, private companies have an alternative: Instead of an IBR, they can 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. The company will have to go back and calculate its own IBR separately.

Many public companies assumed that obtaining the information necessary to produce an IBR would be straightforward and possibly ascertained from rates on existing debt. However, the process for obtaining rates is far more complex than companies expected, largely due to the nuances of establishing rates (e.g., identifying the appropriate entity-specific credit risk adjustment or the impact of full collateralization). Private companies should establish repeatable processes for completing this management estimate and uploading such information into the relevant systems to minimize the administrative burden.

LESSON 5:
Spread the word early about implementation

Many public companies learned that ASC 842 implementation is not an accounting-only endeavor. Other departments may be affected, and they need to understand 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, 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.
- The procurement function will likely need to be involved in explaining the contracts under its purview to help the project management function identify a complete lease population.
- Business units may need to assume a more prominent role in monitoring and maintaining some relevant lease information given they are closer to the day-to-day business operations.
- The treasury function may be involved in better understanding the impacts to financial covenants and helping identify appropriate discount rates for lease calculations.
- Including right-of-use assets and lease liabilities on a company’s balance sheets may result in the recognition and measurement of deferred tax assets and liabilities. As such, it is critical to include the tax department in the implementation planning process.
- For companies with significant real estate leases, it is prudent to include real estate personnel early on in conversations, particularly about technology selection. They may benefit from the use of technology since many of the software solutions have built-in real estate life cycle management functionality.
- Financial planning and analysis personnel should be involved to understand the post-implementation impact on financial statements, including updates to ratios and other key metrics.

Public companies learned that involving other departments upfront is critical, not only for efficient 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 broad impact, it makes sense for affected groups to work on ASC 842 adoption in parallel. Consider building an implementation roadmap showing adoption-related tasks across all affected functions. At the same time, be careful to make room in the schedule for contingencies and engagement of third parties if needed.
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 needn’t start from scratch. They can learn from their counterparts in the public arena, becoming aware of potential pitfalls and turning compliance into an ongoing advantage.
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