

SPECIAL REPORT: ACCOUNTING

Meeting The New Standard

Change in Accounting Rules Brings About A New Business to Facilitate Compliance

BY CHASE SCHEINBAUM

There are many things to look forward to in any New Year. But businesses that hold property and equipment leases for terms longer than one year were not exactly popping champagne corks on New Year's Eve. That's because 2018 brings changes in national accounting standards that are more anxiety-producing and costly than exciting.

Knowing that the changes, which are mandated by 2019, may require more work than businesses are prepared for, three San Diego entrepreneurs are hoping that companies across the globe will want to outsource the task to a third-party vendor the way that many outsource human resources or payroll to firms like ADP.

Accountants know these changes from Topic 842 issued by **Financial Accounting Standards Board**, or FASB, a non-governmental body that nevertheless sets de facto accounting standards in the United States.

In plainspeak, the rules require businesses to record on their balance sheets the total amount

of rental property and equipment costs spanning the life of any lease for which a business will be liable. Since many commercial leases carry five-year terms, annual rental costs will often quintuple on balance sheets. Picture businesses with numerous locations, like banks, restaurant chains, or any with similar footprints, and you can see that keeping track of long-term leases on the balance sheet may become a burden for a company's accountants. And it's a task that changes with the passing of each month.

Seeing the accounting standard changes on the horizon since they were issued in February 2016, **Stephen G. Austin, Simon Terry-Lloyd and Don Mitchell**, co-founders of **AccountLease**, began creating a service to which businesses can outsource this accounting duty.

"This eliminates the way we've been accounting for operating leases for decades," said Austin. **AccountLease**, which is already available, hopes to streamline this accounting task for businesses.

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Photo by Stephen Whalen
Co-founders of AccountLease: from left to right, Don Mitchell, Stephen Austin and Simon Terry-Lloyd. Seeing the accounting standard changes on the horizon since they were issued in February 2016, the trio began creating a service to which businesses can outsource this accounting duty.



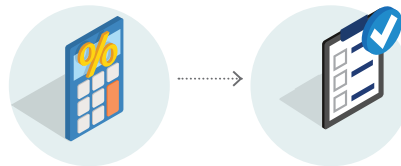
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Applying The Standard

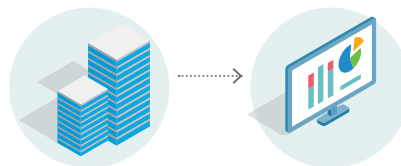
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Issuing Body: Financial Accounting Standards Board, or FASB, a non-governmental body whose rules are nevertheless taken as standard by government bodies.



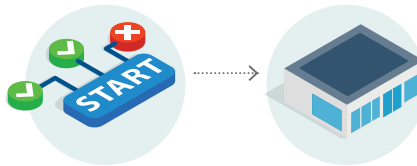
The Rule: FASB Accounting Standards Update No. 2016-2, Leases Topic 842.

To Whom It Applies: Any public company that leases equipment or space.



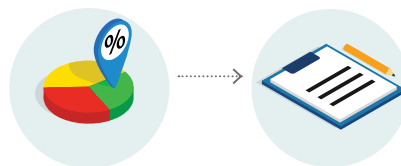
What It Says: The full amount of the entire duration of any lease with a term longer than 12 months must be recorded on the company balance sheet. The rule is technically effective beginning in 2019, but many businesses are beginning the compliance process this year because it may take time to adapt.

Where Did the Rule Originate? Following the Enron accounting scandal in 2001, regulators examined what caused the energy giant to collapse. They identified as one cause the existence of leases that were “off balance sheet,” meaning not reflected in company financial statements.



What's the Impact? Many businesses lease equipment and space for terms of five years, a cost that must now be reflected on the balance sheet. That number can easily balloon for any company with multiple leases, and for any lease entered into for longer terms, like 10, 15, or 20 years, which are not uncommon. Recording this number provides greater transparency to investors.

Why Is It So Burdensome? Recording this number can spiral into a huge task for any business with numerous equipment or location leases, particularly when the lease terms vary individually, or by region, currency and language. Moreover, the number will change each month, at a minimum.



Value of Leases: FASB estimates that the value of leases that must now be recorded on the balance sheets of public companies traded in the United States is \$1 trillion.

BY THE NUMBERS | Readiness Reports

23%

The amount of companies surveyed in a May 2017 PricewaterhouseCoopers' poll of 600 finance and real estate professionals that had not yet begun the process of complying with the new lease accounting rules.

31.4 %

The percentage of 2,150 executives surveyed by Deloitte in May 2017 who said their organization was not ready to meet the new rules.

23%

The amount of companies surveyed by PricewaterhouseCoopers that are hiring consultants to assist with compliance to the new rules. Ten percent of those surveyed said they are hiring additional in-house employees to assist with the transition, and 72 percent said they are reallocating internal resources for compliance.

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"These leases are very common for office space, and probably the vast majority of leases in the United States," he said.

"When you think about a global company with leases in several languages and currencies, you can imagine how challenging that must be to calculate everything and keep it current," Austin said.

"There's a niche here to be filled and a creative accounting firm could jump on that," observes **Seth Kaplowitz**, an attorney and business professor at **San Diego State University** who doesn't know the entrepreneurs. "It's onerous because it's so new and not everyone knows how to deal with it. Like anything new, there's going to be a learning curve and it's going to have to be pretty quick."

The changes do not technically take effect until 2019, but businesses are already beginning to adopt them in order to get the hang of it and begin the process of compliance. Public companies must comply by next year.

Last fall, **Microsoft** became the first public company to adopt the new rule. The accounting tweak added \$6 billion to its balance sheet, Austin says. Austin is also managing partner of **Swenson Advisors**, a San Diego accounting firm. Swenson recently did the same for a client, which is a public company and, "It almost doubled the debt on their balance sheet."

AccountLease will run its customers about \$1,000 per lease, with smaller fees tacked on to keep the numbers current, among other things. Though companies with only a few leases might find their product attractive, AccountLease's creators say companies with 20 or more



Photo by Stephen Whalen

BIRTH OF A NEW INDUSTRY

The entrepreneurs behind AccountLease have created a software-based service that companies can use to outsource this accounting task. AccountLease will charge \$1,000 per lease plus smaller fees for add-on services. They believe many companies will want to outsource lease accounting the way many outsource human resources and payroll tasks.

leases may be the most interested. Their fledgling business has around a dozen clients at the moment, and has a goal of amassing 100 within the year. Among other clients, they hope to score restaurant chains. The co-founders said they expect \$10-\$20 million in revenues in 2019.

Enron Lessons

The accounting changes were an outgrowth of the **Enron** scandal of 2001. After the energy giant collapsed, regulators identified part of the cause as "off balance sheet costs" such as commercial

lease agreements. Since the 1970s, those costs have been recorded as footnotes, but not reflected on a company's balance sheet.

"There were entities related to Enron that should have been recorded but were not; that helped lead to its failure," Austin said. "When you fail to record a large liability on your balance sheet, your investors do not have a true picture of what's going on with the financials."

The federal **Securities and Exchange Commission** has valued the total value of lease payments in the American economy at up to \$4 trillion, Austin said. "It's a huge liability that has not been properly accounted for."

To Be an International Standard

What's more, the new changes will also be adopted by the international accounting standards body, the **International Accounting Standards Board**. "We're not just talking about a U.S. phenomenon. We're talking about a global phenomenon. It's not just the trillions in the U.S., it's the trillions and trillions globally that have to be recorded," Austin said.

In 2002, Congress passed a similar financial transparency regulation, the **Sarbanes-Oxley Act**, which mandates managers certify that financial statements are accurate, and that companies establish internal controls and reporting methods, and that they're adhered to. Accountants who experienced that transition recall a burdensome and often expensive task that companies frequently sought to outsource, and which required more effort than most entities were ready for.

Austin, who remembers that transition and others, says the new FASB standard "is probably the most challenging I've had to deal with in four decades of doing this."

Revenue Recognition Standard

Compounding the problem, another new accounting standard imposed by FASB, known as revenue recognition, which centers on separating revenue from customer contracts on financial statements, is coming on line in 2018.

Revenue recognition is therefore taking priority among many companies' accounting departments, pushing the new lease accounting standard down their to-do list. According to a poll done

ACCOUNTLEASE

Co-Founders: Stephen G. Austin, Simon Terry-Lloyd, Don Mitchell.

Financial data: A dozen clients currently

No. of local employees: About 7.

Investors: Privately funded.

Headquarters: 600 B St., Suite 1400, San Diego

Year founded: 2016

Company description: Accounting and software solutions for lease accounting.

Key factors for success: Assist with compliance to FASB-mandated rules.

Chairman of the board: Board is still in formation.

by **PricewaterhouseCoopers** in May 2017, nearly a quarter of companies surveyed had not yet begun the process of complying with the new lease accounting rules. Even more ominously, a poll by **Deloitte** showed that almost one-third of executives surveyed said their organization was not ready to meet the new rules.

The new accounting tasks will no doubt be more complicated the more leases a company holds, but "Implementation of the new FASB standard is challenging for companies large and small," according to **Journal of Accountancy**.

Promisingly for the creators of AccountLease, the PricewaterhouseCoopers survey showed that nearly half of respondents said they planned on implementing a new system of some kind to comply with the changes. That process will likely force them to at least consider outsourcing the task to a company like AccountLease.

A New Service Is Born

Austin, whose background is in accounting, teamed up with Terry-Lloyd and Mitchell, two managing principals of **Cresa**, a large commercial real estate firm that represents tenants. Two years ago, they started building AccountLease, what is, to their knowledge, the only third-party company offering this service in the world.

"Companies must consider that they have to comply with these new lease accounting standards. It will be imperative in 2018 to get this on their calendar and take action," Mitchell said.

"It's really important for companies to have an end-to-end solution with commercial real estate and accounting expertise," Terry-Lloyd said. "Without knowing what both ends can bring to the table, you're only getting half the story with these leases."

Not Just Public Cos.

The accounting changes will impact any public company, or any company that may be acquired by a public company. San Diego is home to many in the latter category, because so many midmarket companies call it home, Terry-Lloyd says.

"The reason people don't do payroll work in-house is that it's too challenging and you can easily outsource it to ADP or someone else. AccountLease is of the same nature," he says. "People are waking up and realizing this is a big deal."

The founders have trademarks on the intellectual property but have not secured any patent. "I'm not sure it's something you could patent very easily," said Austin. Software-as-a-service often gets sold off to larger companies. That remains a possibility for AccountLease, though the company founders have not made any decision about it.

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