

THE MONTH-END CLOSE PROCESS

FOR LEASE ACCOUNTING

To comply with the new lease accounting standards most organizations have had to implement new business processes, organizational structures, and information systems. While some organizations have transitioned smoothly, others are experiencing significant challenges adapting to the new complexities introduced by the leasing standard. Those with the largest lease portfolios are the ones having the greatest challenges.

LEASE ACCOUNTING CHALLENGES



PURPOSE OF THIS INFOGRAPHIC

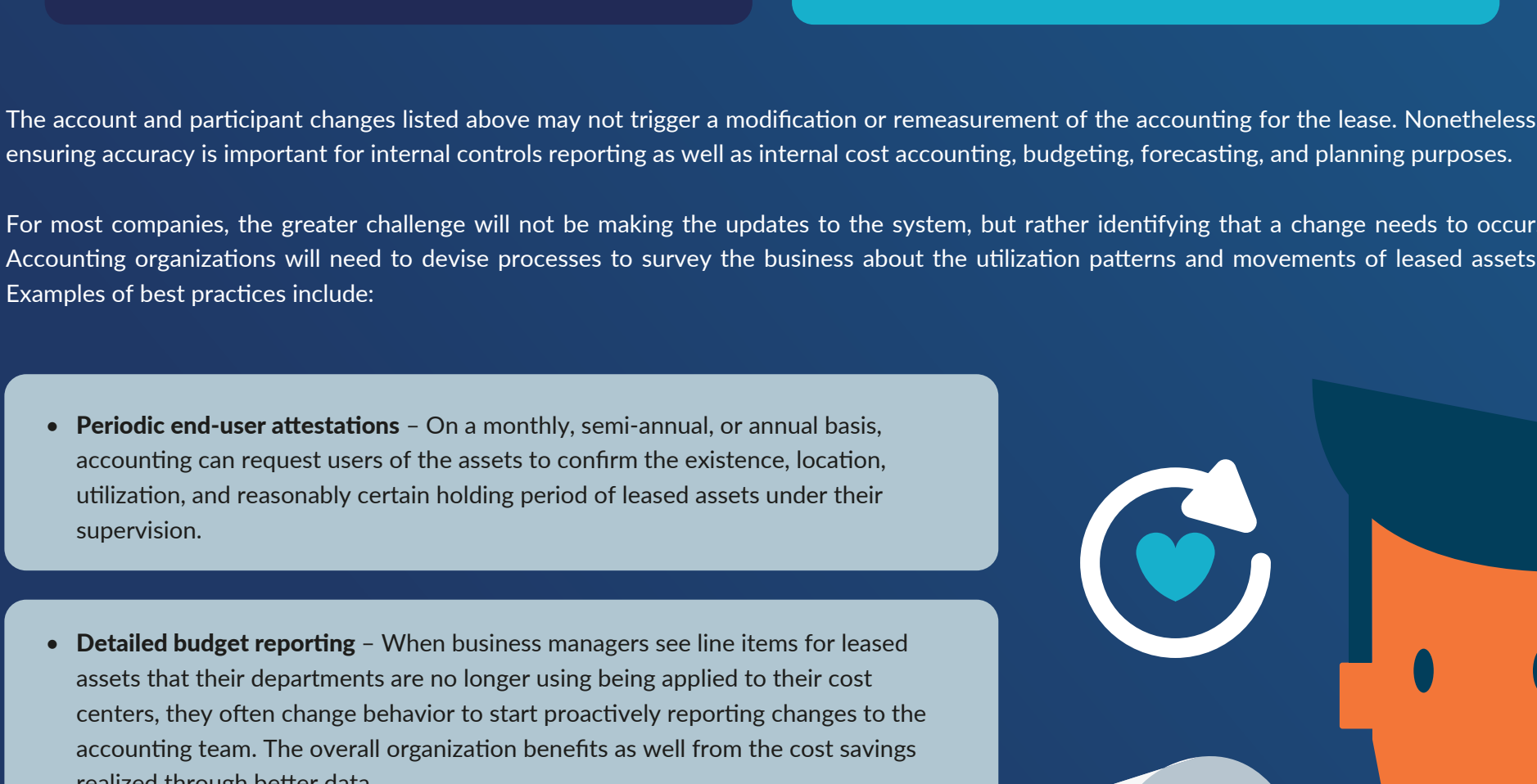
In this graphic we will outline the most common steps that organizations will need to perform in the lease accounting close:

1. MASTER DATA UPDATES
2. ACCOUNT MAINTENANCE
3. EVENT PROCEDURES
4. CONTROL PROCEDURES
5. GL UPLOAD & RECONCILIATION
6. DISCLOSURE GENERATION
7. PERIOD END CLOSE
8. POST-CLOSE ACTIVITIES

1. MASTER DATA UPDATES

Periodically, the lease accounting system will need to be updated with new master data. Examples might include changes to general ledger codes, cost centers, tax rates, depreciation methods, economic lives, credit ratings, or debt weights. Other examples might include the addition of new physical locations, new asset types, and new lessor relationships. Typically, these master data updates would be performed before account maintenance and event procedures.

The latest foreign exchange rates will need to be uploaded into the lease accounting system from the ERP on a periodic basis - at month-end or more frequently. Periodic updates to the incremental borrowing rates used to calculate the assets and liabilities will need to be applied as well.



2. ACCOUNT MAINTENANCE

The general ledger accounts, profit centers, or cost centers associated with different assets might change during any given accounting period. For example, a leased truck that was historically being used by the team responsible for product line A is now exclusively being used by product line B. As a result, the profit center associated with the truck will need to be updated. Account maintenance activities are applicable to both equipment and real estate leases. Suppose that a field sales organization historically occupied two floors of an office space lease that is now being used by customer support. The cost center associated with the lease will need to be updated. Cost center allocations are another area to review. For example, a rack of data center servers that may have been 100% utilized by the financial planning team may now be 50% shared with the sales operations team. If so, the lease expenses need to be split and allocated across the two different accounts.



The account and participant changes listed above may not trigger a modification or remeasurement of the accounting for the lease. Nonetheless, ensuring accuracy is important for internal controls reporting as well as internal cost accounting, budgeting, forecasting, and planning purposes.

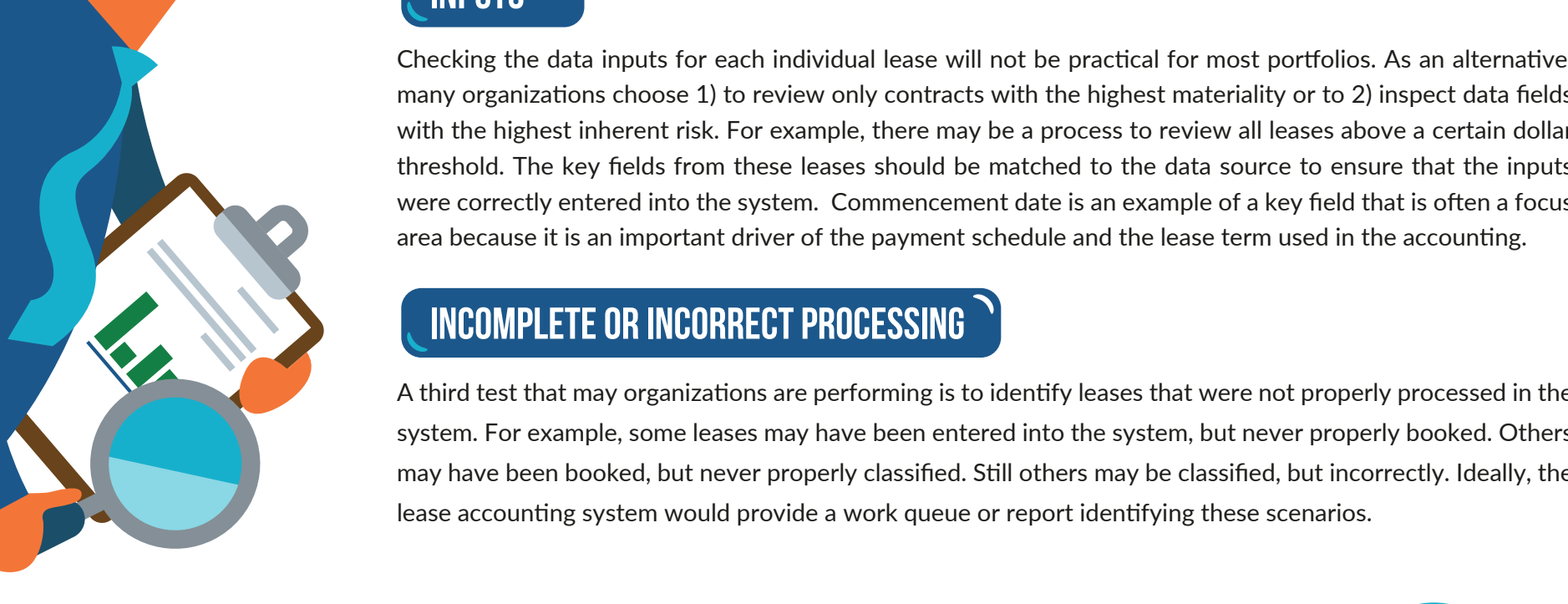
For most companies, the greater challenge will not be making the updates to the system, but rather identifying that a change needs to occur. Accounting organizations will need to devise processes to survey the business about the utilization patterns and movements of leased assets. Examples of best practices include:

- **Periodic end-user attestations** - On a monthly, semi-annual, or annual basis, accounting can request users of the assets to confirm the existence, location, utilization, and reasonably certain holding period of leased assets under their supervision.
- **Detailed budget reporting** - When business managers see line items for leased assets that their departments are no longer using being applied to their cost centers, they often change behavior to start proactively reporting changes to the accounting team. The overall organization benefits as well from the cost savings realized through better data.

A lease lifecycle management application can help to track these utilization patterns and movements.

3. EVENT PROCEDURES

On average, 70% of a renewed lease portfolio changes during any given year. New leases are signed. Rents change. Contracts are modified. Others expire and are renewed or terminated. Ensuring the completeness and accuracy of the lease portfolio will require strong event procedures at month-end close to perform commencement, termination, and modification accounting.



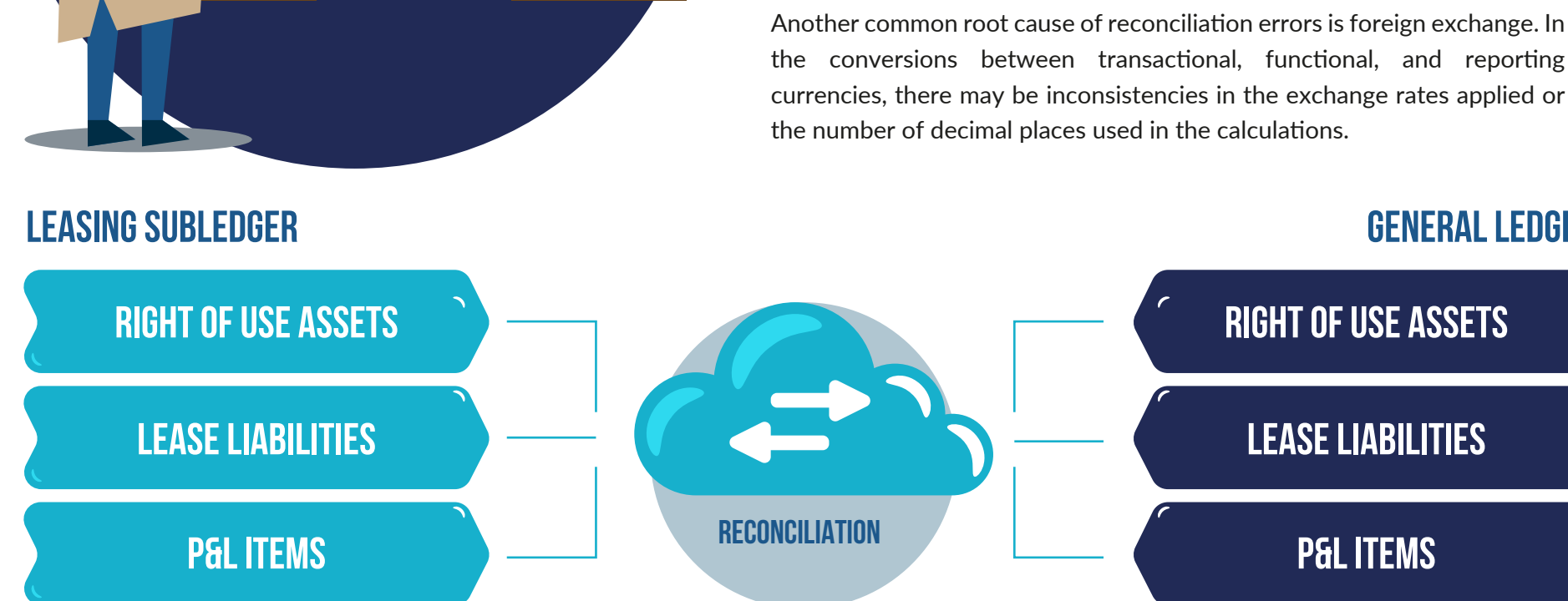
LEASE ACCOUNTING CHALLENGES

- **TERMINATION ACCOUNTING** - All leases that were terminated during the current period should be identified as well. These should include not only leases which hit the contract expiration date, but also leases that may have been terminated early.
- **MODIFICATION ACCOUNTING** - Perhaps, most challenging will be ensuring that leases which may require a modification or remeasurement have been identified, reviewed, and approved prior to the end of the period.
- **MODIFICATION ACCOUNTING** - Many organizations will close the leasing subledger several days before the period end. There may be events that occur in the interim period between subledger close and period close that impact the accounting.

4. CONTROL PROCEDURES

During the close process, a series of control procedures should be executed to verify the accuracy and completeness of the accounting. The types of controls will vary from organization to organization, but most will design procedures to address the areas of highest inherent risk and those that potentially breach materiality thresholds. Common areas of focus include:

- Confirming the accuracy of inputs to and outputs from systems
- Validating judgments, estimates, and assumptions used
- Reconciliations between the general ledger and the subledger



Organizations should consider controls to confirm the accuracy of the data inputs to the lease accounting system as well as to test the accuracy of the journal entries produced as outputs.



INCOMPLETE PROCESSING

- Entered but Not Booked
- Booked but Not Classified
- Classified Incorrectly

OUTPUTS

To test the outputs, debits and credits can be exported from the lease accounting system into a spreadsheet then analyzed to compare results meet expectations. Examples of tests that can be performed include:

- The expense equals the accounts payable clearing account balance or cash expended
- The right-of-use asset is fully decremented at end of lease
- The liability accounts zero out

INPUTS

Checking the data inputs for each individual lease will not be practical for most portfolios. As an alternative, many organizations choose 1) to review only contracts with the highest materiality or to 2) inspect data fields with the highest inherent risk. For example, there may be a process to review all leases above a certain dollar threshold. The key fields from these leases should be matched to the data source to ensure that the inputs were correctly entered into the system. Commencement date is an example of a key field that is often a focus area because it is an important driver of the payment schedule and the lease term used in the accounting.

INCOMPLETE OR INCORRECT PROCESSING

A third test that may organizations are performing is to identify leases that were not properly processed in the system. For example, some leases may have been entered into the system, but never properly booked. Others may have been booked, but never properly classified. Still others may be classified, but incorrectly. Ideally, the lease accounting system would provide a work queue or report identifying these scenarios.

VALIDATING JUDGMENTS, ESTIMATES, AND ASSUMPTIONS

Lease accounting requires a substantial number of judgments, some of which may be appropriate to review during month-end close.

Discount rates, which have a significant impact on the ROU asset and lease liability calculations are a common focus area for inspection. Strategies to quickly identify potential incorrect discount rates that require further focus include:

- Reviewing all new leases and modifications during a period to verify rates
- Comparing the weighted average discount rates used for the current period to those used in the prior period to identify discrepancies

Organizations that report under US GAAP adopting under ASC 842 may want to focus on classification errors as these can impact both the balance sheet and income statement. A specific set of controls to verify the accuracy of assumptions and calculations used for classification may be appropriate.

For example, verify for all newly classified leases:

- The accuracy of fair value assumptions
- The validity of judgments about buyout options
- The appropriateness of system overrides

5. RECONCILIATION

GENERAL LEDGER UPLOAD

Once the detective control procedures are completed, the final journal entries should be prepared for upload to the general ledger. Organizations will need to weigh the costs and benefits of different approaches ranging from fully automated system-to-system integration to manual file extract and upload through the user interface. Companies with multiple different ERP platforms may need to use several different approaches to ensure the journal entries are posted correctly to the GL.



Upon successful completion of the upload, the general ledger will need to be reconciled with the subledger to identify variances and make corrections. GL reconciliation for lease accounting will be more complex with leasing than for other subledgers. Unlike accounts payable or accounts receivable which roll up into a single GL account, leasing often touches 10-15 different GL accounts.

One common cause of reconciliation errors is posting errors. When the journal entries are uploaded from the leasing subledger to the GL, there might be duplicate posts, failed posts, or incomplete posts that create inconsistencies in account balances. The challenges are most pronounced for organizations with multiple general ledgers for which multiple upload processes are required.

Another common root cause of reconciliation errors is foreign exchange. In the conversions between transactional, functional, and reporting currencies, there may be inconsistencies in the exchange rates applied or the number of decimal places used in the calculations.

INTERCOMPANY TRANSACTIONS

Large organizations may have intercompany transactions between different entities. One unit's lease expense is another unit's income. These internal transfers are important for local statutory reporting. However, they should be eliminated in consolidation for external reporting to avoid double counting.

6. DISCLOSURES

The new leasing standards have introduced a number of new qualitative and quantitative disclosures. Ideally, the quantitative reports should be highly automated for items such as:

- Maturity analysis of lease liabilities, both undiscounted and discounted
- Short-term lease expense
- Variable lease expense
- Weighted average remaining lease term
- Weighted average discount rates

However, some organizations are electing not to track off-balance sheet items such as short-term, low-value, and variable lease expenses in their lease accounting system. As a result, separate processes may be required to generate the appropriate disclosures from source data in the accounts payable system. Additional controls may be required for these journal entries that are not produced directly by the lease accounting system.

Some organizations will have more complex disclosure requirements that require modeling and reporting in a spreadsheet. For example, companies with segment reporting by geography, product line, or business unit may not be able to fully automate the reporting due to the complexity. Others that have statutory reporting that does not align with their fiscal calendar may require customized reporting strategies to comply.

Many of the qualitative disclosures such as assumptions, judgments, policy elections, practical expedients, and general descriptions of the lease population are unlikely to change frequently. However, companies will need to ensure that new contracts and modifications identified during the event procedures (e.g. sale-leasebacks) are included as appropriate.

7. PERIOD CLOSE

Once all of the accounting and disclosure reporting is completed and the reconciliation with the general ledger is complete, the subledger can be closed. Some organizations may perform a soft close before completing activities such as control testing or disclosure generation. The subledger can be re-opened, if necessary, to make adjustments that are material to the reporting such as journal entries that may have been missed or an "on top" adjustment to correct prior period errors.

Larger organizations with multiple legal entities and general ledgers will use financial consolidation applications to produce the final data presented on the balance sheet, income statement, cash flow statement, and various footnote disclosures. Post-consolidation, the financial statements will need to be produced in formats consumable by end users including Word, Excel, PDF, and XBRL.

8. POST-CLOSE ACTIVITIES

OUT OF PERIOD ADJUSTMENTS

Following the close, teams should revisit event procedures to identify any changes to the lease portfolio that were not captured in the prior period accounting. Organizations with a longer duration between the time of subledger cutoff and the overall close will likely have more new leases, contract changes, and terminations to evaluate.

The lease accounting system should be able to report on all the new leases and expired contracts from the last few days (or weeks) of the prior period. The unrecorded lease activity can be reviewed to assess the best approach. For example, if the unrecorded activity was material then a "top-side" entry into the general ledger may be appropriate. If it was not material, then an adjusting entry recorded on the first day of the new period may be a better option.

ADDITIONAL BEST PRACTICES

Although the specific processes and controls needed for the leasing close might be different than for other subledgers, many of the same best practices apply:

- **Roles and Responsibilities** - Outline the expectations of each of the key organizations involved in the close process. A center of excellence or shared service center may take the leadership role, but will be critically dependent upon their peers in the business units and other parts of the finance organization for success.
- **Defining Standard Operating Procedures** - Document each of the key processes involved in the close with narratives and flowcharts. User guides for key systems should detail how to perform testing, run reports, and export data. Escalation procedures should be defined for how to troubleshoot and resolve errors.
- **Schedule of Activities** - Define a close calendar for lease accounting with a list of key completion dates for account maintenance, subledger cutoffs, and reporting deliverables that maps into the overall corporate financial close calendar.
- **Contingency Plans** - Identify contingency plans for last minute out-of-office scenarios that might arise with key staff members and unplanned system availability issues that arise. Maintaining an accurate registry of the users associated with each leased asset can help to accelerate any last-minute questions that might arise about specific assets.

LeaseAccelerator offers the market-leading SaaS solution for Enterprise Lease Accounting, enabling compliance with the new ASC 842, IFRS 16, and GASB 87 standards. LeaseAccelerator's proprietary Global Lease Accounting Engine makes it simple, fast, and easy for customers to generate the required accounting and disclosures. LeaseAccelerator's Real Estate, Lease Sourcing, and Lease Management applications generate considerable savings through smarter procurement and easier management.

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