TRANSITIONING CLIENTS TO THE FASB ASC 842 LEASE ACCOUNTING STANDARD

A GUIDE FOR ADVISORY FIRMS

Making It Easier To Comply to the FASB ASC 842 Lease Accounting Standard Changes

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1 EXECUTIVE SUMMARY

iLease Management LLC ("iLease") has been providing insightful research and recommended approaches into the proposed lease accounting changes since 2011. We do provide a brief overview and update of the proposed lease accounting changes in this document, but you will find that this whitepaper is different than others that we have authored. In this whitepaper we explain not only how the proposed lease accounting changes will impact organizations but present, at the functional level, what questions need to be considered in order to successfully adopt with these upcoming standard changes. We dive into functional areas like Corporate, Finance, Treasury, Human Resource and Technology. And given the resource limitations within most organizations, we show how the lease accounting changes will present opportunities to CPA firms and Consulting and Advisory firms ("advisory firms") that are looking for ways to build deeper client relationships and suggest how an advisory firm can position itself to be proactive and provide technology and advisory services that are of critical importance to their clients.

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2 INTRODUCTION

The Joint Project on Lease Accounting has been completed and the final standards have been issued by the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”). The project, which has been ongoing for several years, has significant changes and will present both a challenge and an opportunity for the advisory firm. This whitepaper will focus on the **FASB ASC 842 Lease Accounting Standard** changes and the potential impact to non-public companies.

Leases, currently classified as operating leases, allow the lessee to avoid recognizing the lease obligation as a liability on its financial statements and making expensive investments in fixed assets. The conclusions reached by the FASB require that all leases, except certain narrowly defined short term leases (lease term of 12 months of less), be recognized on lessee balance sheets as a Lease Liability with an offsetting Right to Use asset. The definition of a lease would become more complicated and many provisions in the lease would have to be identified and evaluated to determine whether there are accounting implications that must be addressed. With respect to expense recognition, the FASB classifies leases into two types (Finance and Operating) with most equipment leases falling into Finance and most real estate leases falling into Operating. However, for many leases, judgment will have to be applied to ensure that the lease classification is appropriate. For Finance leases, expense recognition would be accelerated while for Operating leases, expense would be recognized basically on a straight-line basis. As one can see, lease accounting will become extremely more complicated for lessees. And remember, the new lease accounting standard applies to all leases which fall under the definition of a lease in the standard, both real estate and equipment leases.

The net effect of the new lease accounting standard will be a major increase in liabilities that must be recorded on the balance sheet of the lessees and a negative impact on debt to equity ratios. For many lessees that use debt-financing vehicles, which contain restrictive financial covenants, any increase in liabilities could present a particular challenge and may well require a waiver discussion with the lender. Certainly, lease versus purchase analyses will become more important and could result in a decrease in leasing activity. But it is difficult to envision any significant decrease in leasing for a number of reasons. Many companies are cash strapped and leasing presents a particularly advantageous form of financing for those organizations that want to minimize upfront cash outlays.

Additionally, leasing allows companies the flexibility to relocate more easily to another location or to change to a more advantageous equipment type after the termination of the lease. Ownership of real estate and equipment may well inhibit this flexibility. To be sure leasing strategy may change. Shorter-term leases will result in smaller liabilities that must be recorded. But there is a business trade off. Shorter-term leases mean more frequent lease renegotiation risk and the possibility of increased leasing costs.

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3 FINANCIAL IMPACT AND CORPORATE READINESS

The financial impact of the standard change will affect all industries & firms that lease equipment and/or real estate. Implementation of the proposed standard will be a heavy administrative burden on the companies affected since they will have to collect and input a substantial amount of data, perform complex calculations to determine the amount to be capitalized, monitor and continually reassess each active lease.

In a recent survey by EY, **55%** of non-public companies are finding the lease accounting implementation to be more complex than anticipated. The top implementation challenge cited by more than **40%** of respondents was identifying the population of leases and abstracting the data needed for the accounting calculations. Other top challenges cited included modifying existing business processes, project managing the enterprise-wide work effort, and applying new accounting policies. Compared to the revenue recognition accounting standard (ASC 606), **75%** are finding the new leasing standard to be just as much effort or more effort.

Companies must understand these new rules, develop new processes and either modify existing or acquire new technology to comply. Most companies that are using spreadsheets to manage the lease portfolio will more than likely need to migrate the lease information off of spreadsheets and into applications that have been designed to perform the complex calculations that will be required for the changes.

3 FINANCIAL IMPACT AND CORPORATE READINESS

Certain of the specific financial and operational considerations are as follows:

Financial Impact on Lessees

- Debt to equity ratios, existing debt covenants and various contractual agreements will be significantly impacted.
- For certain leases, the pattern of expense recognition may be dramatically accelerated.
- Income tax calculations will become more complicated and financial statement disclosure will greatly expand.
- Costs of implementation will be significant.

Operational Impact on Lessees

- Likely that the accounting for existing leases will have to be revised upon transition.
- No leases will be grandfathered. Existing leases will likely require abstracting of lease details.
- Complexity of lease calculations will increase, as more variables will have to be considered.
- Data will require aggregation from various sources not currently considered.
- More estimates and judgments will be required which will entail tighter auditing and tracking.
- There will be an ongoing need to review, reassess and possibly revise initial estimates.

4 HOW YOU CAN ADD VALUE FOR YOUR CLIENTS

As indicated in the section above, because of the extended period of deliberation about this issue, surveys have indicated that many in the lessee community have not focused attention on this issue and are not prepared for this change. The scope of the impending changes will be enormous and will involve many constituencies within the organization. All active leases existing at the time of adoption will have to be transitioned over to the new accounting method. Policies and procedures will have to be reevaluated and possibly revised. Technology systems will have to be reassessed. Revised lease strategy may be required. And these are only a few of the issues that must be addressed, but it is clear that significant effort will be required to fully comply.

Given the resource limitations at most non-public organizations, all of these issues present both a challenge and an opportunity for advisory firms that are looking for ways to add value to the client relationship. How can an advisory firm position itself to provide services that are of critical importance to their clients? Perhaps the best way to exhibit possible service opportunities is to look at the following matrix of potential issues that organizations will have to consider as part of the transition and how you, as an member of an advisory firm, can provide assistance in helping your clients cope with the issues that must be addressed.

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1 CORPORATE

Roles and Responsibilities

- Will roles change regarding lease management now that liabilities will be added to balance sheet?
- Who will be responsible for overall management of leases now that the liabilities will be shown on the balance sheet?
- Will an organization restructuring be required?

Governance/Controls

- What existing governance controls must be modified and what new controls may be required?
- What Policies and Procedures will require modification?
- A centralized approach may be needed – can this be accomplished with the current organizational structure?
- Who will approve any new policies and procedures?
- What is the flow through the corporation to approve these changes?

Lease Accounting Changes

- Are the lease accounting changes fully understood?
- What needs to change and what will the impact be on the operational, organizational and even contractual levels?
- Has a timetable been developed that will ensure that all required tasks have been successfully completed by the effective date?

Internal Audit

- Is Internal Audit part of the team and working with business units and strategic managers to develop and implement a plan to assess current systems, policies and procedures?

Internal Communication

- How will communication of key issues and resolutions be socialized throughout the corporate structure?

Tax Implications

- Does the income and/or franchise tax strategy require revision?
- Many states utilize a property factor to determine tax liabilities that may impact state property taxes for real estate. Some states use GAAP financial statements to determine franchise taxes. How can we determine if there will be an impact on taxes?
- Has the impact on deferred taxes been assessed?

OPPORTUNITIES to Add Value

- Assistance can be provided in the review of Policies and Procedures.
- Provide general consultation in interpreting the more complex provisions of the new accounting standard.
- Work closely with Internal Audit to develop the Internal Audit Plan for review of the accounting change.
- Provide significant assistance in the review of the income and franchise tax implications.

2 FINANCE / TREASURY

Investor Communication

- How will we communicate the changes in the financial reporting to investors?
- How will we communicate the plan and progress of the transition process?

Contract Administration

- Are the lease data required by the new standards available or will it be necessary to gather the missing data from the lessor(s)?
- Are all active leases available to be abstracted?

Loan Covenants

- Review the financial covenants on the existing loan agreements to determine if the change in the company ratios will cause a loan default.
- Who will work with the lenders on any issues found and negotiations required?
- Do we have the primary contact information at the lending institution?

Ongoing Leasing Strategy

- How will the corporate lease strategy be impacted?
- Should you buy out current leases?
- Should active leases be renegotiated?
- Should we emphasize buy versus lease?
- Additional real estate and equipment acquisitions must be evaluated based upon the impact on business valuation, free cash multiples, purchase price allocation and post acquisition ratios.

Budget and Forecasting

- How can the new calculations be integrated into the existing budgeting and forecasting process?

- Do we need to include any other resources into this process to consider changes in leasing strategy?

Performance Metrics

- What financial ratios will be impacted and how will they be impacted?
- What will the changes in these ratios mean to the business?
- Can we prototype the changes into our financials to understand the impacts?

Financial Reporting

- What is the impact on financial reporting, key ratios and disclosures required?

Capital Requirements

- Issues that are specific to banks, credit unions, insurance companies and other financial institutions that are subject to strict capital requirements and could face regulatory scrutiny. How will the requirements be determined? How will the institution comply?

OPPORTUNITIES to Add Value

- Provide assistance in collecting and abstracting lease information.
- Assist in the review of revised performance metrics and financial covenant calculations.
- Review and assist with the revised budgeting implications.
- Consult on the required revisions to the financial reporting.

3 TECHNOLOGY

System Evaluation and Assessment

- Who will determine what systems need updates?
- Are there any gaps in the current systems?
- Can current systems support required changes?
- Do you need to organize a task force to assess current systems, identify gaps, research and procure new systems?

Accounting System

- Will current accounting system support the new compliance?
- Will Primary Accounting system integrate with Lease Accounting solution?

Reporting Systems

- Who will identify which reports will require modification or what new reports are needed?
- Will current financial reporting produce disclosures that will be required?

Lease Management and Accounting

- Is a lease management system in place that captures the key information required for new standards?
- Does the current system aggregate and calculate the rent data to allow for the calculations to be made?
- Are there system integration issues that must be addressed?

Contact Management

- Has the contact information for all lessors, bankers, insurance reps, property management firms been captured and made available?

Document Management

- How will electronic versions of all the leases, lease amendments and lease addendums that have been identified be stored, tracked and accessed?
- Will scanning of hard copy documents be required?

Infrastructure

- Will existing infrastructure support the additional data that will be required to be stored?
- Will additional hardware and software be purchased?
- Should this effort be hosted or maintained internally?
- Are there any new security requirements with these changes?

OPPORTUNITIES to Add Value

- Assist in the evaluation of technology alternatives.
- Provide feedback to management for possible systems alternatives being considered.
- Consider providing an outsourced, cloud-based technology solution.

As one can see, the tasks and issues that must be considered are significant and the opportunities to add value are far reaching.

4 HUMAN RESOURCES

Resource Availability & Skill Level

- Are resources available to perform tasks required?
- Do in-house resources have the required skills to complete planning and transition?

Outsourcing

- Will outsourced resources be required? Do we have a preferred outsourcing firm with these skills?

Compensation Plans

- Is compensation of employee remuneration contracts based on any of the metrics/ratios that will change?
- Will these changes impact commission structure?
- Should the contracts be re-negotiated?

Training

- With all these new processes and potential new systems how will we train our employees? Can we cross train existing employees to help out with new requirements?

OPPORTUNITIES to Add Value

- Loan staff can be provided to supplement existing resources and assist with data gathering and data input.
- Work as an advisor to the Implementation Task Force to ensure that all required tasks are identified.

5 BUSINESS OPPORTUNITY

With the complexity of the change requirements, specifically the data aggregation of multiple leases and ongoing modification and reassessment requirements, we at iLease believe that companies will find the transition challenging and will look for an enhanced technology solution that can provide operating efficiencies. Additionally, many companies will require assistance from their financial advisers in order to compile the information and perform the required calculations.

iLease believes that there is a very meaningful partnership that can be developed between **iLeasePro**, our cloud lease accounting solution, and the advisory firm community. We have been actively following the progress of the FASB lease accounting changes and have been posting guidance on our blog with a view toward our accounting technology component that will allow users to meet the requirements of the standard changes. However, simply meeting the new accounting requirements is not what companies should be exclusively focused upon. Our accounting component has been developed as part of an overall Lease Analysis, Lease Management and Lease Accounting solution that would allow the users to drive efficiency to the overall lease portfolio through a cost-effective technology solution.

Contrary to our competition, our business strategy and product development focuses on aligning ourselves with business advisers that can resell our solution, possibly assist a client in the set-up or utilize our solution to service your client's lease portfolio as a trusted business adviser. We provide the technology and you, the business and financial adviser provide the consulting/advisory services that are needed by your client.

6 RECOMMENDED NEXT STEPS “FAIL TO PLAN, PLAN TO FAIL”

The final effective date is less than a year away for non-public companies, the transition will entail significant effort. You should be proactively engaging your client to discuss what will be required for a successful Day 1 adoption and the Day 2 procedures to ensure ongoing compliance. Work with your client to develop and participate in a transition team to begin answering the questions presented above. Several of these tasks can be started now to mitigate the risks that will increase as we move closer to the effective date of the ASC 842 standard. By bringing together a task force, you and your client can begin developing an implementation plan that will help in identifying the functional areas within the organization that will be impacted and how these issues will be addressed.

iLeasePro has been designed from the ground up to provide our business advisor partners the ability to offer their clients a cost effective, state of the art solution that can address these Lease Accounting change issues. If this type of business relationship is attractive to you, please contact us so that we can have further discussions.

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ABOUT ILEASEPRO

iLease Management LLC (“iLease”) is an internet technology company founded in 2012 and is in the business of making it easier for firms to manage the lease lifecycle of real estate and equipment leases. iLease has developed and currently marketing **iLeasePro** in a Beta version. **iLeasePro** is a cost effective, cloud-based Lease Analysis, Lease Management and Lease Accounting technology solution that brings transparency, information sharing capabilities and efficiency to the lease portfolio of lessees.

Prompted by the proposed change in accounting, we believe that lessees will require a technology solution that will not only accommodate the requirements of the new accounting standards but will also provide a state-of-the-art technology solution to the entire lease cycle from initial analysis of various alternatives to effective management of lease details. That is why we developed iLeasePro. **iLeasePro** operates efficiently in the Cloud and provides a user-friendly means to capture and extract critical Business Intelligence that is highly pertinent to operating efficiency. **iLeasePro** is a cloud-based Lease Management and Lease Accounting solution specifically developed for Lessees or Tenants of Real Estate and Equipment leases.

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Our Technology Solution Guiding Principles

- State of the art, intuitive and feature rich Cloud Application requiring minimal technical infrastructure and start-up investment
- One solution for real estate and equipment assets
- Improved lease management should be a critical byproduct of the new accounting implementation
- Lease Analysis, Lease Management & Lease Accounting seamlessly integrated for Lessees
- Cost effective tiered subscription-based pricing model for both mid-sized and Enterprise level firms
- Promotes Efficiency, Effectiveness, Quality Review and Information Sharing
- Seamless integration with existing systems

For additional information about iLeasePro and for details as to how you can become a Beta tester of this exciting new product, please go to our website at

www.ileasepro.com

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