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Considerations for the Implementation of the New Lease Accounting Standard: Internal Preparation for Lessors

(Part One of a Three-Part Series)

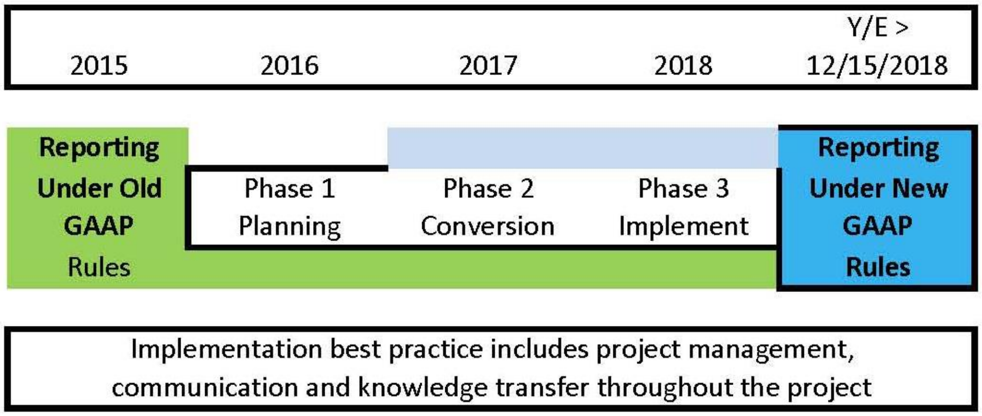
By Gary Anderson, Barbara Galaini, Ann Gill and Scott Thacker

The new lease accounting standard is expected to be issued in early 2016. What is clear is that the changes may result in significant costs to lessors and lessees, and that the time to start planning is now. Many of these costs are obvious. Others are less so. This series of articles will focus on some of the new standard's challenges and impacts to lessors and lessees, and will discuss early planning steps that may reduce implementation costs.

Part I of the series focuses on Lessor's internal considerations (such as Operations, Staffing, Accounting Policies, Education, Underwriting, and Evidence to support key estimates in inputs). Parts II and III of the series will expand the discussion to identify factors to consider for Accounting and Servicing Systems and Customer (Lessee) new requirements and needs, respectively.

As you contemplate the changes and how they will impact your business, keep in mind the following:

- *The effective date of the standard is expected to be the reporting period following December 15, 2018 for US public companies. For SEC registrants, prior year comparative data under the new guidance is required: balance sheet year-end 2018 and income statements full year 2017 & 2018.*
- *For US companies expected transitional relief can be elected. Lessors will be able to elect certain practical expedients that would avoid applying certain new rules to existing leases and continue to use ASC 840 through the transition accounting during the transition period, without retrospective application.*



Phases tend to overlap each other and do not align specifically to time.

Phase 1 During this phase lessors should assess the overall impact of the project and develop an implementation strategy

Phase 2 This is the heavy work phase of the conversion and includes evaluation of the impact of new GAAP differences to old, developing new policy and socializing, revising contracts & marketing materials, determining accounting & servicing system changes and executing on those changes, modify work streams and processes, train staff, etc.

Phase 3 The final phase incorporates all these changes into day-to-day operating activities and can be considered the "go live"

An Entity Wide Concerted Effort

The accounting rule changes will, in some way, effect almost every department in an equipment leasing company. For example, the Board of Directors will need to be briefed about the changes, the cost of compliance, the impact to the customers and the ongoing change in expected profitability. The newest employee will need to be educated as part of his or her introduction to the equipment leasing industry. In short, everyone in your business will need to be aware of the impacts of the changes, and how their job will be altered.

Bringing focus to the pervasive impacts of the accounting changes will be a project for every lessor similar to projects convened to address other significant systemic changes such as a new software system, an acquisition, or a re-organization. The easiest way to begin the project is to follow your established protocol for major changes. For most lessors, that will mean appointing a project leader who can function as the single point of reference. The project leader may be the Controller, Accounting Manager, Accounting Policy Manager, or a senior player on the accounting team, depending upon the size of the organization. Larger lessors may look to the accounting policy staff, the internal audit staff, or a central project management function, as examples.

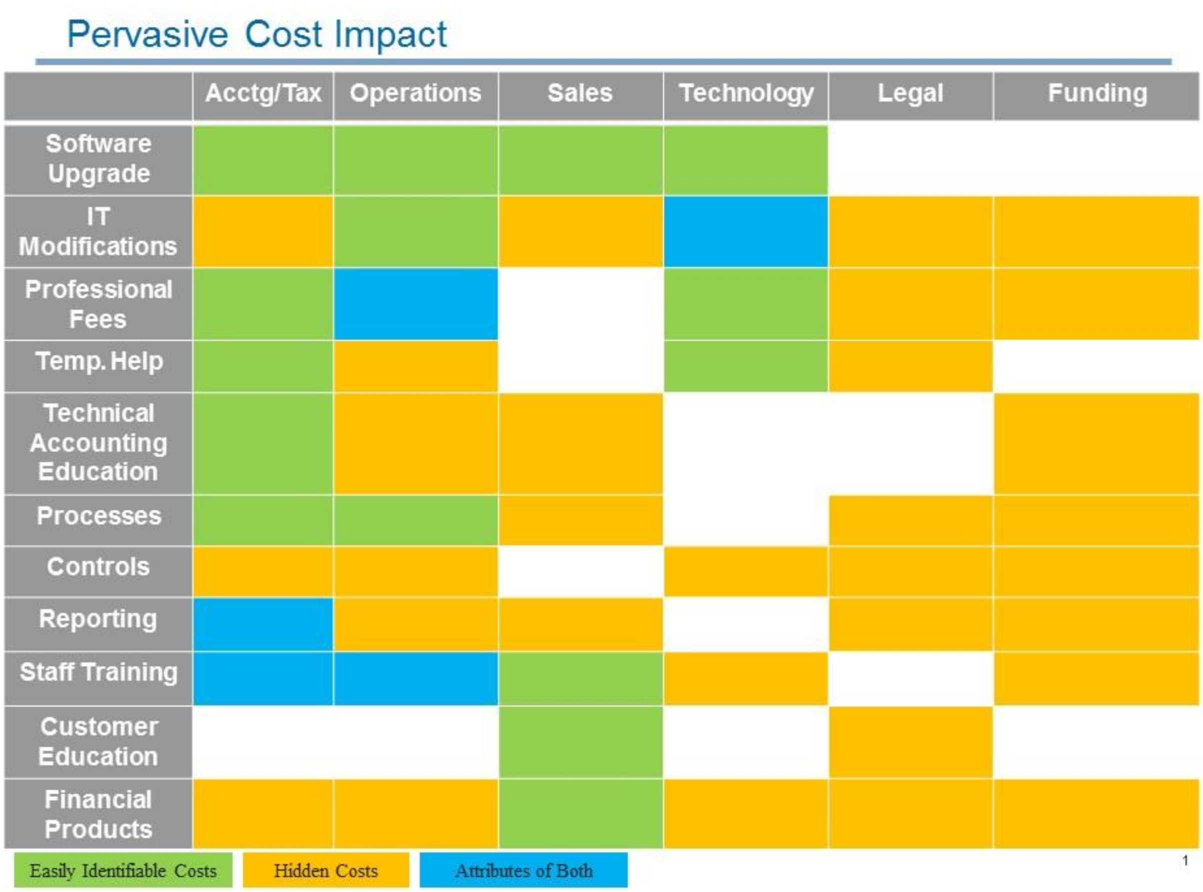
Once a cohesive approach is determined, new projects may offspring. The project leader will need to determine the approach required for every department of your organization. In larger lessors, the scope of activity could include multiple domestic divisions as well as many global subsidiaries, with sub-projects and leaders. For smaller lessors, the approach may be limited to the Controller interacting with a few other departments. While approaches may differ, it is critical that once the final rules are issued, project teams are quickly mobilized to ensure successful implementation.

The Direct and Indirect Impacts

Over the last several years, discussions have focused on debits and credits, footnotes, disclosures, conformance, restatements, software upgrades and tangible costs. Other more subtle yet burdensome implementation costs and time constraints most likely still need to be identified and understood.

The chart below depicts some of the costs that a lessor may face--those that are easily identifiable and others that are more obscure. Depending upon the size of the lessor, all or perhaps only a few will be applicable. However, early consideration of these costs will place your organization in a better position to adequately plan for this project.

Easily Identifiable Potential Costs



Accounting Policy - Implementation an Application

Due to the complexities of the lease accounting project and constituencies impacted, the new standard deliberations have provoked more interest by auditors, standard setters, and regulators than in the past. Many recent standards have explicitly scoped out leases (such as the fair value guidance) until the new leasing standard is finalized. Consistent application of policies and procedures has not been fully vetted to consider the appropriate level of evidence required to support significant estimates and judgments. For example, multiple lease elements and the application of lease accounting to an arrangement that may have included an executory contract and was often classified as an operating lease in the past). Under the proposed rules, the requirement to record the transaction on the balance sheet has heightened the sensitivity around documentation of policies and procedures where judgment is a significant component of the accounting position taken. As the lease accounting project continued, an awareness of the amount of significant estimates and judgments required for applying lease accounting concepts has developed.

Because this standard is more principals based, and although bright-line calculations will serve as guidance rather than absolutely governing its application, accounting policies and application consistency will be required to support each transaction. Parameters will need to be defined by Accounting Policy and implemented consistently addressing the minimum level and type of evidence to be obtained to support judgments regarding residual value estimates, lease terms, variable rent accruals, allocation of purchase price to multiple elements in arrangements (lessee), handling of executory costs, determining sale qualification in sale leasebacks, and representations from management and outside subject matter experts. Those representations include determining what information may be provided to a customer without providing accounting advice and where there may be differences in estimates and assumptions between lessors and lessees. Assumptions utilized to support any modeling or calculations will need to analyzed and supported. For example, weighting the appraisal in the residual value modeling or supporting the relative selling price allocation for multiple elements.

Technical Accounting Education – Accountants and Business Liaisons

Following the identification of the project departmental team leads, educating these project members on the new accounting rules and implications to their business is a crucial early step. Departmental specific educational materials may be necessary to convey the meaningful impacts to each employee’s role. Thorough understanding of the proposed rules and their application (as well as how the rules are applied today) is essential in identifying the compliance requirements across the enterprise that will need to be addressed – from sales generation to internal and external reporting (including Regulatory and IFRS). Collaboration with their internal accounting standards groups, internal and external auditors, regulators and software providers upfront on how the new rules are applied will mitigate costs in the future.

In addition to accountants on staff, underwriters and businesses will need to be educated so that they can adjust their projections, monitor their covenants, and manage internal budgets accordingly. Costs to support key estimates (discussed above) will need to be considered in the pricing of transactions along with having sufficient staff to document the technical accounting decisions made to support these transactions. The changes in how to account for initial direct costs will directly affect margins.

The education is not limited to the leases being underwritten. Budgets will need to consider changes to expenses from the leases held by individual divisions. In addition, any transactions recorded as equity investments may need to be analyzed to determine if the book income will be modified by changes in the standard. For example, a renewable energy investment under Hypothetical Liquidation at Book Value (HLBV) may have a Purchase Power Agreement (PPA) agreement that no longer qualifies as a lease (if the transition package election is not elected by the investee) which may impact both the consolidation and revenue recognition pattern of this investment.

The most effective training involves the development of custom tailored training materials. The development of these materials will help flush out bottlenecks and process misses that would otherwise create operational inefficiencies, mistakes, or errors.

Processing and Operational Changes:
Second to accounting and reporting, perhaps the most impacted function is operations. As software will be modified to fit the new standard, so will the processes that record, monitor and dispose of transactions. Expect rewrites of process flowcharts, internal controls and policies and procedures.

Controls:
As processes change, key controls will need to change as well. Internal audit will need to be trained and will likely need to alter its testing procedures.

Reporting:
Reporting issues are often left to the last task in system upgrades and can consume significant resources for an indefinite period of time. Both internal and external reporting will need to be addressed. New disclosures may require the capturing of additional data from subsidiary ledgers which were not previously accumulated. In addition key estimates and principles may need to be disclosed in both a policy and revenue footnote.

Modifying Financial Products:
Understanding the proposal's impact on the customer, and revisiting your suite of financial products as a result is likely to be a crucial component of your organization's "go to market" strategy. From writing new lease documentation to producing marketing tools, creating new products, and modifying existing ones, will not only consume staff time, but also may be costly should you need to hire legal counsel.

Engaging Resources - Professional Fees and Temporary Help
Industry practice is evolving. Consultants with specialized skills for technical knowledge, process documentation, control compliance, and system development, etc. may be needed as well as temporary help to research lease documentation and perform restatement analyses. Foremost, additional resources to evaluate transition decisions will be needed due to the short time frame to gather historical data.

Keep in mind that some of the technical guidance may be needed in the short term. Many lessors are also lessees, so as you think about transition relief election and an overall transition strategy for your company, you may need to engage some help fairly soon.

Also, it is not too early to think about planning for changes in your lease agreements. Changes in lease contracts and modified products to maintain a competitive edge and to provide lessees with additional data will need to be addressed early for legal compliance jurisdictionally. Identification and separation of services from “leases” will need to be addressed early in the transition period for the modified documents to be in place when the rules become effective.

The opportunity costs of staff reassignment, which could extend for the next three or more years, may be more significant than the potential cash expenditures discussed above. Staff resources will have to be diverted from their normal activities to the accounting rule project. Some companies may want to secure temporary staff to assist or replace their experienced staff that would then focus on the project, while staffs in other companies will simply focus less on normal activities. Given that some of these normal activities are revenue producing, the opportunity costs could be very large.

Other costs to consider that will be addressed more fully in the upcoming series articles:

Customer Education

Customers are interested in knowing what is happening with the new accounting rules, but generally have been staying on the sidelines to date. Soon there will be a rush for information, and your sales teams should be ready. Customers will look to lessors to help them understand the changes and impacts for both new and existing leases.

Software Upgrades

We do know that the new rules will result in necessary software upgrades. In general, systems that employ a more configurable and flexible design should be able to support required changes in the least disruptive and most cost effective manner. The less obvious activities and potential costs include ancillary reporting systems and data bases as well as the general ledger and credit reporting systems.

IT Modifications and System Changes

Many of the larger software providers have multiple customers whose compliance requirements will likely match. For those requirements that do not match, specific company advocacy may be required to insure the software developer delivers upgraded software that fits your company's interpretation of the new rules.

Conclusion

We hope that this article will be a useful guide for you in preparing your budgets and operating plans for the transitional period over the next few years. The impact of the lease accounting changes will be far reaching, and consideration all implementation costs will be necessary to formulate go-forward financial plans and business strategy.

About the Authors

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