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Q&A

Lease Accounting Change Faces Real-World Challenges

An Interview With Simon Little and Luis Lopez Garay of Crowe

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During the first quarter of 2018 and into the remainder of the year, senior-level financial executives are finding themselves working through implementation of the new lease accounting standard. With revenue recognition in the rearview mirror for many public companies, the financial suite is discovering new and unique challenges when it comes to lease accounting changes.

The Financial Executive Research Foundation (FERF) spoke with Simon Little, senior manager with the Crowe risk advisory practice, and Luis Lopez Garay, senior consultant with the Crowe performance consulting practice.

FERF: Several recent surveys reveal that few financial executives feel prepared to implement the new lease accounting standard. Where do you feel are the greatest pain points when it comes to implementation?

Simon Little: I think at the moment a lot of people are quite comfortable with the implementation of the revenue recognition standard. Several organizations probably are tapping the brakes on the leasing standard. We talked to a lot of organizations that tried to get out ahead of it, and then we followed up with them and found that they put it on the back burner.

I'm anticipating a lot of organizations are going to have the same response they did to rev rec: kicking the can down the road and then finding themselves scrambling to get implementation in place. For leasing implementation, organizations first have to go about understanding where all their leases are. And it's all operating leases – not just real estate leases but those for copiers, printers, and computers that may be leased throughout the organization. Companies have to assess whether they have a process that can support the new lease standard going forward.

Many of the companies we started to talk to understand the two big aspects of the new standard: Operating leases are going on the balance sheet, and they probably will need software to help with that. But what they don't know at the moment is what all their operating leases are. And so, organizations are scrambling to figure out where they can initiate a lease. Where can they modify a lease? Where do all their leases reside? How is that going be affected under the new standard? How are they going to adapt their existing process to be able to take into consideration the accounting? I definitely think organizations are behind. They have to put in a little more thought because this is an ongoing exercise. Organizations are going to have to implement new processes, new controls, and new systems down the road to do the accounting appropriately. And that may include additional resources that go on into the future.

I think pain points right now are just understanding answers to some questions: What's the total population of leases that are going be affected? Where do they start? How do they gather that information? How do they evaluate that? And then once they do, what's the impact on the entire process? Are they going to centralize it all? Or are they going to still have it decentralized and have each of the individual business units be able to engage the leases? And then if they do that, how's the new system going be implemented around it?

Luis Lopez Garay: I think that one of the largest challenges right now is that companies are really just focused so heavily on revenue recognition. Because of that, they're going to start almost in a delay with the lease accounting standard. I would encourage companies to pick up the lease accounting implementation effort as soon as they can. We know that the accounting department is going to be busy. We know that they are staffed to the max with the revenue recognition standard. But they should get started as early as possible so that they can be properly prepared for the upcoming deadlines.

FERF: What industries or sectors do you see as the most advanced, and challenged, when it comes to lease accounting implementation?

Lopez Garay: I've seen in the market that retailers and the transportation industry are definitely the most affected by the new standard. And this is because historically these are the industries that have a larger share of operating leases as a portion of their overall lease portfolio. However, because these operating leases are such an important portion of their ongoing operations, most of these companies and these industries have a good handle on their lease portfolio. And so a lot of these companies have lease accounting software in place. They have a centralized way to manage all their leases.

What we've seen in the market so far is that a lot of companies – especially manufacturing companies or other companies where the primary business is centered not around leases but around inventory – will have a lot of hidden leases, and they usually don't have any processes. They don't have any central repository for their leases, and those are the companies that will see the most effect. I think it's just because they are not as prepared as retailers and transportation companies are. They just don't have as good a handle on their operating leases right now.

Little: I think another area to watch out for is larger organizations that acquired many smaller organizations and allowed them to operate independently. They are going to struggle with the standard. We have seen companies with several new acquisitions, and that means several new processes for initiating and modifying leases. Those companies have said, "We need to understand where all our leases are." I think any decentralized organization is going to struggle with this. Ones that don't focus on having operating leases as a main component of their business are going to go out and do some training and do some research into all the potential leases that they have engaged into and what expenses they are seeing under the profit and loss statement that they need to find contracts for and ensure they get into whatever system they decide to implement.

Some organizations are well-managed when it comes to leases and have a centralized function, and those organizations tend to have a lot of real estate leases.

Others are very decentralized with a lot of individual divisions, groups, and operation timelines. That's going to create a lot of headaches when it comes to the accounting because the organization needs to know what point each lease is at in the lease life. So that requires knowing the location of all leases, contracts, and potential embedded leases. And this is before even getting down to start tackling other areas such as what embedded leases exist, what options require estimates, and how often lease renewals happen.

FERF: How would you describe the technology vendors' ability to support implementation plans? Are they ready?

Lopez Garay: I think that's a very important consideration companies should keep in mind when selecting their lease accounting vendor.

I like to draw an analogy here to get my point across. Many executives have hired outside firms in the past to perform a valuation on a new business they purchased or on a fixed asset. Part of the selection process is checking the credentials of the valuation experts. Organizations have to have the same mindset when selecting lease accounting software.

Companies and executives need to understand who is behind the system. A lot of the lease accounting software that's out there started as lease administration software. So these vendors have a lot of property managers and real estate executives behind their leasing software. When looking at vendors, companies really ought to make sure that the software can handle complex lease accounting, including modifications and early terminations. It would help to understand how the vendor employs technical accounting expertise to interpret the accounting guidance and translate it into software.

Little: The only other aspect when it comes to software is understanding what capabilities are needed and scaling the software to meet those needs. So many service offerings exist right now; it's important to make sure that a vendor has some backing when it comes to the accounting space. Two types of organizations are coming at this. Some have a prior accounting focus, and some have a prior lease management focus. I think both are coming with good products.

Organizations just need to think about which one meets their needs the best and whether they want to have some more of that lease functionality or just want to be really solid on accounting. And then they must determine what kind of functionality they want with regards to accessibility. Do they want to host or allow people to access via the web? Do they want it monitored and used by one group within the organization, or should multiple business units and accounting groups throughout the organization have access? Also, how will the company's management be able to assess and evaluate the processes and controls relevant to the software? Those are considerations that companies should go through before they even get to the software selection stage and start evaluating different software capabilities.

FERF: Has the Financial Accounting Standards Board's practical expedient proposal (from January 2018) for the lease accounting transition given enough breathing room for some preparers to implement the changes?

Little: I think the portion of the proposal for transition relief, which we expect to be finalized by the FASB soon, definitely makes things easier having an option to adopt the standard through a cumulative effect adjustment in the period of adoption and not having to worry about grossing up the balance sheet in prior periods.

While it may give organizations a reprieve within the transition process, I think the overall process remains significant. That's because it is just eliminating a portion of leases that companies were engaged in before the transition date. But they still have to go through all the process improvements, all the software implementations, and the reviews of the existing leases at transition.

If they don't have the transition relief, organizations will have to account for the existing leases in the comparative period. It definitely does provide a little leniency. I think people feel more familiar with it because it aligns a little more with the revenue recognition approach of having the option to transition comparatively or in the period of adoption.

Lopez Garay: I think it does allow for some more breathing room, but comparability of financial statements also is important. And if companies do choose the optional cumulative effect approach as opposed to the modified retrospective, the year-to-year comparison will go away in the year of adoption. That is something companies will have to weigh.

FERF: Will the lease accounting changes affect the way some companies do business? If so, where do you see the greatest impact?

Little: The changes are better for the investors. But I also think they're going to drive improvements within organizations.

As they start to evaluate their lease initiatives and modification processes, organizations are starting to understand their individual leases and where they can find efficiencies in dealing with particular vendors, consolidating real estate, centralizing the population of agreements, and then streamlining processes and approvals. They certainly are going to be able to monitor costs and find synergies when engaging in new leases going forward. They'll be able to pull information from and get analytics out of centralized data, which I think is always a great thing for companies to improve on their operations.

The changes are going to benefit a lot of organizations – some more than others. I think the ones that are less mature in the lease accounting space or even the lease management space are probably going to benefit more than those companies Luis talked about earlier: the retailers and transportation companies that are pretty well-managed in those areas. But even those companies might start to see improvements in areas that they hadn't focused on before because they're going through this exercise. Anytime we implement one of these standards – and revenue recognition has proved this as well – it's a great way for organizations to re-examine things they haven't looked at in a long time. They're re-evaluating adjustments. They're educating their people on processes, and out of that always comes new efficiencies and better ways of doing business.

Learn More

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