

Paving a path to success: preparing for new lease accounting standards

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Contents

Introduction	3
Survey demographics	5
Where are we now?	8
What challenges and impact do we expect?	9
What do we need to do?	13
What is it going to cost?	17
Top 10 actions to consider	20
Looking ahead	21

Introduction

New accounting standards aimed at improving the transparency of the reporting of leased assets and liabilities on financial statements could have a significant impact on many companies' financial operations – from implementing new accounting policies and processes to deploying new IT systems. Most companies are aware of the new guidance issued only a few short months ago by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). This is not surprising given the decade-long effort to revise the accounting for leases. Furthermore, more than half of those responding to our survey have begun to take actions toward adopting the new standards, which gives us insight into the journey ahead.

That was one of the key findings from our recent survey to assess the readiness of more than 125 companies with respect to the new guidance. Conducted by EY and FERF in March and April 2016, the survey sought to gain a better understanding of how and when companies plan to address the challenges of preparing for the new standards.

While many are still determining what steps they will need to take to comply, more than half have already taken actions, ranging from forming a project team to completing a readiness assessment to meet the new standards. Yet 83% of respondents have not budgeted for the associated costs.

Impact will vary

In reality, the new guidance will not affect all organizations in the same way. Some companies only have a limited number of leasing arrangements, while others routinely enter into hundreds of leases for new equipment or real estate properties as a way to obtain the use of assets necessary to operate their business without the burden of purchasing or disposing of them when no longer needed. Such historical off-balance sheet financing will now find its way onto the balance sheet as a lease liability and a corresponding right-of-use asset.

For calendar year-end public business entities applying US GAAP, the new standard will be effective 1 January 2019, which means a date of initial application of 1 January 2017. Adapting to the new regulations could represent a major challenge for some companies. This is especially true for multinational enterprises that have decentralized operations and may need to report in accordance with US GAAP and IFRS. The standards proposed by the FASB and IASB differ on some key points, which adds complexity to the implementation.

In addition, because operating lease transactions were kept off balance sheets, only a few organizations deemed it necessary to develop consistent accounting processes and procedures for tracking all leases and integrating data into financial reporting systems seamlessly. Lease contracts also vary extensively and, as a result, many companies will need time to determine the nature of their lease portfolio and begin revamping accounting policies.

To comply with the new standards, companies will need to capture all lease data, make certain determinations for accounting purposes, integrate information and reporting systems, and improve processes for sharing data across multiple business functions. This will require them to implement new accounting policies, enhance enabling technology and revamp business processes and financial controls.

Considering early adoption

The new standards permit early adoption and our survey revealed 5% of the respondents are planning to adopt as of 1 January 2017 or earlier, while another 8% are planning to adopt in January 2018 with the adoption of the revenue recognition standards. These results may change, as 31% of the respondents are still considering the date of adoption.

The survey offers a snapshot on the current state of readiness of lessees to apply the new standards and outlines the steps financial executives are taking to comply. In the interest of understanding what respondents have learned to date, we also performed a deeper dive into the results shared by companies that said they were very familiar with the new standards. Selected highlights are featured on page 4.

Survey highlights

Nearly **90%** of respondents said they are **either somewhat or very familiar with the standards**, with **33%** saying they are **very familiar** and **have closely followed the FASB and IASB board activities**.

While **50%** of all respondents **have yet to take steps to prepare for the new standard**, **11%** have **started to perform a readiness assessment** and another **7%** said that **their project team has begun to create an inventory of lease data**.

A majority of respondents said they **rely on spreadsheets to track and account for leases**. More than **80%** are **still evaluating technology options**, including **29%** who have **no current system for tracking leases**.

Nearly **60%** of all respondents said they **expect either a moderate or significant impact on their balance sheets and on their financial statement disclosures**.

Nearly **75%** of all respondents **expect to have significant or moderate difficulty developing policies, processes and internal controls, as well as getting through the first year audit**.

Among all respondents, **83%** said they **have not started to create a budget for meeting the new standard**. Just **5%** reported that they have designated more than **\$500,000** over the next three years to implement the new standard, and not earlier, with estimates of up to **\$5 million**.

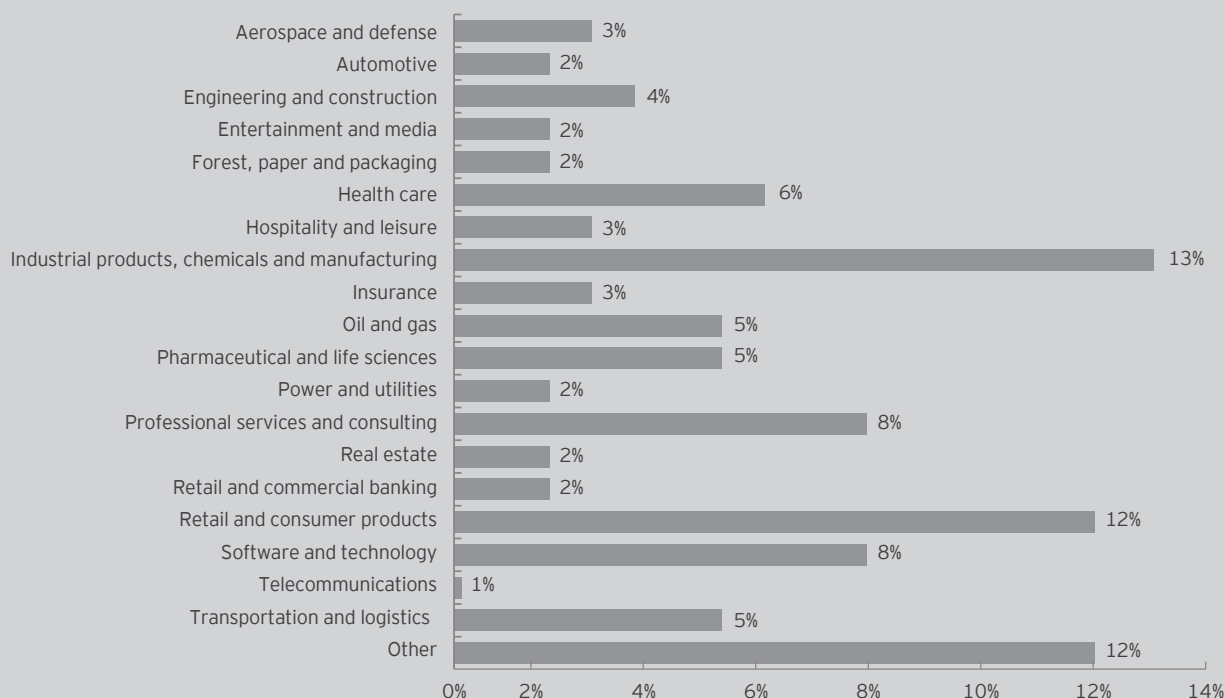
More than half of the respondents (56%) were planning to adopt as of the effective date.



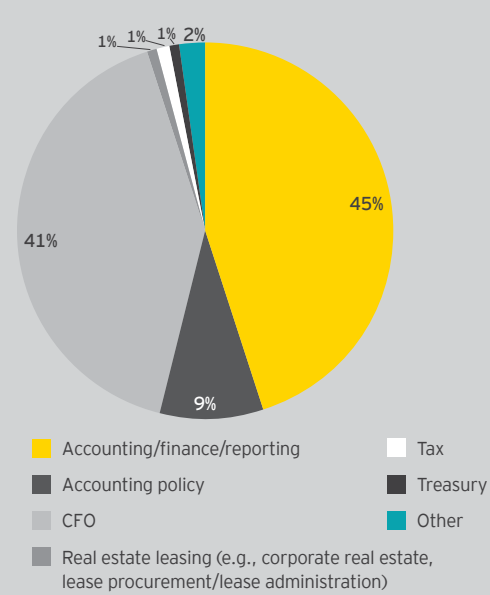
Survey demographics

Most of our survey respondents were either CFOs (41%), or senior-level financial executives in accounting/finance/reporting (45%) or accounting policy (9%). With respect to the size of the organizations, more than 40% have revenue greater than \$1 billion while 50% have more than \$1 billion in total assets. Public companies applying US GAAP as their principal reporting standard represented 81% of our respondents while those reporting in accordance with IFRS for statutory financial reporting purposes represented 79% of respondents. Nearly two-thirds of the respondents said 90% of their real estate and office equipment leases were in the US, while only 50% of the equipment and transportation leases have similar concentrations. Most respondents have less than 1,000 leases of varying types.

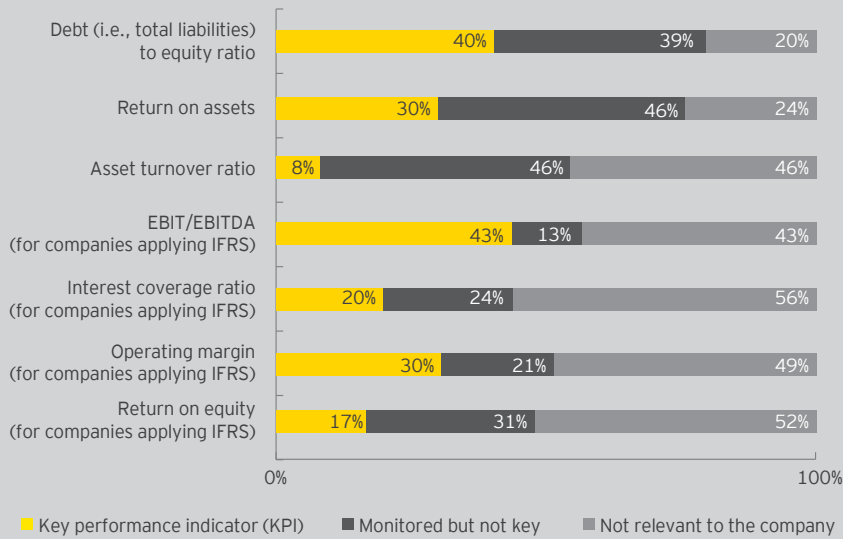
Company industry



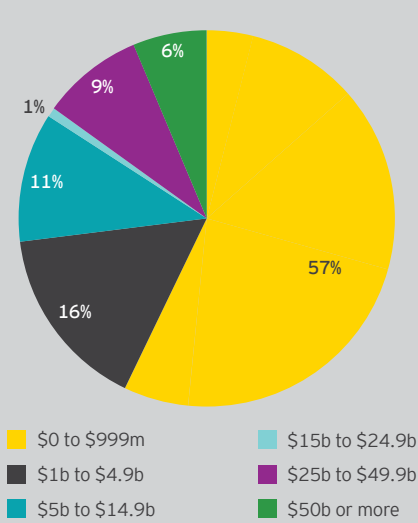
Respondent's current function



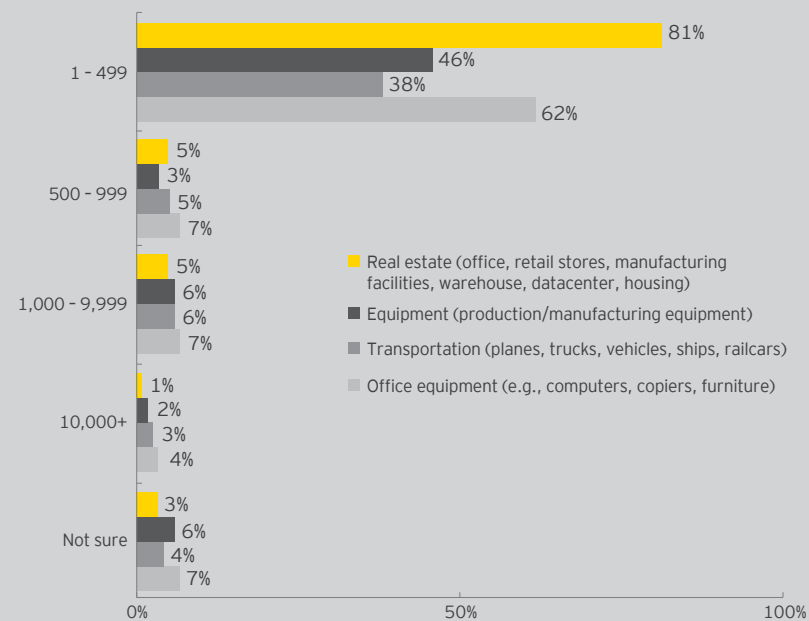
Financial ratios



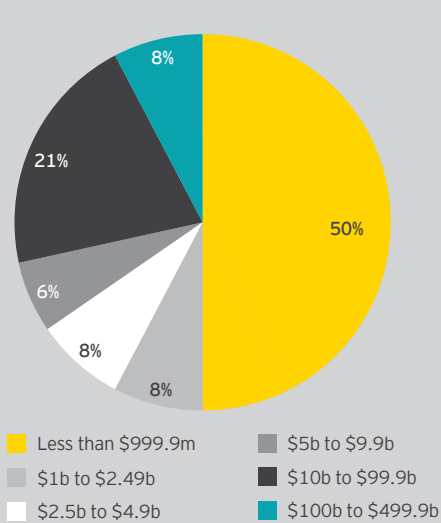
Annual revenues



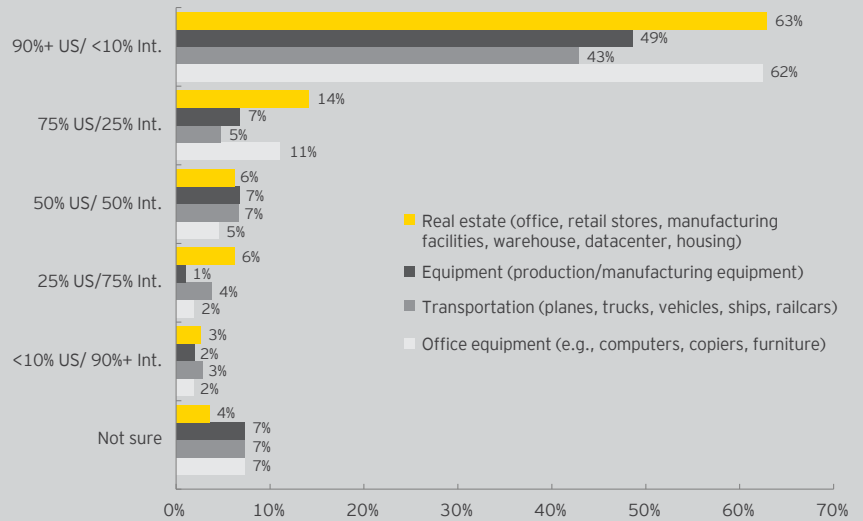
Number of leases (as a lessee)



Total assets

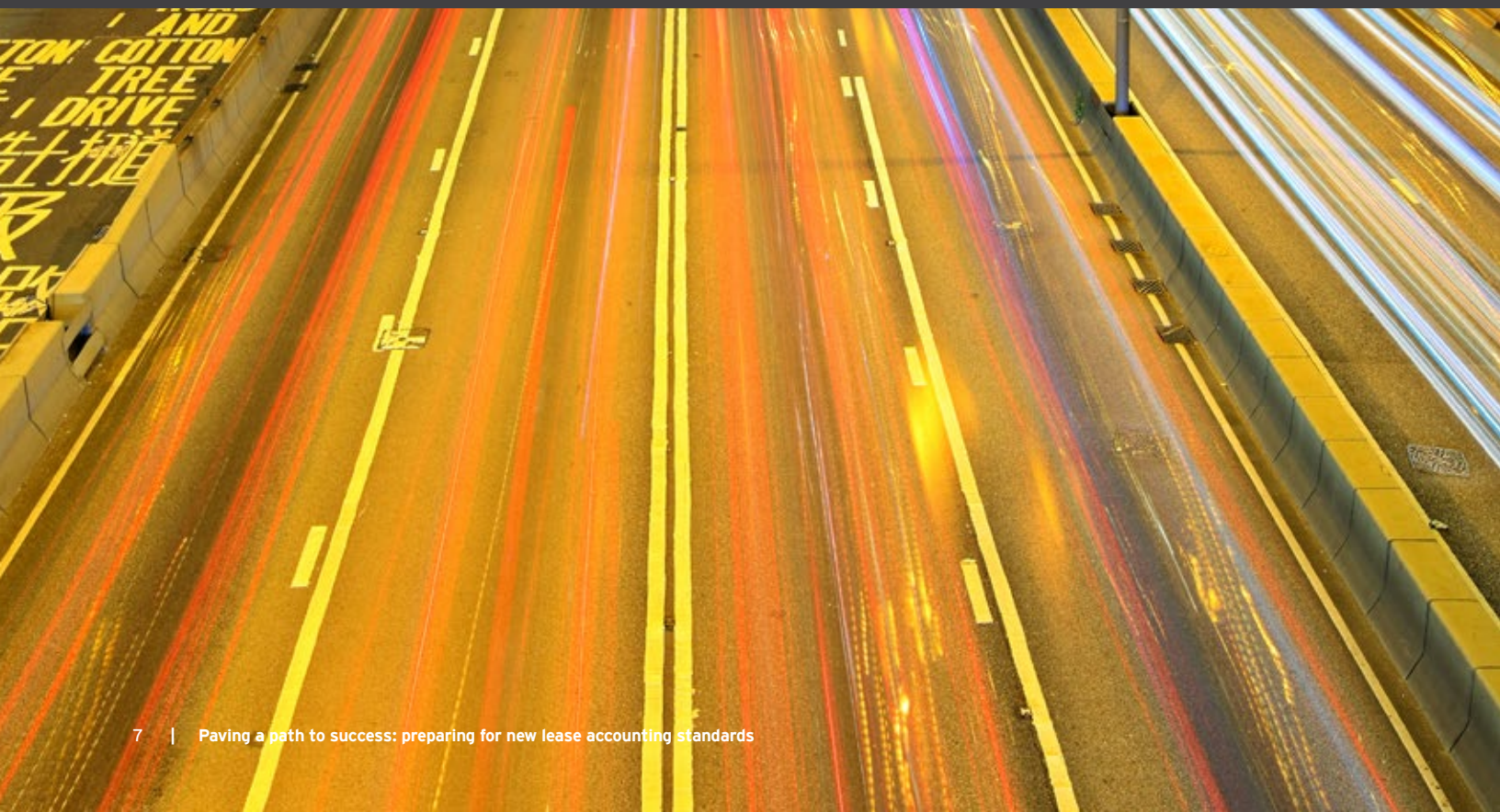


Percentage of assets in US vs. international





“We don’t think that the standards will have a huge impact on our financial statements, but we realize there’s a lot of work to go through to identify all leases. So at the end of the day, even though we don’t we expect a significant financial impact, it’s going to take a lot of work to prove that to ourselves and the auditors.”

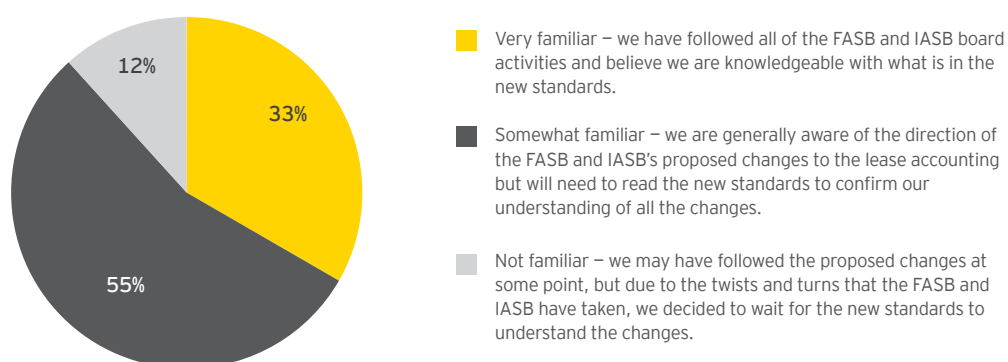


Where are we now?

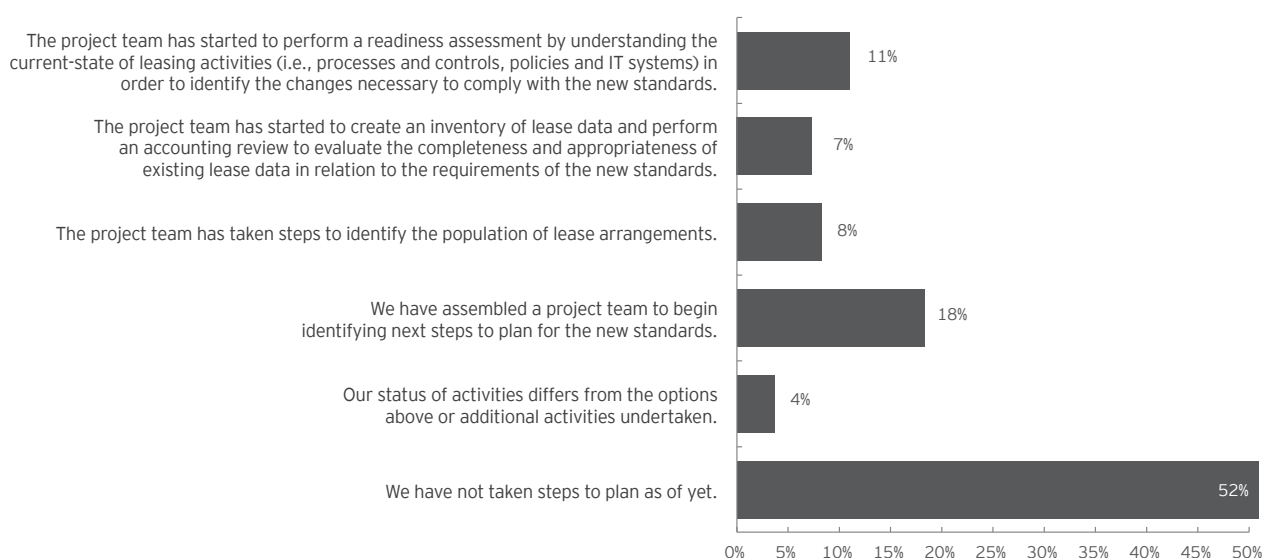
Nine out of 10 respondents said they were either very or somewhat familiar with the new standards. While 50% said they have yet to take steps to plan for the new standards, 18% have formed project teams and 11% have started readiness assessments.

Of the 37 companies that said they were very familiar, 22% said they have yet to take steps to plan for the new standards. One-fourth of the companies that were very familiar had assembled a project team to identify next steps to plan for the new standards. An additional 19% indicated their project team has started to perform a readiness assessment to understand the organization's current state of leasing activities – from processes and controls to policies and IT systems – to identifying the changes necessary to comply with the new standards. Only one company among the respondents said it has completed its readiness assessment and started to implement changes to its accounting and reporting processes, and IT systems.

Familiarity with the new lease accounting standards



Actions companies have taken so far to prepare for the new lease accounting standards



What challenges and impact do we expect?

Complying with the new accounting standards will require companies to do more than simply convert lease commitments from existing footnote disclosures. To reflect lease assets and liabilities accurately, companies may need to change the policies, processes and IT systems that support lease accounting, and may want to evaluate the same for lease procurement and administration while they are at it.

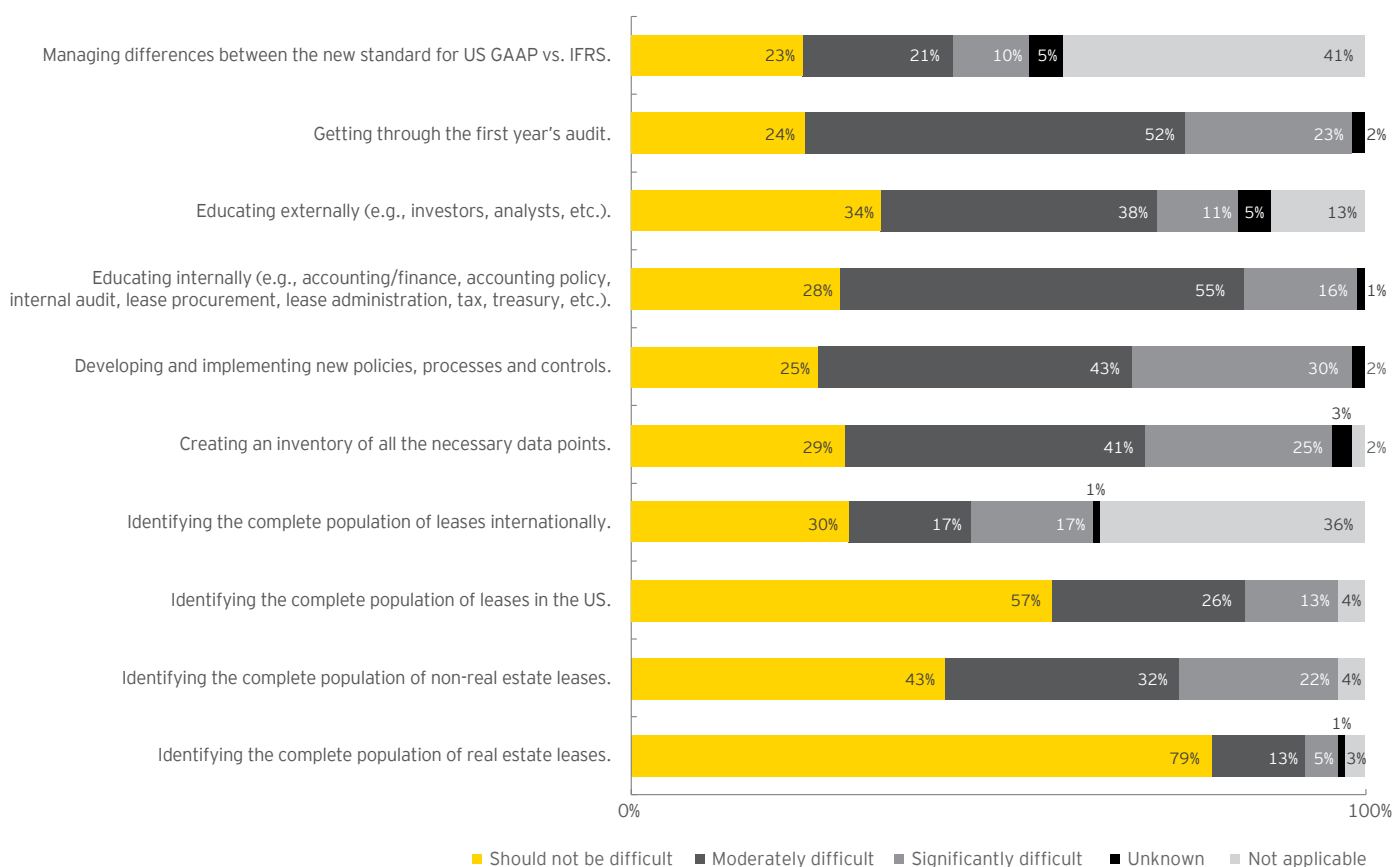
At the same time, even though respondents are aware that it will require additional work to track and identify leases throughout their organization, nearly 80% of all respondents were not concerned about the difficulty of identifying all real estate leases.

Among all respondents, 75% expect to have significant or moderate difficulty getting through the first year audit, while 73% said that developing policies, processes and internal controls would represent a significant challenge.

Identifying the complete population of non-real estate leases (54%) and creating an inventory of all data points (66%) were also expected to represent either a moderate or significant challenge. Furthermore 71% and 49% of the respondents indicated that educating internal and external stakeholders, respectively, would be moderately or significantly difficult.

Similarly, companies that are very familiar with the standards expect to experience significant difficulty identifying a complete population of non-real estate leases (22%), as well as international leases (23%). On the other hand, creating an inventory of all necessary data points appears to be less daunting for 22% of those who are very familiar with the standard. An additional 32% of respondents who were very familiar with the standards believe developing and implementing new policies, processes and controls would be significantly difficult, while 43% thought that task would be moderately difficult.

Anticipated level of difficulty to implement





An industry perspective

Of the industries surveyed, three provided the greatest number of responses: retail and consumer products, software and technology, and industrial products and chemicals. All are more likely to have business models that require a broad range of real estate and equipment leases.

In retail and consumer, responding companies said they expect to see the most difficulty in:

- ▶ Getting through the first-year audit (93%)
- ▶ Educating internal (87%) and external (60%) stakeholders
- ▶ Developing and implementing new policies and controls (73%)
- ▶ Identifying the complete population of leases outside the US (40%) and non-real estate leases in the US (60%)
- ▶ Creating an inventory of all necessary data points (60%)

Companies in the software and technology sector said they expect to experience significant difficulty identifying non-real estate leases (50%), while they anticipate identifying real estate leases to be significantly less difficult (10%). In addition, 60% reported they expect significant challenges in creating an inventory of all necessary data points.

Respondents from the industrial products and chemicals industry expect to experience moderate or significant difficulty in developing and implementing new policies and controls (60%) and creating an inventory of all the necessary data points (38%).

Impact

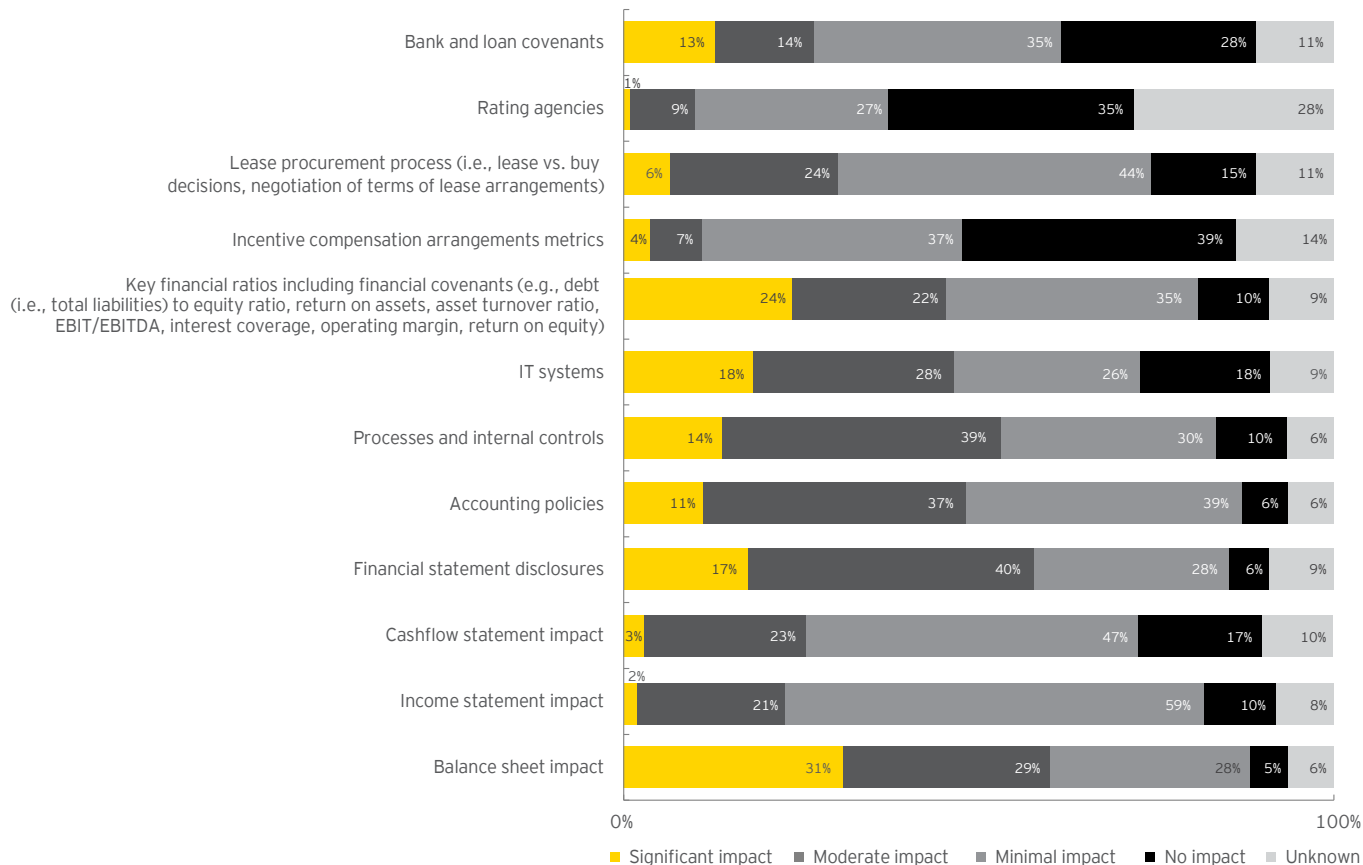
Most companies do not expect the new standards to have a major impact on their income or cash flow statements, or such key metrics as EBIDTA and those impacting loan covenants. However, 60% of all respondents said they expect either a moderate or significant impact on their balance sheets, while 58% expect a moderate or significant impact on financial statement disclosures.

Companies that said they were very familiar with the new standards also don't expect to see a major impact

on many financial metrics. However, they do recognize that adopting the standards will have either a moderate or significant impact on a number of accounting and financial processes. For example, a combined 56% said the new accounting standards would have a significant (24%) or moderate (32%) impact on their balance sheets.

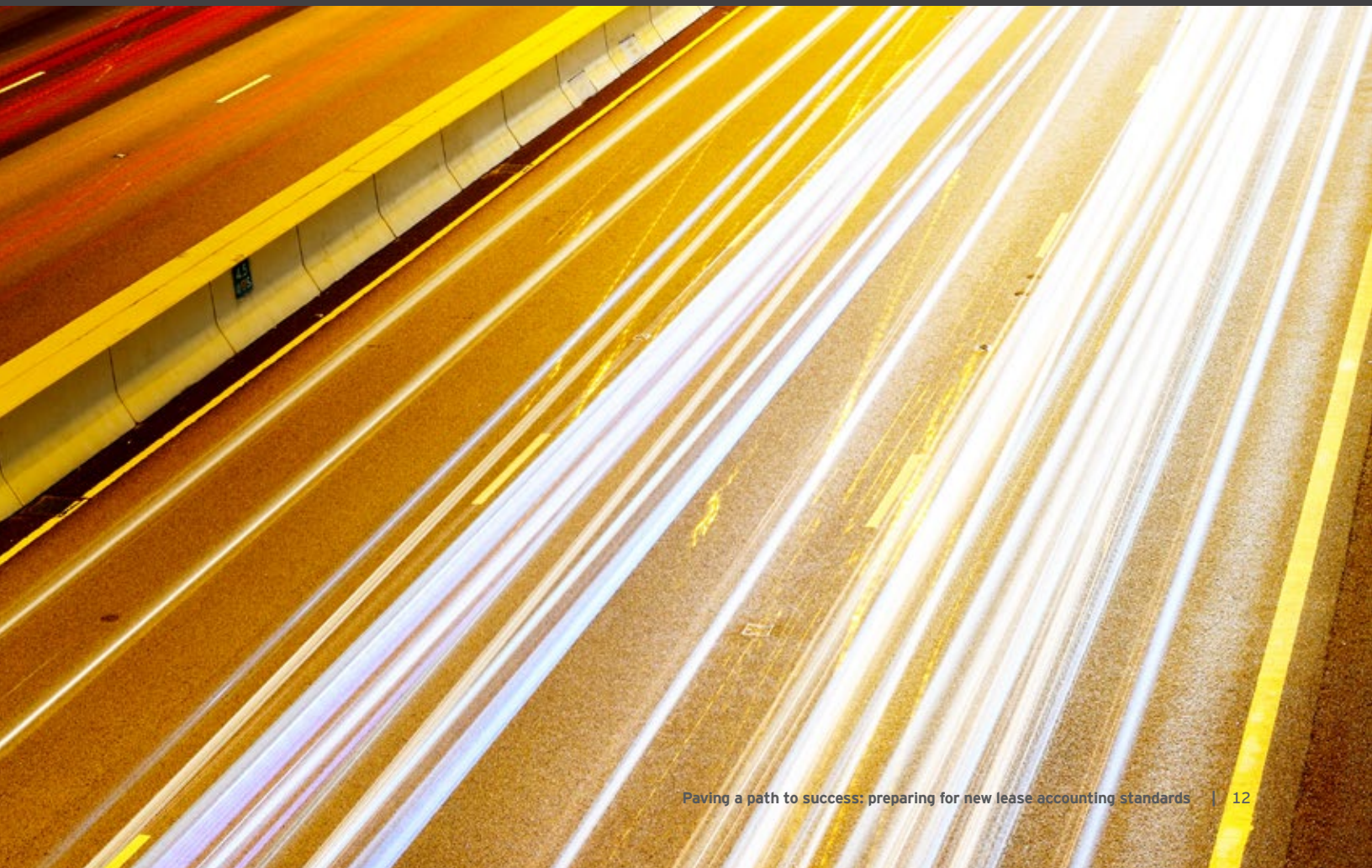
Close to half of the respondents who said they were very familiar with the new standards said they would have a moderate impact on their financial statement disclosures (49%), accounting policies, (47%), processes and internal controls (51%) and IT systems (46%).

Expected level of impact





“The criteria of a specified asset was something that we looked at very closely as the evolution of the guidance continued and that was certainly a concern to make sure our service agreements didn’t somehow get scoped into lease accounting guidance.”





“Leasing to us is a significant issue. We have huge global shared services teams that review our contracts, as well as extensive real estate and software teams, so getting our arms around who is doing what today is hard.”



What do we need to do?

To centralize or not

Since the new accounting standards apply to all leased assets, companies will have to look to at least two different parts of their operations, real estate and non-real estate. A significant percentage of companies reported they have decentralized or no formal systems for lease procurement, administration and accounting functions. Globally centralized functions were more likely for real estate than non-real estate, with greater centralization of procurement, with lease administration and lease accounting being the least likely to be globally centralized.

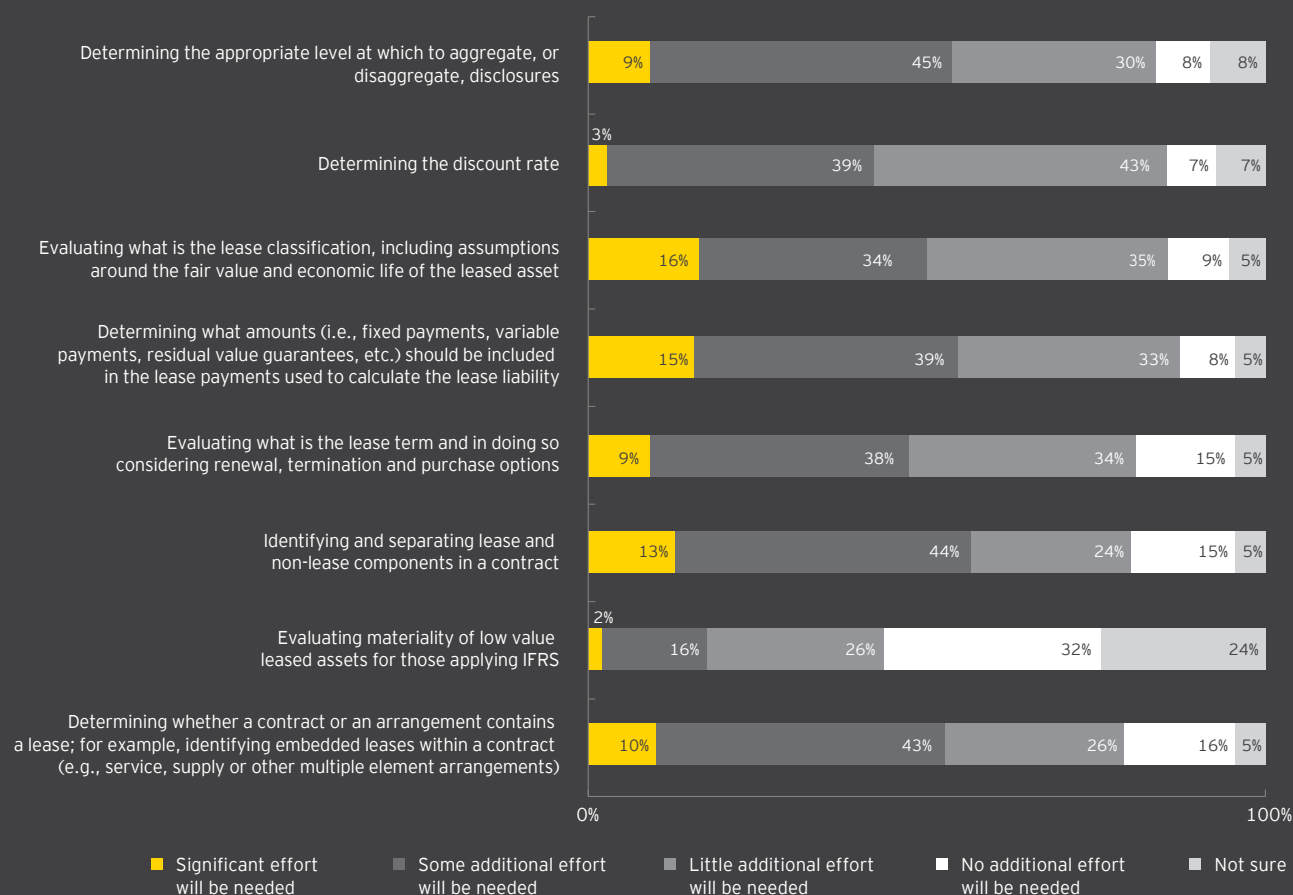
Many of these companies will need to assess the effective design of different approaches currently in place or embark on a major transformation of the information and accounting systems that track their leasing portfolio.

Effort to gather data

Implementing the new lease accounting standards will require companies to consider whether they can rely on current lease data used for footnote disclosure, as well as making certain new determinations for accounting purposes. Companies that already have well-organized lease administration and related accounting processes may simply need to evaluate whether their existing systems, policies, processes and controls can provide that data, while others will have to reorganize or automate their data repositories. More than half of all respondents reported they expect moderate or significant effort to:

- ▶ Determine whether a contract or an arrangement contains a lease (53%)
- ▶ Identify and separate lease and non-lease components in a contract (57%)

Level of effort to gather data



- ▶ Determine what amounts should be included in the lease payments used to calculate the lease liability (54%)
- ▶ Evaluate the lease classification including fair value and economic life assumptions (50%)
- ▶ Determine the appropriate level at which to aggregate or disaggregate disclosures (54%)

While these results matched quite closely with companies that said they were very familiar with the standards, there were several areas where those respondents saw only some additional effort, such as determining which amounts should be included in calculating and evaluating the lease classification. Determination of the discount rate is expected to require little to no additional effort by 50% of the respondents and 71% of those very familiar with the standards.

Once again this illustrates that as companies become more familiar with the standards and the implications, they gain a better understanding of how to leverage existing data, processes and systems to plan the implementation.

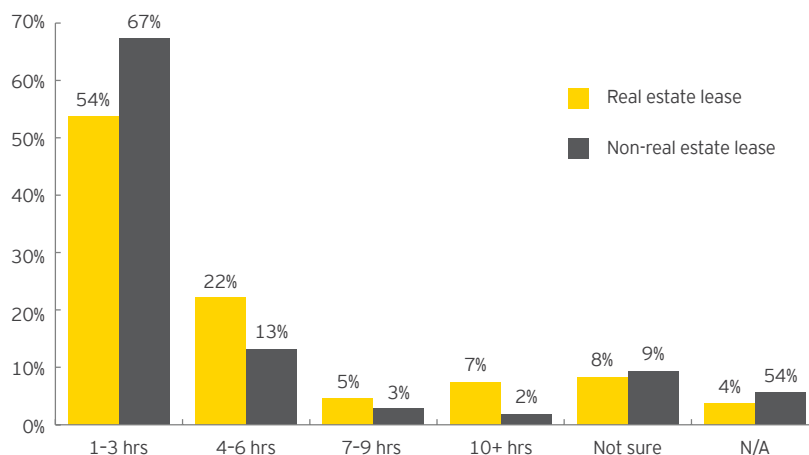
"We are looking at new systems that will give us real benefits through data extraction. Our hope is that once we have automated and have a true lease repository and accounting system, we're going to get efficiencies and a lot more in the way of consistency."

Time required to review a lease

When asked how much time was required to review a lease to determine the appropriate accounting treatment, roughly two-thirds of respondents familiar with the standards said they spend one to three hours reviewing typical lease contracts for real estate (60%) and non-real estate (68%). The reviews are predominantly done by accounting, finance or policy for both real estate (77%) and non-real estate (72%), while lease administration handled the real estate lease reviews for 15% of the respondents, and 10% of the respondents said non-real estate lease administration handled the reviews.

Companies should expect that the time to review leases for initial application of the standards will be greater, as the existing systems companies use to track leases – spreadsheets as well as software – will not have all the necessary information to make all the required assessments.

Average time required to review typical lease contracts



“There’s no new system out there ready to implement this new standard. A lot of systems are going to have to be updated and changed over the next couple years before this standard can take effect.”

Lease administration systems – update, replace or first time?

Most lease administration systems are not set up to perform the calculations required to comply with the new accounting standards and more than half of the respondents indicated they use spreadsheets for managing their lease administration and accounting. As a result, many companies will need to evaluate whether to update their existing systems or to implement a new system. Furthermore, most companies have different bases for external reporting and tax purposes, and in many cases have dual external reporting requirements in US GAAP and IFRS. This will increase requirements on IT systems and could potentially further complicate the implementation of new processes and controls.

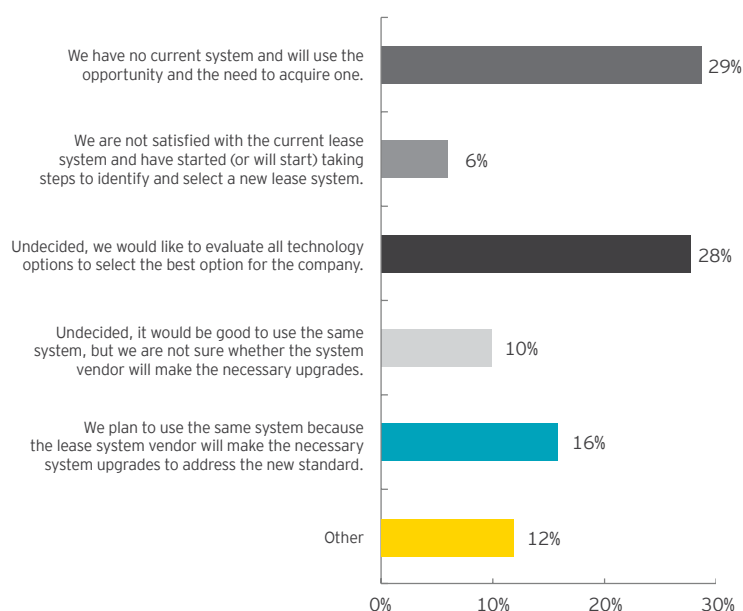
Among survey respondents, 29% reported that they have no current lease administration system and 6% said they are not satisfied with their current system, and will use this opportunity to acquire a new lease administration and accounting system. Only 16% said that they plan to use the same system and expect that the software vendor will make the necessary system upgrades to address the new accounting standards. Another 10% said they would prefer to use their existing system but were unsure if the software vendor would make the necessary upgrades. Another 28% said they still needed to evaluate their technology options.

The fact that more than 80% of the respondents are still evaluating which technology will fit their needs is consistent with the finding that only 13%

of respondents have project teams performing or completing a readiness assessment to understand the current-state of leasing activities (i.e., processes and controls, policies and IT systems). This is a critical step in identifying the changes necessary to comply with the new standards.

In addition, as companies either design or upgrade IT financial reporting systems, they should consider the new standards and incorporate lease administration and accounting into their initiatives. This will help to reduce costly rework and help companies comply with the new standards.

Plan for lease administration system



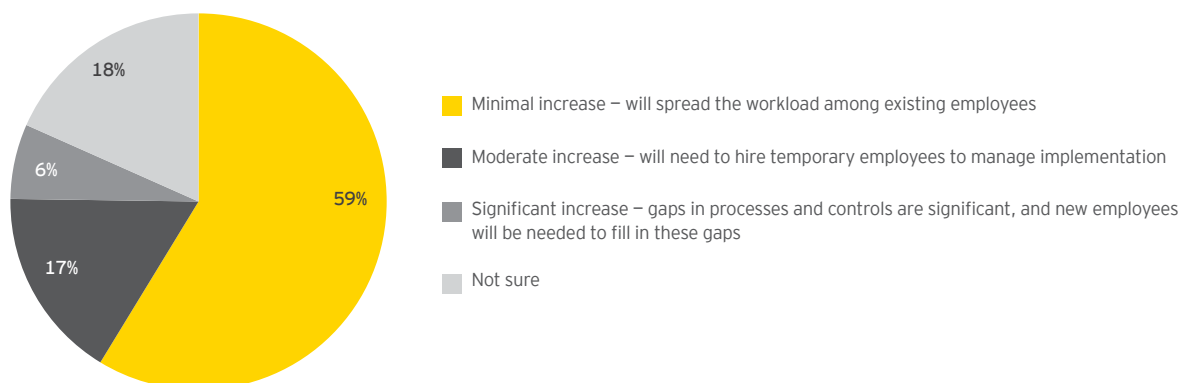


What is it going to cost?

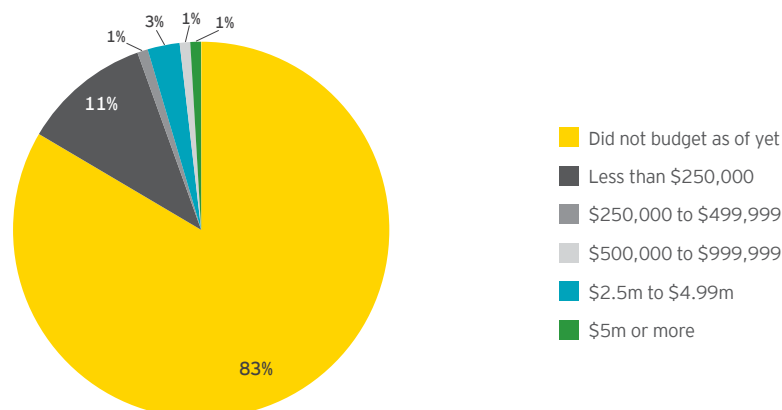
Companies will need to deploy resources to assess the current state, identify the gaps in data, process and technology, and then design and implement the future state. Nearly 60% of the respondents expect only a minimal increase in internal staffing costs to implement the new standards and plan to spread the workload among existing staff.

Interestingly, among all respondents, 6% of the companies said they expect to see a significant increase in spending to address shortcomings in processes and controls, while 17% expect a moderate increase in spending and 18% were unsure.

Anticipated impact to internal costs to implement



Amounts included in total budget for the next three years for incremental costs to implement



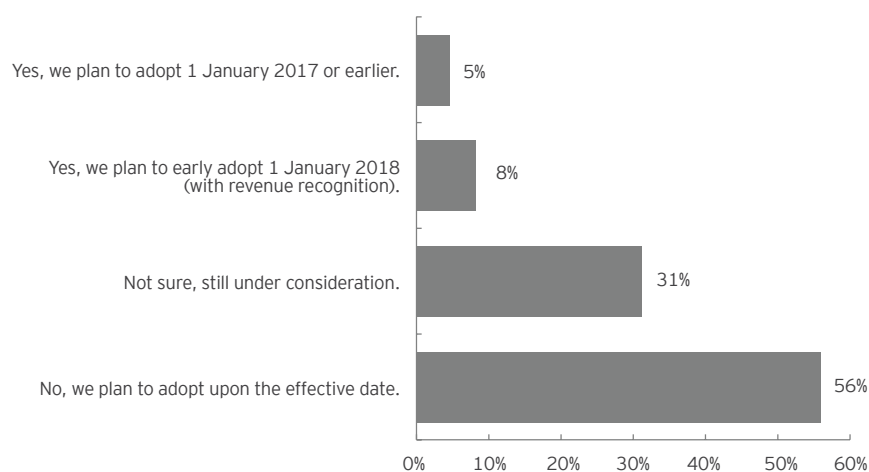
Two-thirds of the respondents said they do not plan to rely on external resources to provide project management and half did not plan on using external resources to abstract their leases. In addition, half said they will seek technical accounting assistance from their external auditors or another accounting firm. Of those respondents very familiar with the standards, half said they were planning or would consider using external resources to support IT software selection and implementation while nearly 20% were unsure.

Only 14% of respondents were unsure of the need to consult external resources on technical accounting matters, while nearly a quarter of the respondents were unsure of their needs for external resources in all other categories. In fact, 83% of survey respondents have not yet budgeted anything for implementation. For many, this may mean they will start to budget once they get a stronger sense of the actions and changes they will need to take to comply with the standards.

Early adoption

More than half (56%) of the respondents plan to adopt upon the effective date and 31% are undecided. Respondents very familiar with the standards were slightly more likely to be early adopters (17%). Many of the planned early adopters said they would do so in conjunction with the implementation of the revenue recognition standards.

Do companies plan to early adopt





Accounting policy elections

The lease standards provide companies with the opportunity to make certain policy elections in transition and ongoing by asset class. While most survey respondents are not sure which accounting policies they may elect upon transition, one-third reported that they would take advantage of the transition relief provided by the standards. In addition, 58% of the companies familiar with the standards said they plan to apply a method similar to current operating lease accounting to short-term leases (those less than 12 months) and 24% reported that they may elect an accounting policy (by class of underlying asset) to account for the lease and non-lease components of a contract as a single lease component.

Preliminary accounting policy decisions derived from a diagnostic of current lease portfolios can be instrumental in determining what data needs to be collected and the processes and systems required in the future state.

Raising awareness

In addition to updating policies, procedures and internal controls, companies will need to also provide guidance and education to internal stakeholders to ensure everyone in the organization follows consistent and appropriate procedures.

Companies will also need to assess the potential impact the new standards will have on financial statements and metrics reported to external stakeholders. As a consequence, they will need to evaluate how the new standards may change the way stakeholders and investors view the company's financial performance. This will require a broad effort to educate them on how financial statements and key performance indicators may change as a result of the new standards. This may include investors as well as analysts, who view all leases as liabilities that should be on the balance sheet, and make adjustments to "capitalize" operating leases today based on differing methodologies and amounts that may result in changes to these metrics.



Top 10 actions to consider

- 1. Enhance understanding of the new standards and raise internal awareness:** Companies that are very familiar with the standards and its implications understand what to expect on the journey ahead. Set up training sessions and share insights.
- 2. Establish cross-functional project team:** Include all business functions that can contribute to the project or be impacted by the changes required to adopt the new standards.
- 3. Inventory lease types across the business:** Analyze all lease types and consider other arrangements for potential embedded leases. Evaluate existing processes for data collection and select a sample of lease arrangements to evaluate.
- 4. Perform gap analysis:** Assess the current accounting and reporting policies, processes, technology and internal controls for selected arrangements. Perform gap analysis to the required future state, summarize changes and identify options.
- 5. Develop initial implementation plan and evaluate synergies and interdependencies:** Develop and budget for a cross-functional plan to address the required changes for data collection, processes and technology. Identify the impact of other related internal projects, such as IT systems updates and adoption of the new revenue recognition standards. Update implementation plan to avoid potential bottlenecks and resource constraints and identify need for external resources.
- 6. Make accounting policy elections:** Define and adopt updated accounting policies to comply with the new standards.
- 7. Determine transition date:** Evaluate whether there are any benefits of early adoption and confirm date of adoption.
- 8. Perform an impact assessment:** Evaluate the magnitude of impact the changes will have from a financial statement and business perspective, including treasury, tax and procurement. Advise the board and audit committee on how the new standards will impact financial metrics. Draft and communicate required transition disclosures.
- 9. Update and implement transition plan:** Finalize the transition plan and budget. Confirm commitment of the required resources to meet the required timeline. Implement systems and process changes, including parallel periods and dry runs. Go live.
- 10. Communicate to key stakeholders:** Identify key stakeholders, including the board, analysts, regulators and other capital providers and communicate the effects of the new standards on transition and beyond.



Looking ahead

Virtually every company leases equipment or property and as such will need to comply with the new standards. In that respect, the key to approaching the new standards may be to not view them simply as a burden, but also as an opportunity to improve efficiency within the business and support effective lease procurement and administration. As a result, organizations that plan for the new standard appropriately may find themselves positioned to drive organizational improvements by monitoring their lease activities more effectively.

For example, some companies may opt to transform operating models for leasing in ways that drive savings through improved management of lease procurement and end-of-term management. And as part of a more holistic transformation of their financial systems, organizations may also find ways to streamline accounting procedures, improve the flow of data throughout the enterprise and support improved decision-making at all levels of the organization.

While there's still time to comply with the new standards, many companies have a great deal of work to do and many decisions to make.

"Leasing won't go away. There are lots of reasons to lease other than just from a financial standpoint of being in the footnotes rather than on the balance sheet."



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For more information, please read EY practical matters, "Leases make their way onto the balance sheet: plotting the course for a smooth journey"

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