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Impacts of the new leasing standard – beyond accounting

Consider these top systems, data and process challenges – and potential solutions

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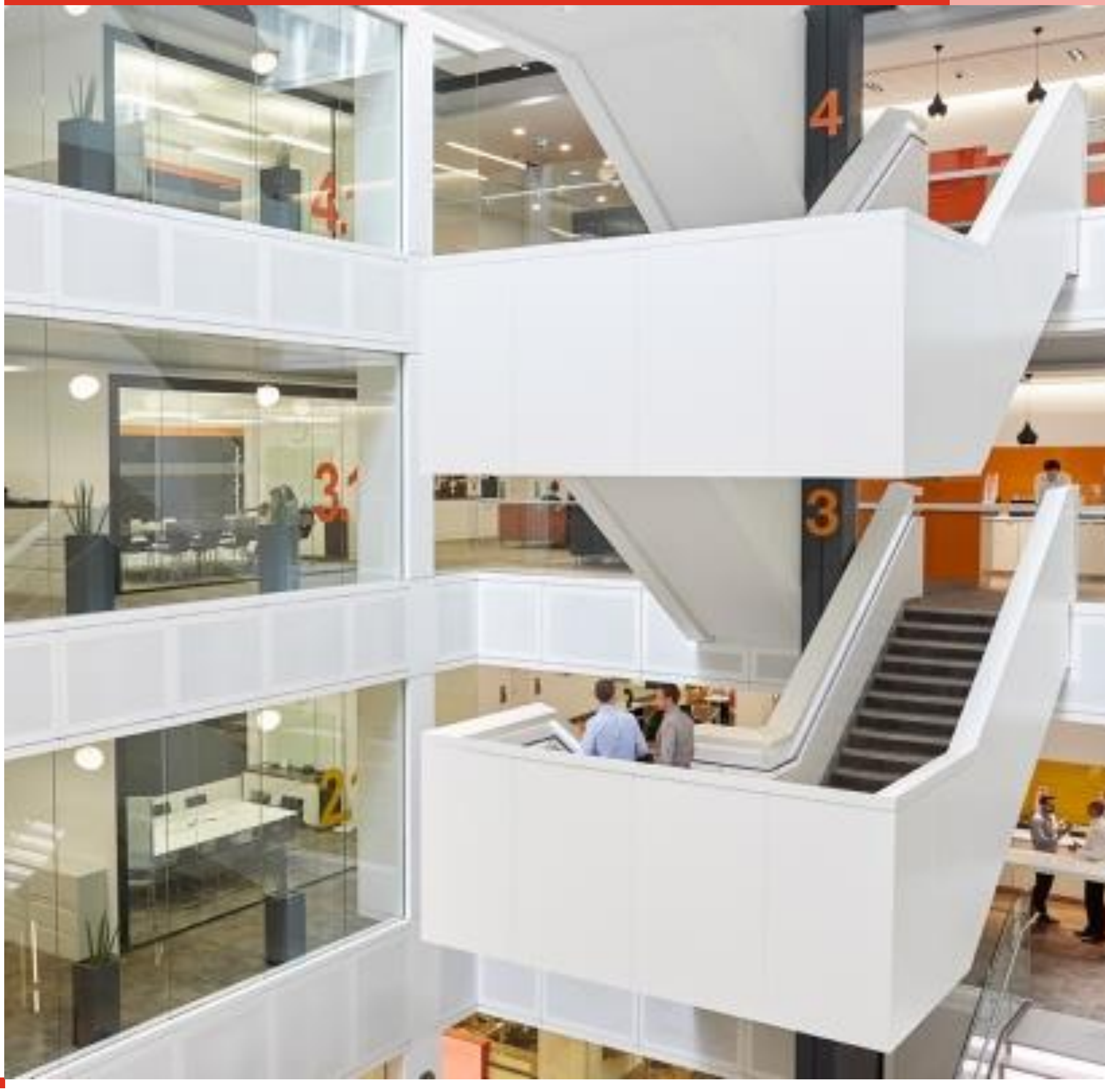


The new leasing standard in a nutshell

- Virtually all leases must be reflected on the balance sheet
- Rules are in effect for all fiscal years starting after December 15, 2018
- Retrospective requirement will oblige companies to spend time evaluating the financials of existing leases—in order to show them as comparisons starting in 2018

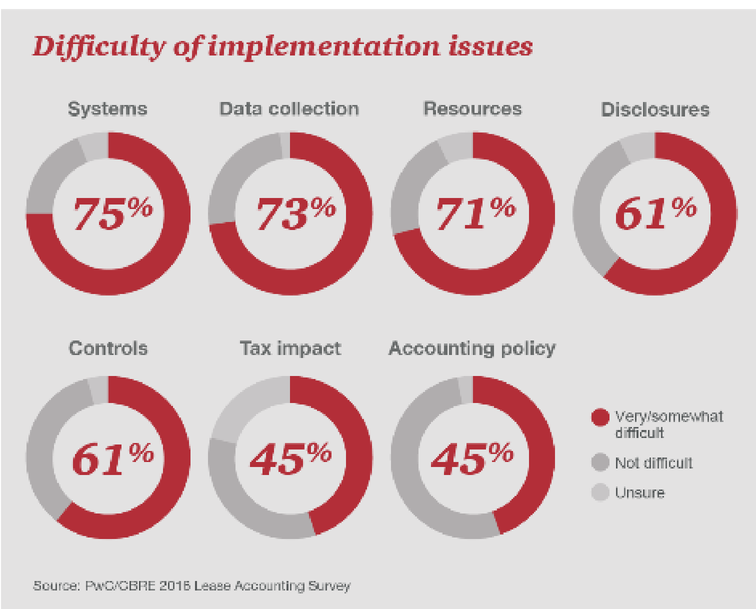
Consider these top systems, data, and process challenges – and potential solutions

When the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their new lease-accounting standard in early 2016, the clock started ticking on a sweeping set of changes that companies are going to have to implement in the next two years. But the adjustments will be needed beyond the accounting department because the new rules will impact any department that deals with leases—including procurement and corporate real estate—and virtually all of the systems and processes that companies use in managing their lease data.

At this still-early stage, companies' main concern does not lie principally in understanding the new rules, which, from a technical accounting perspective, are straightforward enough. In fact, in a June 2016 survey by PwC and CBRE, less than half of all companies said they thought the accounting policy itself would be hard to implement.[1] More companies said they expected the difficulties to come from the systems they'll have to put in place to meet the new requirement and from their resource constraints.

There are also uncertainties about the data collection that will be required for complying with the new standard. According to PwC's survey, 39% of companies currently manage their lease agreements and related accounting in a decentralized manner, which means they're going to have to gather information from dozens, perhaps hundreds, of separate sources. And even at companies that *have* centralized their lease data, the information may be in different kinds of spreadsheets or in original paper agreements or in scanned pdf files that contain inconsistent characterizations of lease terms and other fields. To put it another way, the term *centralized* doesn't necessarily mean usable.

Some of the most daunting challenges the new leasing standard will pose for companies are only tangentially related to accounting. What are the key hurdles companies must overcome as they transition to the time that the liabilities leases represent will be reported on their balance sheets? This is our view of what companies should be thinking about now so they are not playing catch-up when the rule goes into effect.



[1] *http://www.pwc.com/us/leasingsurvey*

Challenge 1: Reorganize your lease data

Companies are right to be concerned about their lease data. In addition to the lack of centralized lease information, many companies may have no information at all about small leases they hold—including, say, leases for office equipment—or about leases held at subsidiaries. Inadequate controls over lease data and missing information about who entered into or uploaded a lease agreement in the first place can cause additional problems.

As a consequence of those issues, many companies don't have complete and accurate information about their lease portfolios. Moreover, there is no single action they can take to remedy the situation – some leases exist in paper form only and have to be digitized. Already-digital leases may have to be scrubbed and cleansed. There has to be an audit trail that tracks any changes made to leases along the way. Some leases include data gaps that will have to be filled in. And then there's the problem of inconsistencies between leases—an inevitable result of the differences in templates used by lessors. Those inconsistencies have to be reconciled.

Fortunately, advances in unstructured data analytics are helping companies handle some of these challenges. Notably, improvements in optical character recognition and natural language processing have accelerated and enhanced the conversion of paper documents into consistent, machine-legible formats. In addition, machine-learning technology—by which computers learn from experience in their analysis of large data sets—can make the extraction and organization of key lease terms even more efficient. Over time, a system can come to recognize different types of documents, thereby enabling companies to classify leases into different categories; and it can automatically abstract key lease terms to reduce the amount of manual work required to channel critical lease information into a database.

The numbers and types of data problems that exist will determine how much time a company should allot for its initial data assessment and data-gathering activities. However, there is no question that for many companies, the task represents a big undertaking.

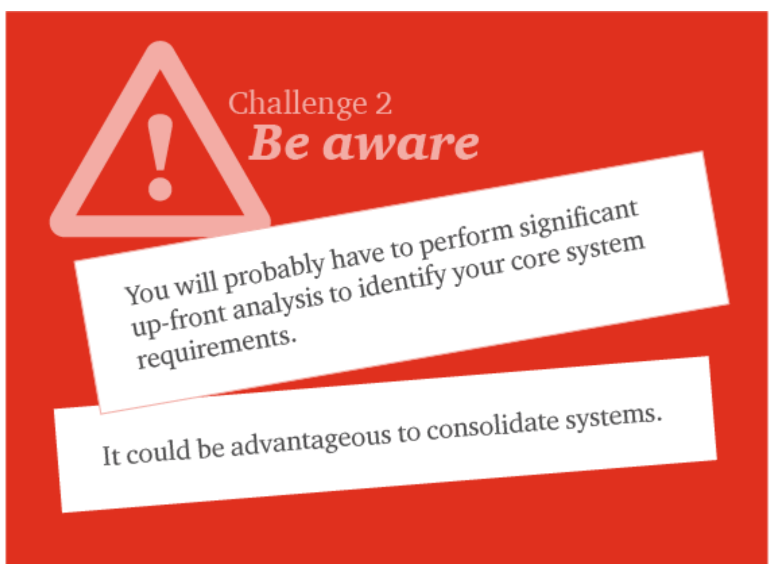
Challenge 2: Get the right systems in place

Once the new leasing standards have gone into effect, companies will need sustainable systems to handle their lease administration and accounting. Our survey found that for more than two-thirds of companies today, the default approach is to manage and account for leases by using spreadsheets. Under the new rules, spreadsheet use will become extremely difficult and time-consuming. With the high number of manual touch points required to track lease activity and maintain the accuracy of lease data within spreadsheet-based leasing inventories, spreadsheets present too high a risk of errors. Companies generally won't be able to rely on them when lease data moves to the balance sheet.

Most companies are planning to migrate to software solutions that are built specifically for the purpose—meaning that they are designed to perform the lease calculations required by the new standard. Many software companies that sell into the corporate accounting function are already developing modules that can handle the new lease accounting rules while offering operational benefits for the end-to-end lease management lifecycle. Implementing the right software can provide financial managers with the confidence they need for compliance and reporting.

For the 90% of companies that, according to our survey, haven't yet selected a software solution for this purpose, a period of self-assessment is in order. During this period, some companies (particularly those that rely heavily on spreadsheets, or those with complex operations) may want to consider developing an interim lease management solution that takes advantage of the data integration, visualization, and analytics tools currently on the market, many of which these companies may already use for other purposes.

Implementing a provisional solution can offer companies the time they need to take a proper inventory of the leasing systems they currently have in place, if any. If they have multiple systems, they should consider consolidating into a single system. A company with both equipment leases and real estate leases should decide whether it can manage both of those lease types with a single system. This is also the time to determine major features a next-generation lease accounting system should have—for instance, integration with accounts payable or procurement, and any special reporting or analytics capabilities. As they decide on those issues, companies will effectively be creating the set of core requirements they'll need in the vendor-selection process; and those requirements can also be used in an evaluation of software vendors' product roadmaps.



Challenge 3: Improve your lease-accounting processes

Because of the absence of a uniform way of processing leases—and because of the historical lack of dedicated accounting or software systems for maintaining leasing activity—most companies haven't followed consistent processes for requisitioning or monitoring leased property or equipment.

With leases moving onto the balance sheet, those inconsistencies will have to change. At most companies, leases will become part of financial statements, which will require a different level of scrutiny—not only scrutiny of the tracking of accounting treatment but also scrutiny of the processes surrounding lease management and lease lifecycles.

As a result of the increased attention expected to be paid to processes surrounding lease management, many companies will have the opportunity to rethink the ways they handle lease terminations, lease bookings, and lease negotiations. The new processes have to be documented so they can become standard operating procedures throughout the company. And as with any information that ends up in a company's financial statements and that is subject to Sarbanes-Oxley rules, strong internal controls have to be in place and adhered to.

The silver lining: A chance to improve the business model

In issuing the new guidelines, the FASB and the IASB focused on filling in a conspicuously empty portion of companies' balance sheets. Public US-based corporations with investors have no choice: they will have to comply with the new rules. But many of them should be looking to go beyond meeting the minimum requirements of compliance. They may be able to use the upcoming change as a springboard to making business-model improvements.

For instance, some companies may want to more directly involve their procurement departments in their leasing activities, allowing procurement to negotiate lease terms on an enterprise-wide basis. Other companies, having centralized their leasing data, may want to analyze the terms and conditions offered by their lessors—and thus do a better overall job of managing lessors and applying consistency or standards related to acceptable terms by asset. And all companies should seek to reduce or eliminate the cost leakage that results from not taking timely action on leases whose terms are expiring.

Companies may also want to standardize their leasing processes by incorporating necessary controls and establishing the circumstances when the lease-versus-buy model gets used. The stronger lease-versus-buy models incorporate additional factors into the discounted cash flow analysis that typically pertain to a company's leasing strategy, such as equipment-obsolescence risk or alternative-minimum-tax considerations. Finally, companies may want to consider performing periodic lease portfolio trend analyses to evaluate both positive- and negative-impact decisions so they can make timely leasing-strategy and leasing-process improvements.

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Making better leasing decisions through portfolio analysis

Portfolio analysis reports can help companies identify trends in their leasing behavior they may wish to continue, adjust, or terminate. A few such reports include:

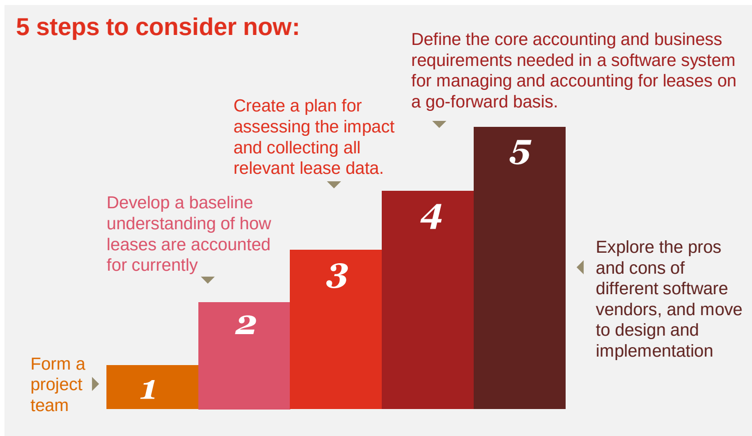
- **Lessor concentration.** This report shows the concentration of the portfolio by lessor and can drill down into asset type, year, region, and other attributes. The value of this type of analysis is that it can highlight potentially excessive concentration among a small group of lessors, or it can show where it makes sense to increase concentration among certain lessors.
- **Rate analysis by lessor.** This report compares rates for similar types of assets among lessors to see if they are comparable or not, and it may identify opportunities for better rate-shopping.
- **Expired leases.** This report shows leases that are past their original or renewal end date and require action. A similar report can show how long leases were held past their original or renewal end dates before action was taken. This type of analysis may reveal particular areas where this type of extended lease-holding is more prevalent than others (e.g. certain types of assets, certain business units, etc.).

Getting started

Adjusting to the new lease accounting rules is no small matter, and a lot of companies are unsure where to begin. Our suggestion would be to assemble a project team consisting of senior accounting staff, the chief financial officer, the controller, the main professionals responsible for real estate, and the main technology and system contacts.

An initial meeting can begin by asking what everyone knows and what everyone thinks of the company's existing lease processes. Such a meeting will likely provide the project team with a sense of how the company approaches leasing, of its relevant policies and procedures, and of where and how it maintains its lease records. After that, the company can dive more deeply into the structure of the leases it holds and the nature of its lease agreements. Some companies may have special circumstances that merit attention. For instance, the inclusion of lease obligations on the balance sheet could affect some companies' bond covenants depending on how the covenants are defined. Other companies may have to account for so-called embedded leases that involve equipment they are effectively renting as part of a larger outsourcing or service relationship.

Companies can begin to meet the data, systems, and process challenges related to implementing the new lease accounting standard by taking five steps:



In taking these steps, companies will get on the road to accomplishing what they must by 2018.

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Today's business environment is different. More complex. More connected. Companies face new and unknown risks, but also new and untapped opportunities. PwC Risk Assurance is at the forefront of this change, ready to transform how you perceive – and capitalize on – risk.

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