KPMG

Lease accounting is right around the corner

KPMG's 2018 Lease Accounting Change Survey reveals the key remaining challenges and how to tackle the upcoming deadline

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With only months left before the new lease accounting standard becomes effective, many public companies have not taken the steps needed to meet the deadline. KPMG's latest survey reveals that the entire implementation process is much more complex and expensive than anticipated and that identifying embedded leases is the most challenging aspect. The survey indicates that both public and private companies need to quickly assess their current state and invest in the resources needed; not doing so can have significant implications later.

Lease accounting changes—time is running out: What are the key challenges and how should you respond

With just months until the new leasing standard becomes effective for public companies, KPMG's latest survey reveals that companies are still struggling with implementation challenges that are impeding their progress towards the finish line. Compared to last year, some progress has been made, particularly in selecting lease accounting software (from 18 percent to 54 percent) and compiling a lease inventory (from 29 percent to 40 percent). However, only small improvements have been made in other key activities, such as collecting and validating data (from 4 percent to 11 percent) and completing an accounting assessment (from 13 percent to 19 percent).

We believe that many companies may have underestimated just how time-consuming the process would be and are currently running out of time to meet the deadline. Therefore, as the compliance date approaches, companies that are behind schedule may be forced to use interim measures that do not reflect their ultimate, preferred end-state processes, and which may have significant and costly implications in the future.

Survey methodology

The new leases standard is one of the major rule changes that has an impact on virtually every company that leases assets. The new leasing rules take effect on January 1, 2019 for calendar-year public companies and one year later for non-public companies and government entities.

In order to gain a greater understanding of where companies stand in this process, KPMG recently surveyed companies across all major industries:

— Nearly 400 companies

— 75 percent public and 25 percent private

— 2/3 have revenue of $1 billion or more.

Other key survey insights include:

Companies need to understand just how complex and expensive the process can be. Total expected costs for implementation increased this year for 65 percent of public companies, primarily because of the expense of new software. These costs should be budgeted early.

Companies have been most challenged by identifying embedded leases and entering leases into a new leasing system. To deal with these challenges, many companies should increase their budgets and seek out the expertise of outside advisors. If possible, accounting and process assessments should be done as first steps to avoid the risk of inefficiencies.

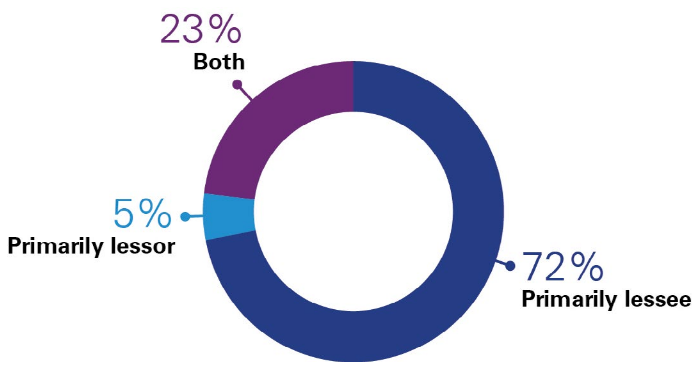
Both public and private companies need to quickly assess where they are in the process and develop a clear plan to meet all required steps. The risk of getting it wrong is substantial and may involve higher post-implementation costs and a loss of stakeholder confidence.

In addition, companies should include all stakeholders in the process to increase efficiency, enable transparency and help with future audits.

Background

In February 2016, the Financial Accounting Standards Board (FASB) issued new rules on lease accounting, which have the effect of moving most operating leases onto a company's balance sheet. Since most large companies have thousands of operating leases spread across numerous geographic locations, simply compiling these leases into a complete inventory is a huge undertaking. These leases need to be abstracted (i.e., for the data necessary to account for leases under the new requirements), analyzed, entered into a lease accounting system, validated, and monitored throughout the lease term as they are accounted for on a company's balance sheet. This abstraction, data collection, and validation process can be particularly challenging.

Which of the following best describes your organization's leasing activities?



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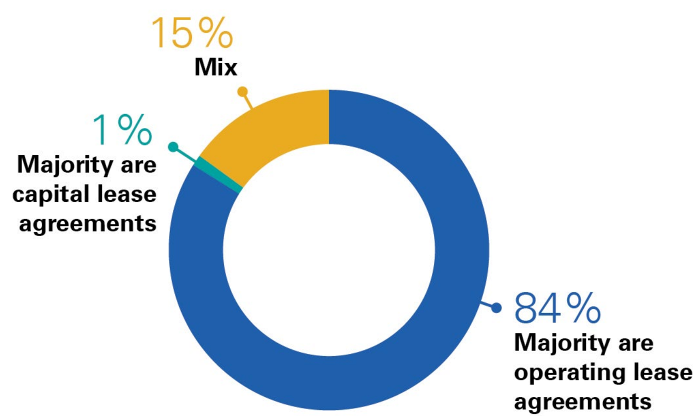
Some leasing profiles are more affected than others

The new leasing standard is impacting companies across all industries; however, certain types of companies may be more impacted than others, depending on their lease portfolios. Lessees with most of their leases classified as operating leases and located in numerous locations may require more time for their implementation effort. In our survey, 72 percent of companies were primarily lessees, and 84 percent of their leases were classified as operating leases.

Multinational corporations may find the process even more burdensome as they will need to deal with another level of complexity. Because the International Accounting Standards Board accounts for all leases as if they are finance leases, whereas the FASB maintains a distinction between operating and finance leases, U.S. multinational companies may need to consider the use of a system that will support two different sets of leasing rules in order to comply with statutory reporting.

How would you describe your lease contracts?



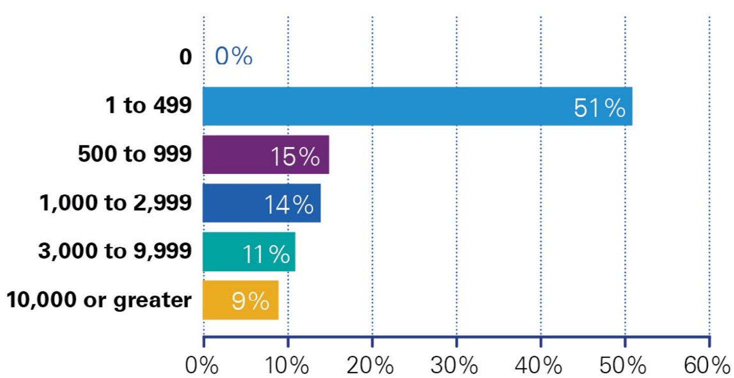
Among those who selected "primary lessee" or "both" in previous question

Leases are numerous and dispersed

Companies are still challenged by the same issues that were a problem in prior years. It is difficult to locate and ensure completeness of the huge population of leases that exist, especially to ensure all leases that reside within larger service or supply contracts (i.e., embedded leases) are captured. The process of ensuring that embedded leases are appropriately identified can require a significant amount of time, as well as the involvement of more senior accounting personnel. And once located, it may take much longer to abstract, analyze, and enter those leases into a lease accounting system.

Almost 50 percent of respondents said that their companies had 500 or more leases, and 45 percent said their leases were sourced from 10 to 30 or more physical locations. Just finding and collecting data on these leases can easily require thousands of man-hours. Some companies may discover that their original estimate of their lease population is not accurate or complete, especially when considering embedded leases.

How many leases does your organization have (including both real estate and equipment)?



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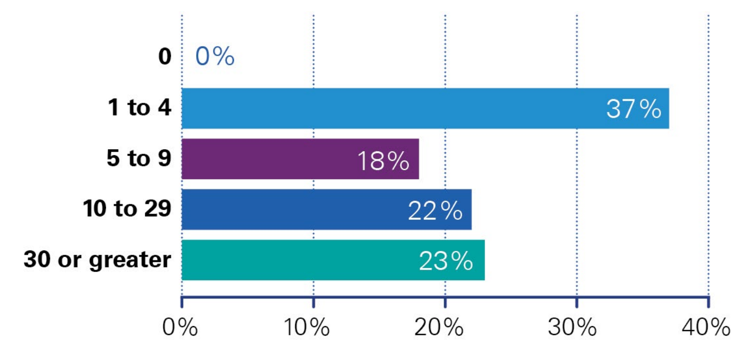
From how many locations does your organization expect to pull source lease data (original lease contracts)?



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Progress has been made, but is it enough?

While some companies may be fatigued from implementing the new revenue recognition standard earlier this year, the percentage of total respondents who indicated they had not yet started to assess the accounting impact of the new leases standard did drop from 35 percent in mid-2017 to 14 percent this year. With only months left, however, only 21 percent of public companies have completed their assessment, which means that more than three quarters of all public companies still have a substantial amount of work to do.

Of those who started their assessments, 71 percent have established a program management team; 40 percent have completed their lease inventory; and 54 percent have selected lease accounting software. However, a large percentage of respondents have made no progress in a number of areas, including designing a software solution (34 percent) and developing system or process requirements (24 percent).

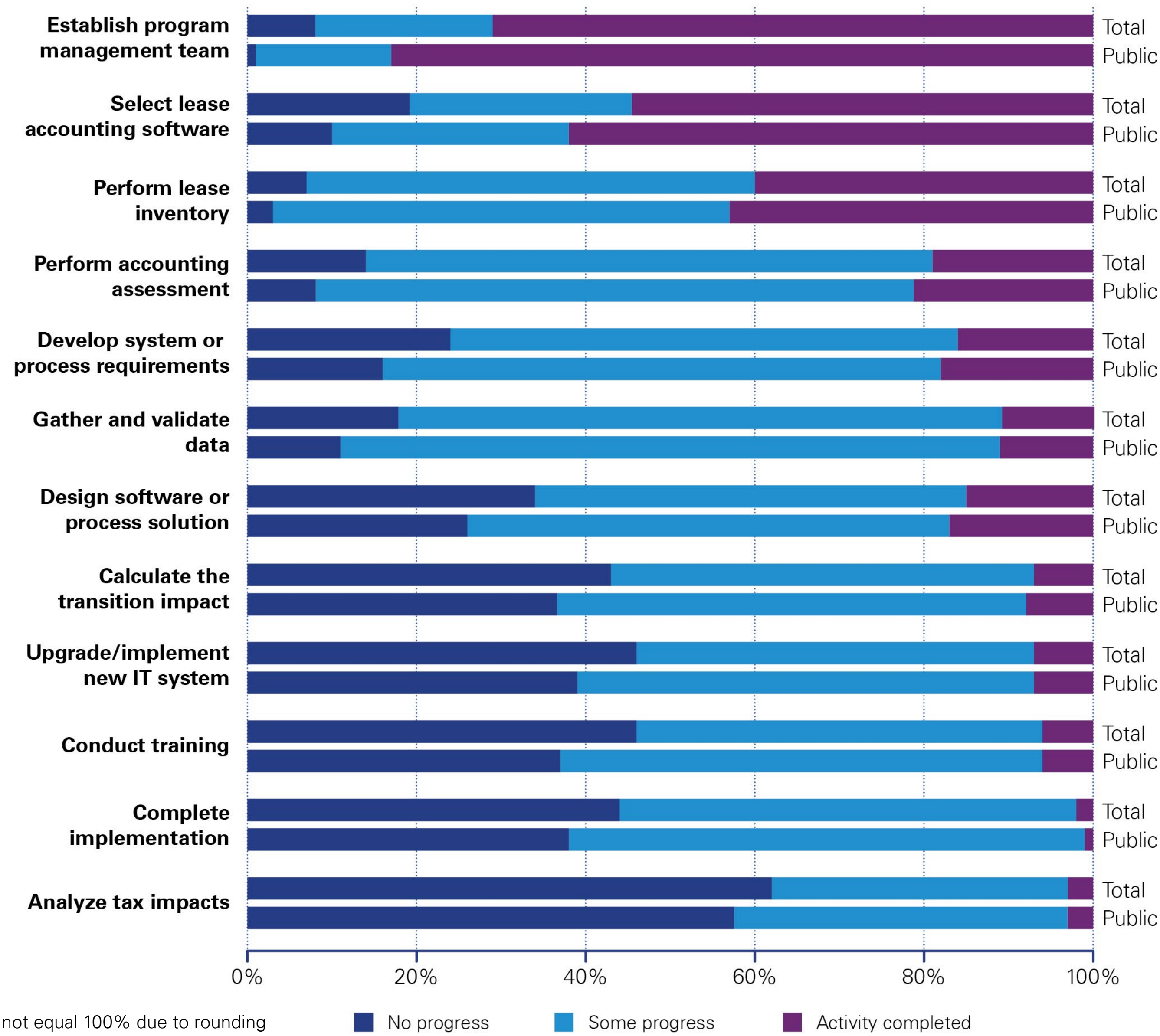
Considering that over 50 percent of companies have selected lease accounting software, but less than 20 percent have completed an accounting assessment or have developed system or process requirements, many companies may not fully understand their accounting, operational, and process gaps first, before determining what type of system change is needed. This could result in the selection of software that is not optimal for their particular needs. Because acquiring lease accounting software is a significant investment for most companies and system implementations can be a costly process, it is wise for companies to complete their needs assessment before selecting software and undertaking its implementation.

For companies that have not selected software yet, considering a cloud-based preconfigured software, such as the KPMG Leasing Tool (KLT), may help speed up implementation efforts to meet the deadline due to short setup times and rapid deployment of upgrades.

KPMG's perspective

Based on our experience with companies adopting both the revenue recognition and leases standards, the trend is reminiscent of the dash to revenue recognition adoption, which has left companies in a haze with countless system and process workarounds and post deadline implementation steps that could have been avoided through earlier preparation. These workarounds result in added costs and solutions that are less efficient. Given the rapidly approaching deadline and the significant amount of work remaining, many companies seem to be following a similar path as revenue recognition, where significant effort toward implementation will be back-loaded.

Please indicate the progress your organization has made against each of the following implementation activities related to the new leases standard.



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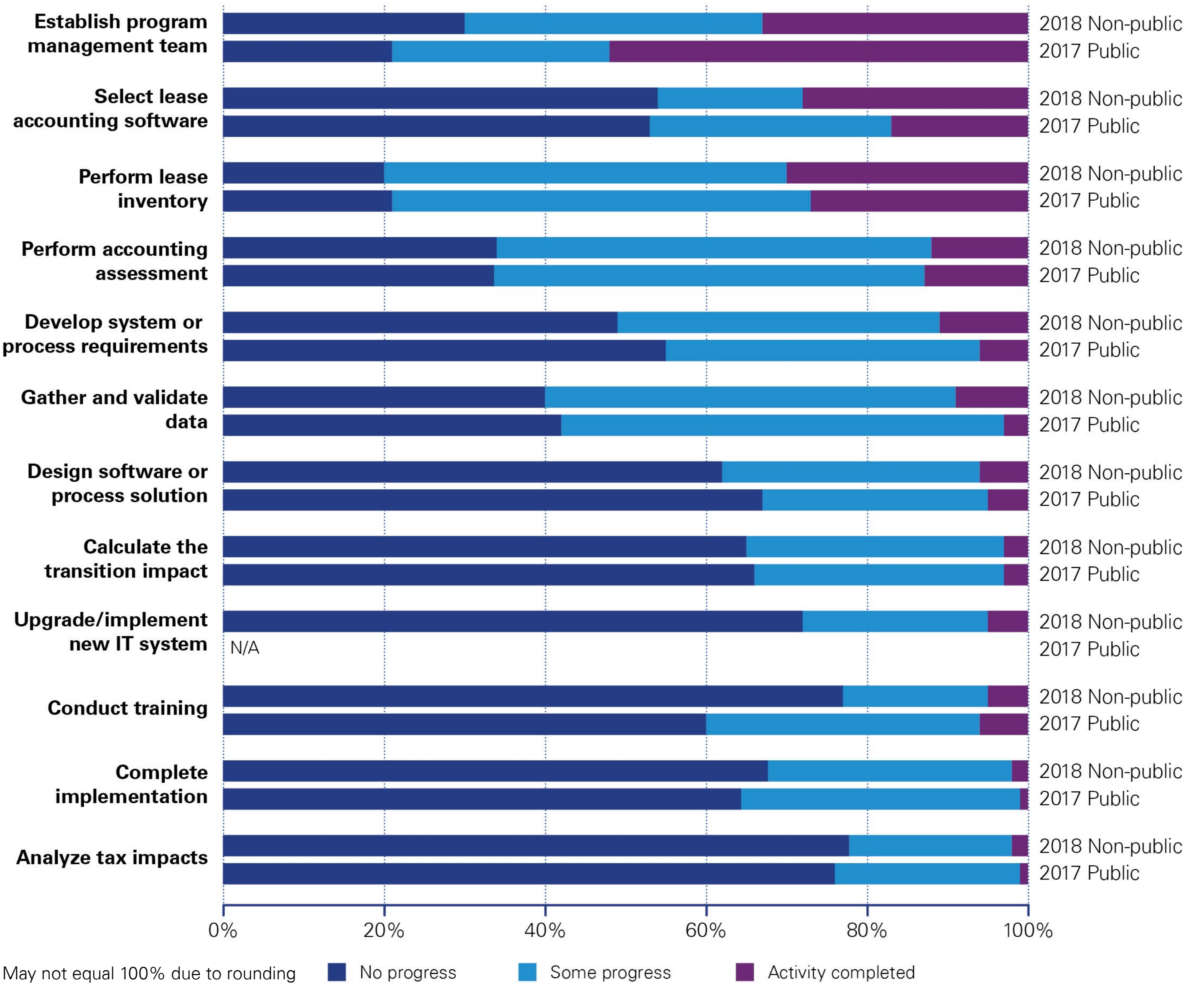
Private companies are taking the lessons learned and making some headway

Even though private companies have an extra year to adopt the new leases standard, having seen the struggles faced by many public companies implementing the new revenue recognition standard, private companies are learning from those lessons and appear to be making more progress in implementing the new leases standard than public companies had achieved at this point a year ago. Non-public companies have progressed more rapidly in a number of areas, including 28 percent have already selected lease accounting software compared to 17 percent of public companies last year; 30 percent have completed a lease inventory compared to 27 percent; 11 percent have developed system or process requirements compared to 6 percent; and 9 percent have collected and validated data compared to 3 percent.

Private companies should continue to learn from public companies who have already implemented the new revenue recognition rules and are currently implementing the new leasing rules

- Complete the detailed assessment as soon as possible and move on to design and implementation
- Take a holistic approach: all stakeholders should be involved since the implementation effort is complex and the process can be enhanced with input and expertise from across the organization
- Appoint a professional project manager to keep the project on track
- Understand the complexity of the process and be realistic when assessing the availability of your resources and estimating your budget costs
- Consider a cloud-based tool, such as KLT, which is relatively easier to set up with automatic updates released for new functionality

Please indicate the progress your organization has made against each of the following implementation activities related to the new leases standard.



Considerable challenges exist

One quarter of companies said that they were on track, but an overwhelming 75 percent said that they were facing challenges related to implementing the new leases standard. Companies continue to be challenged by the process of identifying embedded leases, which was their number one challenge this year (35 percent) as well as last year. Other significant challenges include abstracting and entering leases into a leasing system (28 percent) and establishing an appropriate incremental borrowing rate (IBR) (24 percent).

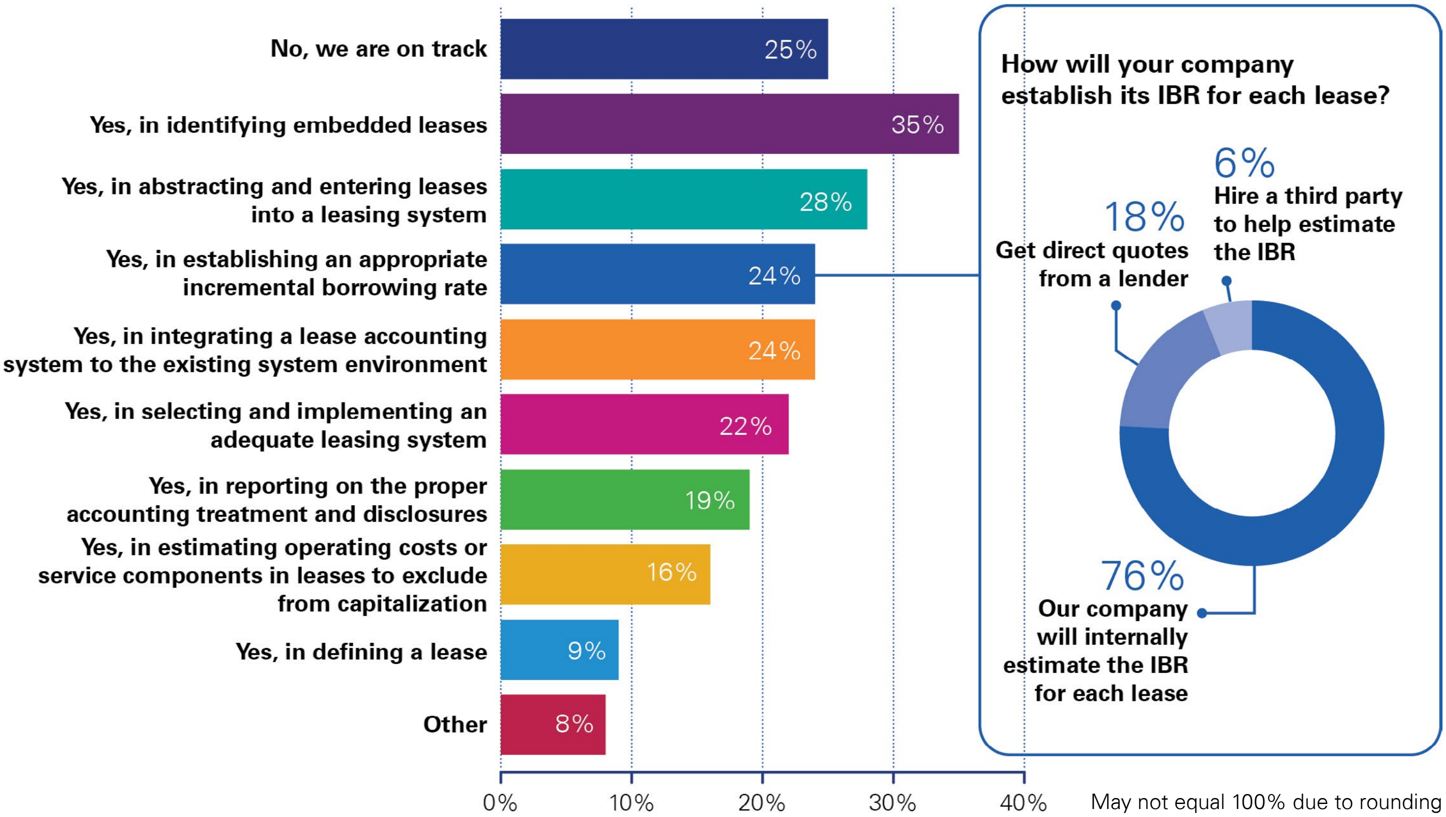
In order to deal with these challenges, 33 percent of companies have had to request additional funding to implement the leasing changes. Companies are also increasing the resources assigned to this task, either through an external accounting advisor (28 percent), by adding internal resources (23 percent), or hiring and managing multiple vendors (21 percent) to analyze contracts that may contain embedded leases, determine discount rates, and evaluate other areas that require substantial judgment. Companies are also engaging outside vendors to assist with systems and process implementations.

With regard to tackling the IBR challenge, 76 percent of the total respondents plan to internally estimate the IBR for each lease while 18 percent plan to obtain direct quotes from a lender, and only 6 percent plan to hire a third party to help them estimate the IBR.

KPMG's perspective

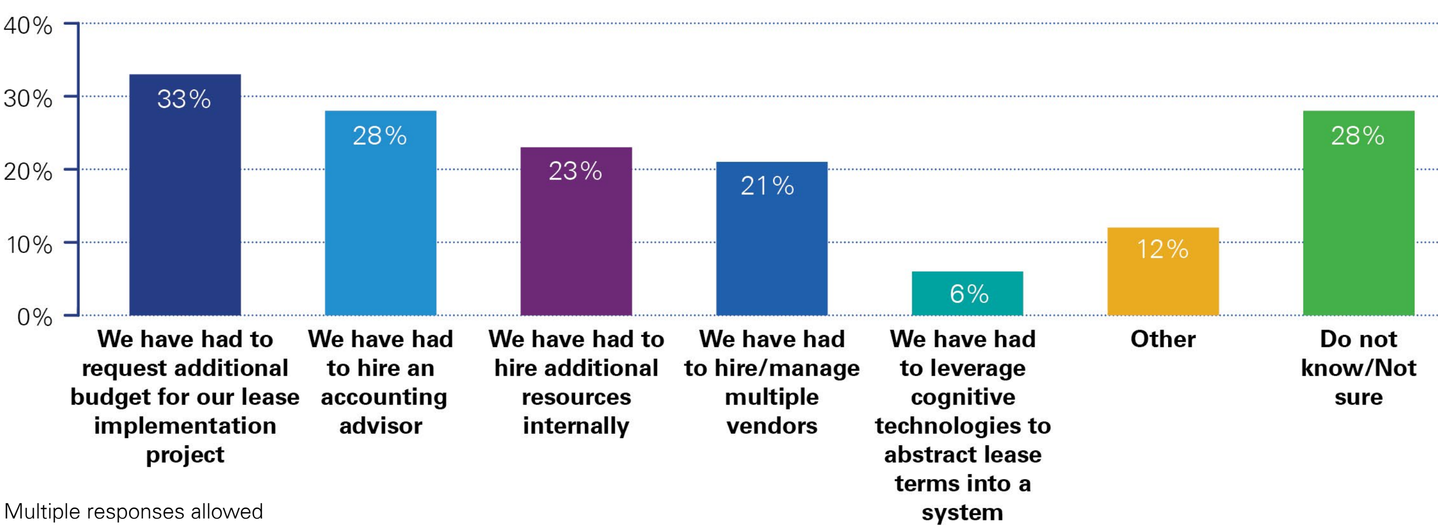
No matter where you are in your adoption time line, it is prudent to reevaluate the steps to adoption and consider insights and efficiencies from peers and industry cohorts so that you can adopt to quickly ramp up or streamline your implementation efforts. Consider your current resource allocation and assess whether you have the appropriate skill set to address these real-time challenges or whether you need to augment your team via a third party. Additionally, any mergers and acquisition activities should be accounted for in the context of this leasing standard in the deal's integration plan.

Is your company facing any challenges related to the implementation of the new leases standard? (select all that apply)



Multiple responses allowed

How is your company tackling some of the challenges with implementing the new leases standard? (select all that apply)



Multiple responses allowed

The need for lease accounting software is causing companies to reconsider their implementation budgets

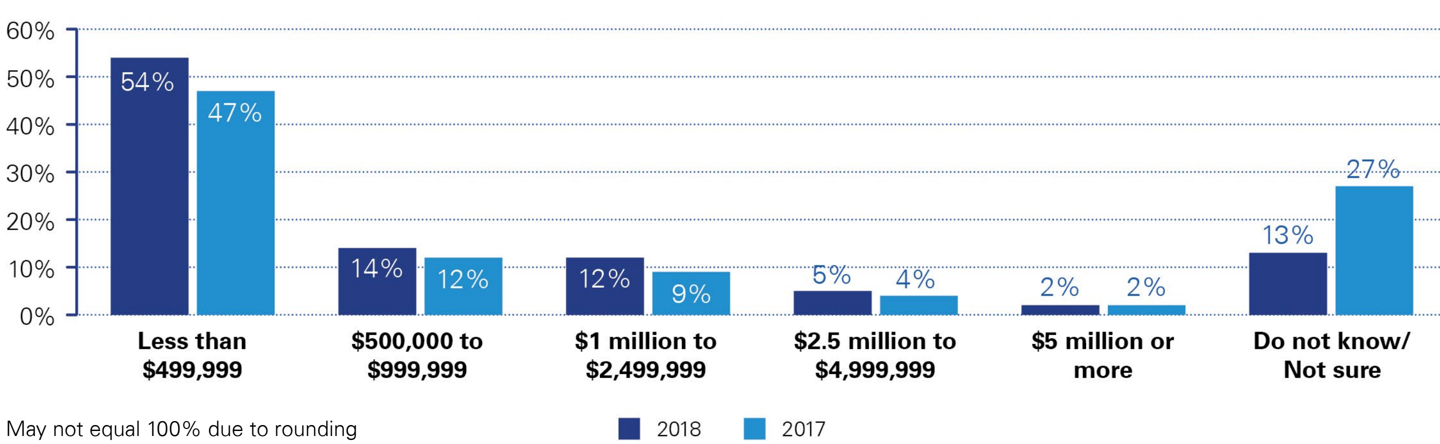
In last year's survey, 27 percent of respondents believed their total implementation costs would amount to $500,000 or more. This year, that percentage increased to 33 percent, indicating that the implementation is taking longer and costing more than anticipated.

Nearly 63 percent of companies are expecting higher implementation costs this year as compared to 39 percent last year. The top reasons cited were the need for new lease accounting software (30 percent), an increased need for outside advisors due to internal resource constraints (26 percent) and the greater-than-expected time needed to ensure the company has a complete lease inventory (including embedded leases), as well as abstract, and enter leases into a system (23 percent). Companies should not underestimate the time it takes to accumulate all of the required lease data needed to comply with the new standard. Collecting all of the key pieces of data for the company's leases, and ensuring a complete lease population, is not a small undertaking, and companies should budget enough resources and time to complete these tasks.

KPMG's perspective

For companies with sufficient time remaining in their adoption time line, given the lead time and cost to implement a new system and migrate and integrate data, they should complete their accounting and process assessments to gain a better understanding of the impacts requiring system changes before beginning their system implementations. For companies that are in their last six months or so toward implementation, such ideal sequencing may no longer be practical, and they may have to accept some inefficiencies from running a parallel track of assessment and implementation.

What do you expect the total cost (internal and external) will be for the implementation of the new leases standard?



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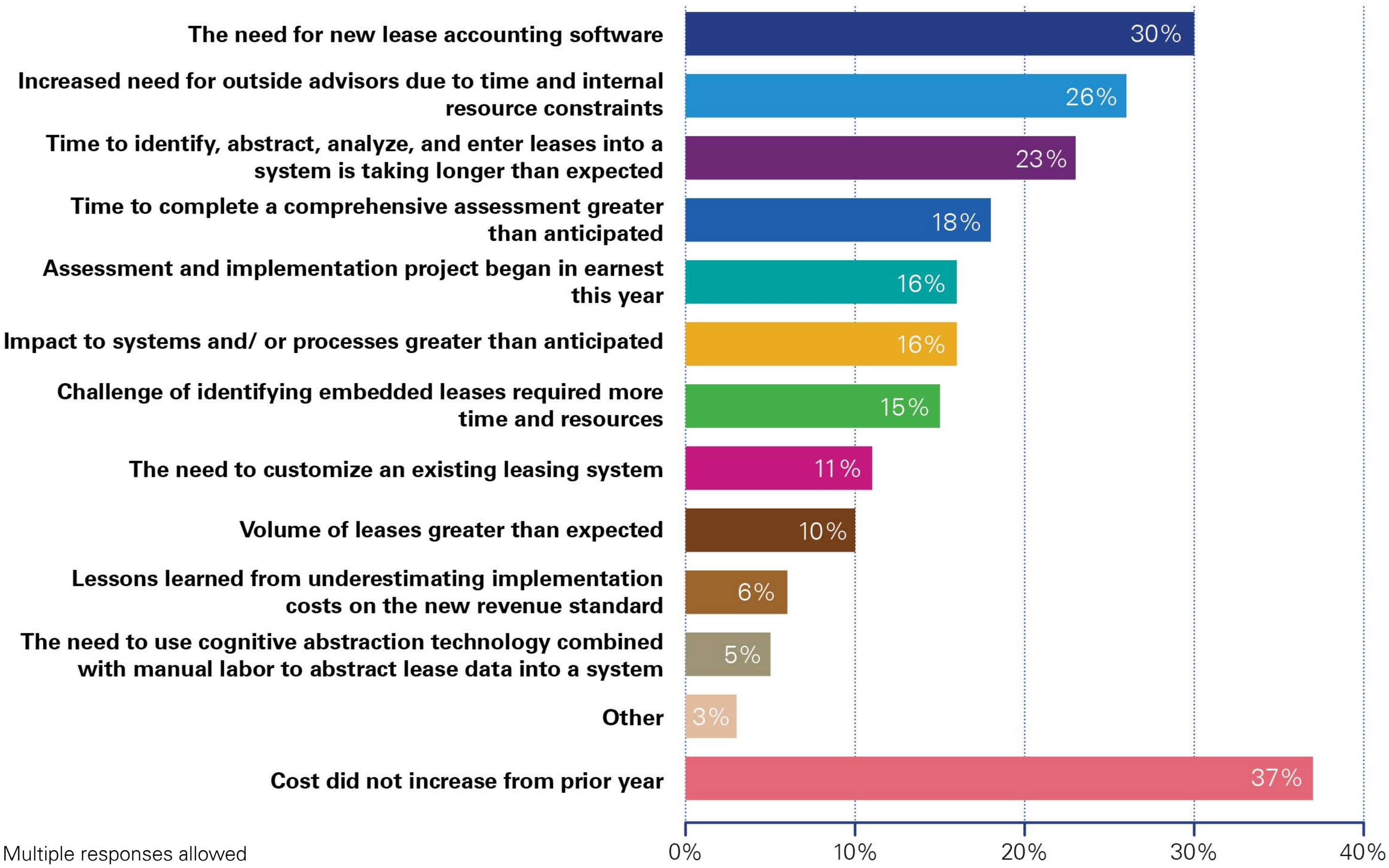
If your organization's total expected cost of leasing implementation increased from the prior year, what circumstances led to the increased costs? (select all the supply)



Multiple responses allowed

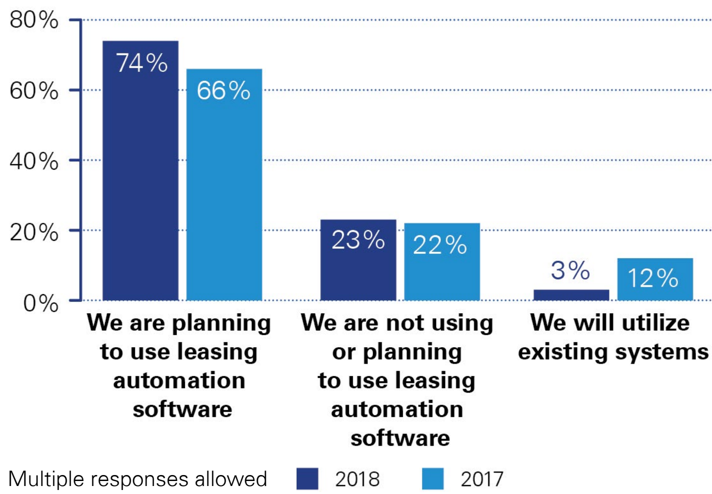
Many believe system changes will go live before the effective date but it takes time

For many companies, implementing the new leasing standard will require a new IT system. The percentage of respondents who plan to use leasing automation software increased from 66 percent to 74 percent between this year and last year. Additionally, of those implementing system changes, 80 percent expect the system changes to go live before the effective date. However, 46 percent of companies estimate it will take more than six months to implement changes to an existing system or a new software solution. Therefore, any company that has not started implementing system changes will likely need to apply some manual work-arounds, as the system may not be ready for compliance.

KPMG's perspective

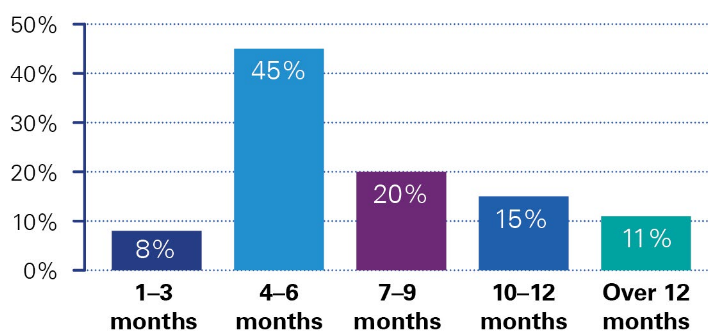
Companies are underestimating the time it takes to implement a new IT solution, perhaps due to the fact that they are unaware of all the steps and requirements. While there has been an increase in the number of companies having selected software since last year's survey, the job is far from complete. Companies must get a handle on all data that needs to be migrated and input into their system and have an effectively controlled process to ensure completeness and accuracy of that data. In addition, there are system requirements that often take longer than expected, including data migration, controls and validation testing, linking system and reporting needs (e.g., journal entries, foreign exchange rates, etc.), and system training.

If your organization is using a system for the new leases standard, select the following that best describes your organization's current situation.



Multiple responses allowed

The total amount of time to implement changes to the existing system or new software solution is expected to be:



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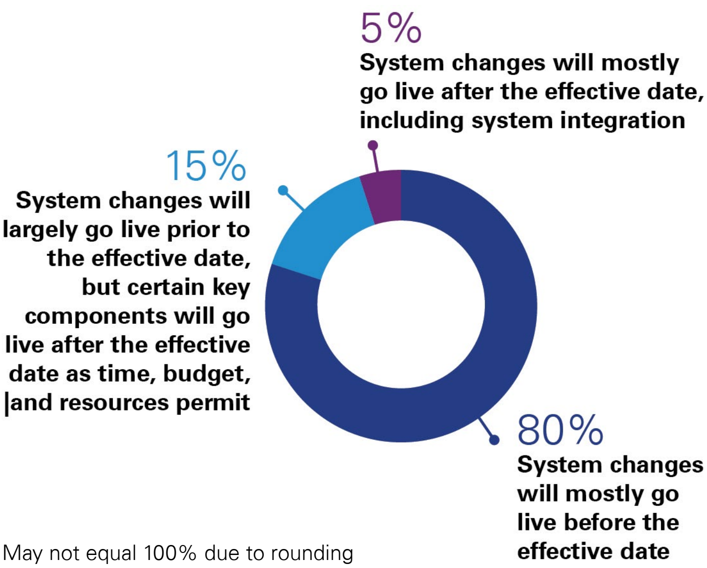
What is the timing of your organization's system changes?



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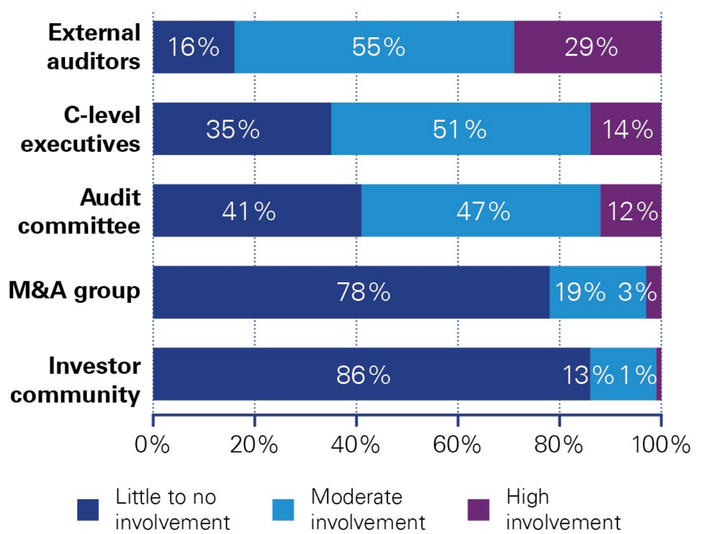
For a more successful implementation, involve all key stakeholders

According to the KPMG survey, external auditors are the key stakeholders that have been most involved in the implementation process. However, only 29 percent of companies have involved their external auditors. External auditors should be involved early on, so there is time for them to substantiate data and test new systems and controls as well as audit new accounting policies. About one third of respondents indicated that there has been little to no involvement of key executives or the audit committee and three-quarters said there was little or no involvement from the M&A group and the investor community on the new leases implementation effort. Now is the time for companies to start communicating with the investor community to clearly articulate expected impacts to the company's assets and liabilities so that analysts do not get confused with any abnormal trends or incomparability in the financials.

For each of the following groups, how involved has your company been in discussing the new leases standard implementation progress and anticipated impacts to the organization?



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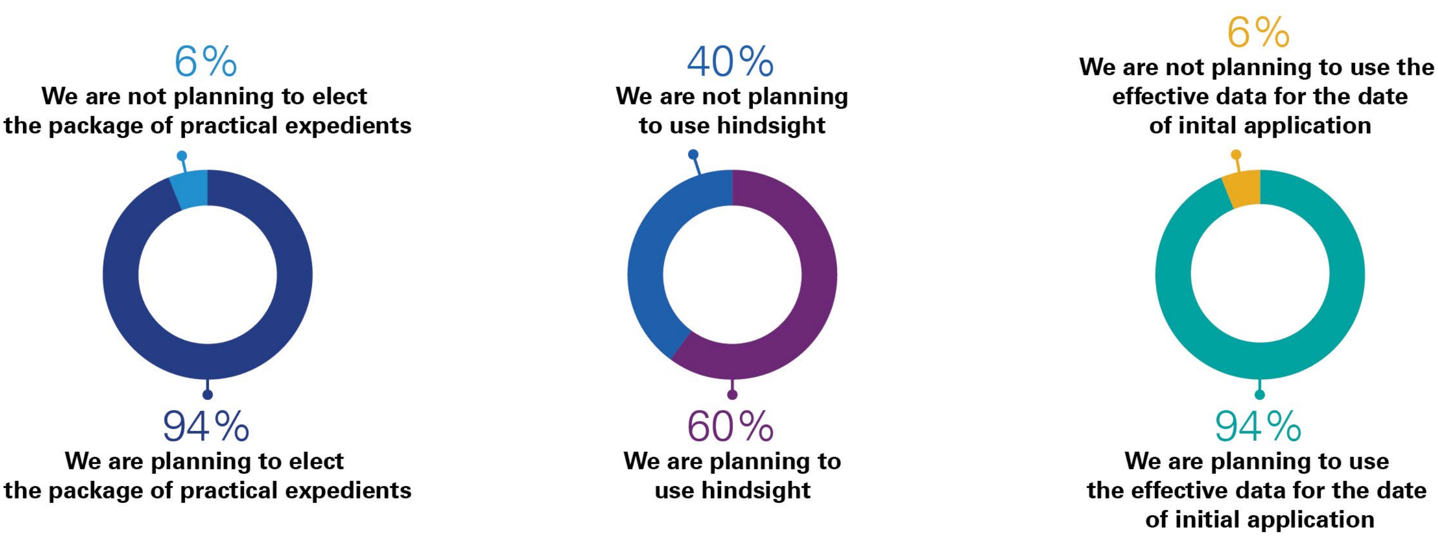
Companies are taking advantage of transition relief options

New FASB rules have given companies additional choices when it comes to transition financial reporting. A significant 94 percent of respondents said that they are planning to elect the "package of practical expedients," while a similar 94 percent are planning to elect the FASB's new transition option to use the effective date as the date of initial application.

In addition, 60 percent of respondents indicate they are planning to use hindsight in accounting for their leases in transition, despite the additional effort the use of hindsight will generally entail.

What is your company planning to elect for your transition to adopt the new leases standard for each of the following?



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Getting over the finish line

As discussed above, a significant percentage of public companies still need to take several important implementation steps before the standard becomes effective at the beginning of next year. Remaining open issues should be identified and addressed in the next few months.

Private companies have made considerable progress and should continue to move forward to meet their deadline in 2020. Already tackling the new revenue recognition requirements and learning from their public company colleagues appears to have helped private companies meet key milestones earlier. Moving forward, private companies should focus on completing a detailed impact assessment and work through their resulting design and implementation needs. Involving all key stakeholders will improve the process and understanding just how time-consuming and complex the process is will help ensure that the company budgets adequate resources.

Public companies: What steps should you take now?

- Complete your impact assessment
- Identify any other steps that still need to be taken to implement the new standard and create a detailed plan to address any open issues
- To speed up the process, hire additional personnel and outside advisors with expertise
- If lease accounting software is required and time is running out, consider a cloud-based solution, such as KLT. As a last resort, you may need to use temporary workarounds, although these will lead to higher costs and more complexity later on
- Plan an open dialogue with external auditors, investors, and other stakeholders to make sure they understand the financial impact of the leasing standard
- Make sure your company has included the appropriate C-level executives and the audit committee in the process and that all necessary internal controls are being developed
- Quickly identify what steps are needed in these last few months and determine how you can accomplish them.

Private companies: What steps should you take now?

- Understand the added cost of delay and the risks of not being able to implement the standard in a timely manner
- Start (or complete) your impact assessment
- Compile your inventory of leases with an understanding of how complex and time-consuming the process is
- Review lease reporting and policies, disclosure gaps, and tax policies
- Identify process and key control impacts
- Perform contract reviews by asset classes and analyze areas for embedded lease arrangements
- Understand practical expedients that are available upon transition
- Plan for your implementation
- Analyze system options by also considering current process and reporting needs
- Develop a high-level solution blueprint
- Map a future-state process, including system output to meet end-user needs
- Document system and integration requirements
- Document a detailed plan to transition

Conclusion

While companies have been focusing on implementation, the lessons learned experienced by the early movers and adopters shed insights into what it takes to adopt the standard, as well as the process to sustain and add value after the initial compliance date.

Key areas to focus on include:

1. Decisions and steps related to systems selection and implementation, including data
2. Resource allocation with the requisite knowledge and skills to combat the challenges, such as identifying embedded leases, and visibility into leading practices from peer organizations and regulatory bodies
3. Communication with key stakeholders to prevent any analyst confusion and provide transparency to help auditors efficiently plan and execute the audit.

To minimize business disruption and improve the chances of a smooth transition, financial reporting executives are advised to prioritize their immediate implementation goals. There are only a few months left for calendar year-end public companies to complete their leasing implementation. Private companies have just one more year and should not overestimate how much additional runway that one year actually affords them.

For more information, please contact:

Marybeth Shamrock
Advisory Leasing Leader

216-875-8158
mshamrock@kpmg.com

Scott Muir
U.S. Leasing Topic Team Co-Leader

212-909-5073
smuir@kpmg.com

About KPMG

KPMG: an experienced cross-functional team, a global network

KPMG's Accounting Change specialists combine industry knowledge and technical experience to provide companies with holistic advice on uncovering how accounting and financial reporting policies, processes, and systems will need to change to comply with the new rules.

Our global network of professionals have helped a number of companies to understand the impact of these new rules and to implement the required changes; our experience has provided us the insights into how companies in various industries will be affected and the steps that they can take now to help ease transition to the new standards.

How KPMG can help

Our experience with accounting change has positioned us well to not only help provide timely advice on the impacts of the new leasing standards, but also to help enhance current leasing processes, communicate with stakeholders, and provide training and change management support to facilitate a smooth transition to the new standards.

KPMG's Proprietary Leasing Tools

Our thorough solution also includes the KPMG Leasing Tool, a Web-based SaaS application, designed to help you transition to the new standard and serve as an accounting engine beyond the lease accounting conversion. KLT is a rapidly deployable, preconfigured solution in use by FORTUNE 500 companies to help comply with the new leases standard. KLT features project management functionality, dual reporting compliance with ASC 842 and IFRS 16, lease activity business intelligence reporting, financial reporting and disclosures, migration and integration of data with your current systems, and so much more.

Our global leasing offering also includes the KPMG Accounting Change Evaluator (KACE), a cloud-based assessment tool containing our accounting change methodology designed to give you a clear picture of regulatory gaps across functions.

Our Lease Extraction System can help close identified data gaps with advanced optical character recognition and cognitive natural language processing capabilities. Our Lease Review Tool provides you access to workflow approval on reviews of extracted data.

Please visit our Web site for the following:

KPMG's Lease Accounting capabilities

KPMG Leasing Tool

Explore KPMG's Lease Accounting capabilities

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