1-1-2015

Preparing for the Looming Changes in Lease Accounting

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A Technological Solution for the Informational Problem

By Dennis Chambers, James Dooley, and Catherine A. Finger

Donald Rumsfeld famously stated, "There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know." Rumsfeld's statement can be applied to our state of knowledge regarding the accounting for operating leases in the future. There is general agreement (that is, a "known known") that new standards will require lessees to report most of the assets and related liabilities associated with operating leases on the balance sheet—a significant change from current off-balance-sheet reporting. A "known unknown" is the final form of the accounting standard, including the way leases will be classified (e.g., not operating, but what instead?), and the specific patterns of expense recognition for leases newly recognized on the balance sheet. The "unknown unknowns" can apply to lessee companies that do not yet understand the extent of the preparation and data gathering they face in order to be ready by the new standard's effective date (whenever that proves to be).

The purpose of this article is to help lessees that have extensive operating lease portfolios reduce the uncertainty related to preparing for new lease standards *before* the final revised lease standards are released. The article starts with a discussion of the significant, information-related problems facing most lessee companies. This is followed by the challenges faced by, and the significant opportunities available to, companies in the process of solving those problems. The article concludes with a framework for a solution to the problem of preparing for the new leasing accounting regime, including action items that companies can engage in now to get ahead of the curve.

The Problem

Most companies with large portfolios of operating leases do not have ready access to the lease contract information they will need for reporting under the new standard—nor do they have that information in an electronic form that will maximize its usefulness. One reason is that, until now, companies have not needed to expend the resources necessary to centralize information about most of their operating leases. It has been said that information about operating leases follows an 80–20 rule. Lease information relating to the highest value leased assets (that is, the assets representing 80% of the total value) is contained in only 20% of the leases. Companies track these leases carefully, because there are relatively few of them with high asset values. That leaves information about the lowest value leased assets spread out over 80% of the lease contracts. Companies have not maintained information about these leases in a systematic way. As a result, they may be facing a huge project to gather and organize the lease information they will need under the new standards.

Second, lease negotiation and management is often done at the division level or lower; as a result, lease-specific information may be maintained at the lease origination point (instead of centrally) using spreadsheets that are housed on individual computers. What is more, that information tends to be limited to that which is necessary to prepare aggregated totals, which are then sent upward to the corporate finance unit for processing the lease payments or to the corporate accounting unit for use in reporting the lease footnote. More disaggregated information will be needed under the new standard—information that may not be currently available. For example, lease options related to renewals, purchase, bargain purchase, termination, and rights of first refusal may not currently be stored in electronic form for most, if not all, of a company's operating lease portfolio. Yet these options may have significant effects on the measurement and recognition of leases under the new standard. A renewal option with significant economic incentives might result in a longer recognized lease term, while a termination option might do the opposite. Information about the underlying leased asset is also central to recognition decisions, and it is not currently part of the information retained by most companies in searchable or electronic form. Data such as the economic life of the asset, the starting asset value, and the expected residual value may be important to determining how much of the leased asset is consumed during the lease.

The lack of complete, useable information about operating leases will cause significant problems. First, assuming that the adopted standard is similar to the current proposal, the initial recognition of leased assets and liabilities on the balance sheet will not only increase assets and liabilities but it will also increase debt ratios, EBITDA (earnings before interest, taxes, depreciation, and amortization), and interest expense while decreasing net income. EBITDA will tend to be higher because, for Type A leases that were formerly accounted for as operating leases, most of their lease-related expenses shift from above EBITDA to below. Net income will tend to be lower because the new standard requires effective-interest accounting for Type A leases, which front-loads interest expense in the early years of a lease term. Because most enterprises are growing, more of their leases tend to be in the earlier part of the lease term. Mark E. Riley and Rebecca Toppe Shortridge ("Proposed Changes to Lease Accounting under FASB's Exposure Draft," *The CPA Journal*, June 2013, pp. 28–33) mention that the current ratio and return on assets will typically decrease. Companies with financial ratios incorporated in loan and bond covenants (e.g., restrictions on debt-to-equity ratios or interest coverage) will have a significant problem if they are unable to predict the effect new guidance will have on the relevant ratios (e.g., whether debt covenants could become binding). Different ratios could cause lenders to increase interest rates or alter, reduce, or refuse credit lines. Without greater information about their portfolios of operating leases, companies cannot make a thorough "what if" analysis to provide the basis for renegotiation of covenants in anticipation of changes.

Another similar potential problem exists for companies that have incorporated financial statement–based numbers (for example, EBITDA or return on assets) into employee incentive contracts. Because changes in lease accounting could significantly affect the reported numbers, companies without access to operating lease information will not be able to predict the effect on incentive-based compensation.

Lack of useful information about operating leases also will make predicting

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future deferred taxes difficult. Predicting book-tax differences, and the timing of their reversal, requires complete knowledge of the terms of a company's many operating leases. Until that information is gathered and organized in a usable form, predicting how the new lease accounting standard will affect deferred taxes will be impossible. The latter also is a potential problem for banks when regulators have capital rules regarding deferred tax assets.

Overall, when corporations with large operating lease portfolios lack information about lease terms and the way those terms will affect the lease reporting under the new standard, they are ill equipped to avoid problems by dealing proactively with the effect of new lease reporting on debt covenants, employee compensation, and tax obligations.

The Challenges

In order to meet new reporting requirements, companies with large operating lease portfolios will have to convert their incomplete, decentralized lease recordkeeping into an information system that contains complete information about the terms in each lease, makes the information available centrally, and enables the information to be used for analytical and predictive decision models. In addition, the lease information system will need to meet the internal control standards that chief financial officers will impose to guarantee the accuracy of the balance sheet. Companies will face many challenges in order to accomplish these goals.

Although lease origination and renegotiation may continue to take place at the division level or lower, information about those leases must be available to the corporate accounting unit so that the reporting of those leases complies with the new standard. Therefore, the lease information system must simultaneously allow input and maintenance of lease data at the point of lease origination and management and permit information access throughout the organization, particularly by corporate accounting units that prepare financial statements and SEC filings.

Assembling complete lease information will be time consuming and labor intensive. Many companies do not have a complete and accurate inventory of all leases, for example, leases that are embedded in service contracts. In addition, the data needed to measure the value of the leased asset and corresponding liability for lease payments under an operating lease may not be available except by gathering data directly from the original lease documents. (Compiling information from these documents is commonly termed "lease abstracting.") If the company has international operations, lease information may be kept all over the world, contracts may be written in their local languages, and legal standards may differ across countries. For example, an accountant from a major U.S. global manufacturer, in a discussion with one of the authors, admitted to not knowing how many such leases the company had across the globe, but ventured to guess it could be as many as 40,000. (See the sidebar about Mohawk Industries' efforts to obtain and organize information about its 5,000 operating leases.)

As a result, many companies may need to go back to most, if not all, of their operating lease documents and "reabstract" the information. This includes identifying contracts that contain lease-related components and separating that information from the nonlease components. Because the transition to the new lease standard will require restated

A *FORTUNE* 500 COMPANY'S EXPERIENCE

Mohawk Industries is a *Fortune* 500 company and a leading global flooring manufacturer of products for residential and commercial spaces. It is the lessee in approximately 5,000 leases and, prior to its implementation of a lease information system, had little companywide access to information about the terms and conditions of many of its leases. Mohawk's leases were negotiated independently by each division, and the lease information was then tracked in a worksheet database. As a result, there was significant uncertainty about the completeness of the inventory, the terms of the leases, and the proper accounting calculations. Mohawk decided to engage a software provider (CoStar Real Estate Manager) to create a lease information system to track, account for, and report all of its leases.

The implementation of the system required significant time and resources and has led to the following benefits:

- It tracks all of Mohawk's leases (325 real estate leases and 4,500 non-real estate leases).
- It integrates with the enterprise resource planning (ERP) system so that payments, accounting, and reporting are all streamlined.
- It allows a better workflow process to approve leases and perform SFAS 13 calculations.
- It accurately calculates straight-line expenses for current lease accounting needs.
- It prepares the company to account for its leases under whatever final leasing standard is adopted.
- It allows for the estimation of the impact of proposed lease accounting requirements on financial reports.
- The process of reconciling the lease inventory with the general ledger is now significantly improved, which
    - improves accuracy,
    - saves time,
    - increases confidence in the data,
    - assimilates new leases into the single system more quickly, and
    - reduces time and money spent on testing and retesting each year.

financial statements for two or three years prior to the effective date, the lease data for prior years will have to be included in the lease abstraction and data conversion. For example, assuming no grandfathering and an effective date in 2017, information about leases on the books as early as December 31, 2014, may be required, as long as the lease term extends into the reporting period.

Some lease data may only be available in a hard-copy lease contract. In addition, even if lease data are already in electronic form, they may not be useable. Electronic data must be in specific data fields to compute the numbers required for financial reporting and to assess the effects of alternative standard changes. The need to extract information from text files or hard-copy lease contracts, identify other contracts that contain embedded lease components, separate the lease components for information gathering, and then enter the data into specific data fields illustrates the labor-intensive nature of the task.

It will be a significant challenge to assess and implement the staffing needs for the labor-intensive transition to a centralized lease information system. During the transition, additional staff will likely be needed to review and possibly change current lease-related procedures (including current lease abstracting policies), collect and enter into the information system the more comprehensive information that will now be required, and ensure the accuracy of lease inventory and data.

Companies may also need more permanent employees to maintain and manage the lease information system. Because more data items will be required and information will need to be maintained for more leases, there is likely to be an increased workload associated with tracking, monitoring, and maintaining leases. Ongoing lease administration procedures will include—

- negotiating and approving leases,
- collecting lease contracts,
- abstracting lease data from the contracts,
- entering data into the lease information system,
- auditing the data for completeness and reliability, and
- sharing data with decision makers and central accounting.

A major training effort also will be required for current employees and new hires.

Corporations should assess whether their current lease administration staff is able to do the additional work required for both the transition and ongoing periods; if not, they will need to hire people or outsource the work. If a needs assessment leads to the decision to outsource either for the transition or permanently, it is important to form outsourcing relationships early, before outsourcing firms are overwhelmed by late-moving companies.

Prior to implementing the data-gathering process, companies will need to establish consistent methods of applying accounting judgment and to assess what data will be needed. If (as proposed) the threshold for lease classification includes determining whether the lease is for a "significant" part of the underlying asset's economic life and whether "insignificant consumption" will occur, the terms "significant" and "insignificant" will be subject to interpretation. In FASB's May 2013 exposure draft, the terms "identified asset" and "control of the asset" are used and would require accounting judgment to apply in practice. Other areas requiring judgment could include—

- specifying what to include in initial direct costs,
- determining how to measure the future fair market value of a lease renewal option,
- determining how to measure the recognition term of a lease with an automatic renewal clause, or
- measuring lease terms with alternative renewal options.

Other judgments could include—

- the discount rate,
- the finance rate for non–real estate leases if not specified,
- whether the present value of the future lease payments is "significant" relative to the asset's fair value,
- how to determine when impairment of a leased asset has occurred, and
- how to break up a multiasset lease.

The Opportunities

Although the transition to the new leasing standard presents significant challenges, there also are significant opportunities to leverage the increased availability and usefulness of lease information in order to improve outcomes and provide value-added services to corporate decision makers.

The decentralized maintenance of lease information has led to significant variations within a company, even in the treatment of similar leases. For example, the discount rate applied to similar leases may be significantly different from one division of a company to another. Bringing all lease information into a centrally designed and maintained information system can be used to enforce more consistent treatment across the entire organization.

Having a complete lease information system in place well before the new lease standard takes effect will provide useful data for current lease negotiations. While the final standard is still pending, many corporations still have to regularly negotiate the renewal of existing leases and make decisions about whether to lease or buy. Kevin M. Lightner, Bill Bosco, David G. DeBoskey, and Sharon M. Lightner ("Accounting for Leases under the Forthcoming Exposure Draft," *The CPA Journal*, January 2013, p. 16) state that lessee negotiation parameters will be different going forward because there will no longer be a need to structure a lease to avoid capitalization. When negotiating new leases, lessees may want to consider shortening lease terms to reduce their balance sheet impact.

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Decisions about the way to structure a lease (for example, the length of the lease, whether payments are variable or constant, or which lease options to incorporate) can have significant financial effects for many years into the future. Therefore, before entering into a contract, lessees need to assess the income statement and balance sheet presentations of new leases under potential scenarios. "What if" analysis is only possible if decision makers have access to reliable data.

An accurate and reliable information system for leases will provide opportunities to improve operations and cost-control efforts. Managers can use the data to make operations more efficient; for example, verifying the data for every lease will ensure that data entry errors are not costing the company money due to overpayments. Companies typically have large numbers of non–real estate leases. After the standards change, these leases are likely to become more significant and will need to be managed more carefully and therefore accounted for more accurately. The availability of detailed and accurate information about these leases will make it possible to improve the management and monitoring of leases and lease policies.

The Solution

The solution to the problems and challenges discussed previously will involve a new software implementation to collect, house, and manage lease information. Ken Tysiac ("Taking Stock of Leases," *Journal of Accountancy*, November 2013, p. 18) briefly describes some tips for transitioning to a centralized information system for leases based upon the experience of Judy Ryan, who led the implementation of such a system at Johnson & Johnson. The following expands upon her useful advice.

Choosing a software provider is among the most important steps to solving the lease information problem, and there are many criteria that companies should consider. Companies should ask a number of questions about the proposed software solutions.

- How easy will it be to add items to accommodate changing standards?
- Can the software easily incorporate lease renegotiation?
- Can the vendor quickly issue new versions of the lease accounting package after the guidance is finalized?
- How easy will it be to keep data current?
- How secure is the data, in terms of confidentiality, loss, and disaster recovery?

The system should be able to incorporate information about all types of leases (e.g., the "Type A" and "Type B" leases described in the May 2013 exposure draft). The information should be accessible throughout the organization, such as those in corporate accounting who need it to meet financial reporting requirements and those in remote offices who need to enter and maintain data. Finally, the system must be accessible and user-friendly for decision makers.

The software solution must be able to do the calculations necessary for reporting and operational purposes (e.g., present values and amortization schedules), incorporate lease changes, and archive the assumptions, data, and calculations. It must also be able to do the required "what if" analysis needed by managers, lenders, and other stakeholders.

Software solutions should allow the use of profiles (i.e., templates) to record and maintain data for similar leases and be able to override profiles when exceptions are needed. For like-kind leases, many of the lease-related data elements and decisions will be the same. Saving these decisions and data into a reusable profile will streamline the entry of lease data and increase accuracy and consistency, as well as allow changes to flow through to all leases tied to that profile. Profiles can be used to model the effect of future accounting changes on lease reporting, and they can allow leases to be grouped by type of asset or by geographical region. Profiles based on lease attributes or location can ensure consistent organization-wide treatment of similar leases and lease terms.

Companies also must decide which data items to collect and include in the new lease information system—a crucial step in the process. The data collected and maintained in the lease information system should be comprehensive and adaptable. There are useful lists of suggested data items available from software providers. (For example, "50 FASB-Focused Fields You Can't Do Without" is a white paper by CoStar Real Estate Manager, available at http://www2.costarremanager.com/library.) Such lists have been based on the FASB May 2013 exposure draft and will need to be adapted to the official standard.

Facing the Unknown

Companies that have not yet started the transition to the new lease standard face an "unknown unknown." They will not fully grasp the magnitude of the task that lies before them until they examine the way the issues discussed above pertain to their companies. The authors believe that the task facing most companies will be enormous, requiring a new lease information system, many labor hours, and a long implementation period. The sense of urgency exists not just because of the enormity of the task, but also because restatements probably will require an expanded set of data about all leases on the books as of December 31, 2014.

Many companies may be waiting until the final form of the leasing standard is released by FASB to begin working on the transition, arguing that they need to know the details of the new standard before starting. However, companies should start preparing for the new leasing standard now in order to fully understand what they will need to do, determine how long it will take, and start doing it. From the beginning of the process, there has been little debate about whether operating lease assets and liabilities would be shown on the balance sheet: they will be. Thus, no matter what form the standard takes, companies will need a complete lease inventory and a comprehensive lease database. The availability of comprehensive lease information will significantly advance a company's preparedness for whatever accounting changes are eventually adopted. In addition, preparing for the new standard also will yield other important value-added benefits. ❑

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A Software Solution for Leases May Prove Elusive

I read with interest "Preparing for the Looming Changes in Lease Accounting" (Dennis Chambers, James Dooley, Catherine A. Finger, *The CPA Journal*, January 2015), and I commend the authors of identifying "the problem" in a clear manner. The authors are correct to point out that there is an operational and accounting challenge in acquiring, retaining, maintaining, analyzing, and reporting the various types of leases defined by FASB.

Less clear in its practicality is the solution that the author proposes. Software implementation of a changed accounting rule for enterprise resource planning software, and even just for accounting software, carries with it risks, challenges, and—significantly—increased costs.

Simply assuming that existing software (be it enterprise-resource planning [ERP], custom-built, or off-the-shelf accounting software) can be effectively and efficiently revised is a course of action that most small and midsized entities are unable to take.

The article's example from Johnson & Johnson drives that point home: a *Fortune* 500 company can undertake this kind of effort successfully; success in implementation may not be at hand for most small and midsized entities, however.

The risks for small and midsized entities are that attempts to use existing off-the-shelf software may result in incorrect disclosures. Alternatively, the risks of creating ad hoc databases for lease accounting may result also in subpar quality of software, as well as incorrect results.

I fear that a solution is not immediately at hand. Software developers will eventually include features that partially or fully address the complexity of lease accounting. Until then, it is really FASB's role to understand that in its effort to revise the rules, some serious unintended consequences have resulted to most, if not all, stakeholders.

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The Authors Respond

We appreciate Yigal Rechtman's interest in our article and his comments on the subject. It appears that (as of the last FASB meeting in February 2015) the new leasing standard is moving forward and is more a matter of when, not if, it will happen. The boards have been soliciting feedback, listening, and deliberating since the original exposure draft was issued in August 2010.

Now is the time for companies to get ready and assemble a plan to address the new standard. The primary changes that have been made since the original exposure draft have been mostly about how to amortize these costs off the balance sheet, which led to the reexposure in May 2013. Along the way, it has been fairly consistent that operating leases are going onto the balance sheet.

Given that apparent certainty, the authors believe it is necessary to determine how to move current operating leases to the balance sheet easily, accurately, efficiently, and consistently. The tenets of this approach will be scalable from small to medium to large organizations. The nine points cited in the article citing the Johnson & Johnson example are universal, and good guidance for an organization of any size.

Change is always risky. That is why starting as soon as possible is the preferred way to help mitigate risk. There are few software offerings available today, but CoStar Real Estate Manager delivered new data elements and functionality as far back as January 2012 to help companies collect the data needed and quantify the impact on the balance sheet. This allows an organization to collect, audit, and input the data now, which is a large part of the work for every organization.

The benefits of just getting "ready" for the changes are numerous, let alone preparing for the ultimate compliance and need for restatements. Our article lists such benefits gained by Mohawk Industries—cost savings, improved accuracy, process efficiencies, saved time, and increased confidence in the data. This helps in negotiating better leases, reduces audit fees, and has the benefit of preparing for the final accounting standard and quantifying the estimated impact.

The solution is more available than companies might think. Hoping that change will not happen, or will be delayed, does not seem to be a viable option.

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