White Paper

Taming the Monster: A Roadmap to ASC 842 Compliance

Bloomberg Tax

Introduction

Since 2014 there have been four major updates issued to the U.S. Generally Accepted Accounting Principles (GAAP). As a result, accounting professionals have faced years of unprecedented change and volatility. The good news is that the Financial Accounting Standards Board (FASB) has promised to refrain from issuing additional major changes until companies have had the chance to implement the numerous policy and system changes required to comply with the four recently issued updates.

This should give accounting departments time to turn their attention to the new lease accounting standard, ASC 842. Once they do, they'll realize *it's the most significant change to lease accounting in 30 years* — impacting every company that has leases, whether real estate, equipment, printers, furniture, etc. Compliance with ASC 842 will require broad organizational programs and significant changes to lease management processes and systems.

Some organizations are still assessing the impact of the new standard and haven't yet begun the potentially arduous compliance tasks ahead of them. In a recent survey conducted by the Deloitte Center for Controllership, only 20 percent of finance leaders said they were "prepared" or "very prepared" to comply with the new standard.[1]

While implementing these changes can be a daunting task for organizations with many leases, careful planning and execution can help streamline implementation processes and reduce the risk of surprises that could delay readiness for compliance. Additionally, the new lease accounting standard will not impact the ability of companies to acquire productive equipment to grow their businesses or to enjoy the benefits of equipment leasing and financing. There are many reasons to lease equipment, and those benefits will remain intact under the new rules, from maintaining cash flow, to preserving capital, to obtaining flexible financial solutions, to avoiding obsolescence.

This white paper explains the risks, benefits, and challenges of ASC 842 compliance and offers a five-step guide to help organizations meet deadlines, minimize risks, overcome hurdles, and accelerate the implementation process.

Risky compliance methods

In a **Bloomberg Tax survey** of over 500 tax and accounting professionals conducted in mid-2018, 49 percent of respondents reported that despite significant risk of error, the majority of companies use spreadsheets to account for leases.

A Landmark Change in Lease Accounting and Investor Metrics

For the FASB, the primary objective of the new lease accounting change is to address off-balance-sheet financing concerns related to lessees' operating leases. That's why, for the first time, companies will be required to recognize the majority of leases as assets and liabilities on their balance sheets for all financial reporting.

1 "**Lease Accounting: What's the Holdup**," Vincent Ryan, CFO.com, March 30, 2018.

The new leasing standard retains the current dual approach on the income statement, requiring leases to be classified as either operating or financing. Both financing leases and operating leases will result in a new asset and require complex calculations for right–of–use (ROU) assets and liabilities that should be reflected on a company's balance sheet. This will help provide greater transparency to shareholders, investors, lenders, and other interested parties.

The accounting process on the lessor side will remain similar to the current approach while lessees stand to be the most significantly impacted by the new standard. When a lease is recorded, a liability must be recognized based on the present value of future lease payments, with an offsetting entry to recognize an ROU payment. Present value is determined based on the rate implicit in the lease, or the lessee's incremental borrowing rate.

A recent *Wall Street Journal* article predicts the new standard will bring $2 trillion of lease liability onto S&P 500 balance sheets. With new assets and liabilities being disclosed for the first time, shareholders, investors, lenders, and credit–rating agencies, will likely see a material impact on the financial metrics of many companies.

In filings with the Securities and Exchange Commission (SEC), JPMorgan Chase predicts the impact of ASC 842 on its balance sheet will be $10 billion. Apple states that it expects a change of $9.6 billion. Microsoft has already adopted the new standard, which added $5.4 billion in operating lease liabilities and $1.2 billion of other current and long–term liabilities to its balance sheet.[2]

What will compliance cost?

A PwC and CBRE lease accounting survey found 24 percent of organizations did not know their total costs for complying with the new lease accounting standard. Of the respondents, 43 percent believed their costs would be less than $250,000, while 33 percent estimated costs would be higher.

Source: "**2018 Accounting Change Survey Results**," PwC, May 2018.

The Benefits (and Risks) of Compliance

While compliance is mandatory, ASC 842 presents a valuable opportunity for improving processes, controls, management, and visibility into leases for companies that invest the time and money to centralize the lease accounting process. Instead of approaching the effort as purely a compliance task, companies that reframe it as a strategic initiative stand to gain:

- **Improved lease management processes.** ASC 842 presents an opportunity for companies to integrate key business processes — from procurement and sourcing to lease accounting — for greater oversight, administration, and overall efficiency.
- **Greater visibility into leasing costs.** With comprehensive, centralized lease data, companies can get the deeper insights needed to make better, more informed leasing decisions.
- **Cost savings.** Greater visibility and access to lease data can help companies analyze current and future leases to identify unused lease assets, free up cash, and improve future lease negotiations.

2 "**This next accounting rule change will add liabilities to every balance sheet**," Francine McKenna, MarketWatch, April 26, 2018.

At the same time, however, there are certain business risks that ASC 842 compliance can introduce. Compliance efforts should include identifying which risks apply to your company and how best to mitigate them. Some of the most common business risks include:

- **Decreases in share price/market capitalization.** Large leasing portfolios could add millions of dollars in debt (operating liabilities) to the balance sheet, which in turn could affect your company's share price and market value, at least in the short term. Disclosing the expected impact may help mitigate this risk.
- **Unknown impacts on financial metrics.** As new liabilities are added to the balance sheet, company metrics such as asset turnover, return on capital, return on assets, and net worth may be negatively impacted. It's important to identify how metrics will change and create a strategy for communicating those changes to investors and shareholders.
- **Reduced ability to borrow.** If new lease liabilities increase the debt on your company's balance sheet, it may hurt your ability to borrow money or raise new debt. Identify and address the potential impact of operating liabilities with your lenders to avoid surprises.
- **Inability to comply due to software limitations.** Inaccurate or delayed reporting by public companies can result in penalties or fines levied by the SEC. While private companies aren't subject to SEC rules, they can be at risk of losing investor and lender confidence, which can hinder future financing. Make sure your systems can capture and accurately manage the lease data required for compliance.
- **Material weaknesses.** Auditors are preparing for changes to their audit procedures to reflect the new leasing standard. As scrutiny increases around the new standard, your auditor could identify weaknesses in your lease accounting processes and systems. To avoid this, proactively collect all relevant lease data, including embedded leases, and document all key assumptions and exactly how your company consistently applies them.

The First Challenge: Data Collection

In a survey from the Deloitte Center for Controllership, 6 in 10 financial professionals say they are surprised by the challenges they are running into when adopting the new leasing standard. For anyone who has already completed the implementation, it will come as no surprise to learn that the one of the major hurdles, according to respondents, is collecting the necessary data for compliance.[3]

There are three major challenges that companies face when collecting relevant lease data:

1. The quantity of leases: Some companies have hundreds, thousands, or even tens of thousands of leases for which they need to collect data. In a PwC survey, 13 percent of public companies report having 10,000 or more lease assets, 9 percent report 5,000 to 9,999 lease assets, and 21 percent report 1,000 to 4,999.[4]
2. The amount of detail per lease: Real estate lease documents can contain more than 100 pages of details, requiring two to three hours of examination for sufficient lease abstraction. This could mean budgeting thousands of hours of work for complete data collection and review. For example, an organization with 1,000 leases may need to allocate 2,500 hours for thorough review and abstraction of critical lease information.

3 "**Lease Accounting: What's the Holdup**," Vincent Ryan, CFO.com, March 30, 2018.

4 "**2018 Accounting Change Survey Results**," PwC, May 2018.

3. The location of leasing data: Leasing data is often fragmented across the organization, making it difficult and time-consuming to locate. In the PwC survey, 60 percent of respondents cite identifying the lease population as somewhat or very difficult.[5] Additionally, some information that is required for the new standard isn't necessarily contained in the lease agreement, for example, the fair value of the asset or its estimated useful life.

Unfortunately, that's not all. There are other potential hurdles to accurately collecting lease data, including:

- Decentralized leases across multiple business units
- Missing or lost contracts
- Contracts in multiple languages
- Embedded or implied leases in other contracts

A Roadmap for Compliance

To build a robust compliance process in time to meet the implementation deadline, your organization needs to overcome data collection challenges and hurdles as well as put new processes and systems in place to centralize and manage lease data moving forward.

Based on industry best practices, the following five-step process can not only ease and streamline compliance with the new leasing standard, but also help your company achieve the longer-term business benefits of centralizing lease data.

Step 1: Build a Cross-Functional Team
Because leases have a broad reach across the company, it's imperative to begin your implementation efforts by building a cross-functional team made up of representatives from multiple business units and departments. This should include representation from the entire organization: Accounting/Finance, Tax, Treasury, Legal, IT, Real Estate, and Procurement. Designate a lease process owner or group responsible for gathering all lease data from each business department. It is essential that your team coordinates its inputs and efforts with your internal and external audit teams.

Step 2: Collect Contracts
Once a team is in place, you'll need to begin the most tedious step of implementation; locating all of the leases and extracting the relevant data. You can start by looking at your company's income statement and analyzing rent, services, and supply expenses. From there, you'll need to dig further to uncover, gather, and organize all relevant documents, including master leasing agreements, addendums, embedded leases within contracts, and other lease-related documentation.

Step 3: Determine Whether the Contract is a Lease, or Contains a Lease
The objective in this step is to analyze each contract to determine whether a lease exists. While the criteria for determining whether an arrangement meets the definition of a lease under ASC 842 is similar to current GAAP rules, an important differentiator is whether or not a lessee has the right to control the identified asset.

---

5 Ibid.

Step 4: Capture Lease Data

Once you've established that the contract is a lease, or contains a lease, you'll need to capture the relevant data. Aside from the complexities of understanding diverse leasing terms, the bigger question is what will your company do with this data? Many companies will discover that they need a new system designed specifically to support ASC 842 compliance processes — centralizing and controlling lease data, automating complex calculations, and creating reports.

Step 5: Automate the Workflow

Many companies currently track and store leases outside of current finance and accounting systems, relying instead on manual processes such as spreadsheets. For companies with dozens, hundreds, or thousands of leases, the inefficiencies, and risk of error inherent in manual processes make this option untenable for complying with the new standard. As you create a new workflow for leases to support compliance, it's an ideal opportunity to automate the steps of your new and revised processes along with the flow of data across departments and systems.

New System Requirements

While many companies currently rely on spreadsheets to collect lease data and create lease reports, the complexity of data management and calculations for accurate reporting (as well as the requirement to maintain audit trails) renders manual efforts infeasible for all but the smallest companies, with fewer than a handful of leases.

This also includes companies using outdated or decentralized systems for tracking leases. Legacy applications may not have the capabilities and automation your company needs to accurately and efficiently handle the management and reporting of lease data going forward.

That's why many companies are now looking to adopt modern lease accounting software. With the right lease accounting software solution, your organization can effectively meet ASC 842 compliance requirements and, better yet, reduce compliance efforts, improve accuracy and control, and deliver visibility into your company's leases across the entire organization.

Nearly half of companies expect to change their lease accounting system

In a PwC survey, 43 percent of respondents say their company plans to implement a new lease system. Source: "**2018 Accounting Change Survey Results**," PwC, May 2018.

When choosing a new lease accounting software solution, keep this **checklist** in mind:

1. Is the solution from a reputable provider with asset management experience?
2. Does the solution include an entity management function that can help you track lease assets by entity as well as manage periods and consolidated groups?
3. Does the solution offer connectivity between lease and fixed assets systems to handle buyouts?
4. Does the vendor offer professional services to help your company automate repetitive processes and integrate with your enterprise resource planning (ERP) and/or tax systems?
5. Can the solution help to automatically classify assets?

6. Does the solution handle both book and tax accounting?
7. Does the solution include built-in documentation management?
8. Is the solution cloud-based to support decentralized teams?
9. Does the solution offer a full audit trail?
10. Can it provide robust reporting, including disclosures?

Conclusion

Adopting the mandatory lease accounting standard is not a trivial exercise. But compliance measures can also create an opportunity for companies to take a closer look at their leasing process and gain greater control and visibility into it, providing insights for informed leasing decisions in the future.

Using the *5-Step Roadmap to Compliance* outlined in this white paper together with a robust lease accounting software solution, your company will be in position to overcome complex lease accounting challenges and meet the requirements for complying with ASC 842.

To find out more about Bloomberg Tax Leased Assets or to request a consultation, please call 800.424.2938 to speak with a sales representative.

To learn more about the benefits of equipment finance, visit the Equipment Leasing and Finance Association's Equipment Finance Advantage website for end users at **www.equipmentfinanceadvantage.org/ef101/benefits.cfm**.

About Bloomberg Tax

Bloomberg Tax provides comprehensive global research, news, and technology services enabling tax professionals to get the timely, accurate, and in-depth information they need to plan and comply with confidence. Our flagship Bloomberg Tax platform combines the proven expertise and perspectives of leading tax practitioners in our renowned Tax Management Portfolios™ with integrated news from the industry-leading Daily Tax Report®, authoritative analysis and insights, primary sources, and time-saving practice tools. Bloomberg Tax technology solutions on our proprietary Advantage platform help professionals simplify complex processes to better control risk and maximize profitability. For more information, visit **https://www.bna.com/tax**.

For more information call 800.424.2938, contact your local Bloomberg Tax representative, or visit www.bloombergtaxtech.com.

1801 South Bell Street, Arlington, VA, 22202

1118rc