

Understanding Technology's Role in Implementing the New Lease Standards

As companies race towards the effective date for the new lease accounting standards (January 1, 2019 for companies applying IFRS and public companies applying U.S. GAAP), those with large volumes of leases will be understandably tempted to rely on software to extract information from lease agreements that is needed to comply with the requirements of the new guidance.

While available software tools can ease the implementation of the new standard, it is important that management responsible for the implementation effort understand the limitations of such technology and recognize that using contract extraction software will not replace the need for human intervention to ensure that all provisions in a lease agreement that are relevant to the accounting requirements have not only been captured, but appropriately interpreted.

Most contract extraction software tools incorporate several “out of the box” or “off the shelf” clauses that identify and extract some relevant lease information (e.g., contract title, agreement type, parties, effective and commencement dates, term, termination, general pricing terms). The handful of market-leading contract extraction software providers “train” the platforms through a process in which a “seed” sample of contracts are used to educate the platform on which contract clause or text should be identified under which category (i.e., to associate the contract text with a specific topic such as “lease term”). Most platforms enable the user to perform this same process to build their own custom clauses and categories, but the immediate capability a user receives upon purchase or license of the software reflects the extent to which the

provider has pre-trained the platform. These core-offering clause extractions can be effective for providing basic data required to comply with the new standard.

However, these software platforms have their limitations. These standard offerings are mostly trained to extract terms relevant for lease administration but may not be adequate to capture all provisions needed to account for the lease properly. Out of the box, the software generally is challenged with or incapable of accurate extraction of the more nuanced clauses and information required to perform comprehensive lease analysis against the new standards

(e.g., purchase options, fiscal funding clauses, residual guarantees, deposits, lease incentives, services that could give rise to non-lease components, individual assets for separate lease components, supplier substitution rights).

Further, companies who did not previously assess whether agreements to purchase or sell goods or services contained a lease should take a measured approach when using contract extraction software to facilitate the review of agreements entered into or modified for periods beginning after May 28, 2003 (the effective date of the guidance for determining whether an arrangement contained a lease). Because the guidance in the existing lease standards requires extensive judgment to determine whether an arrangement involving the use of property, plant, or equipment not located on the customer’s premises or being operated by the customer contained a lease, extraction software requires expert-directed training to locate content indicative of embedded leases but cannot conclusively identify them.

Training Software

To effectively locate embedded leases, extraction software could require close to 100 hours of training depending on the complexity of the contract set. The process of training the software requires accounting experts to provide guidance on what elements of a contract are important to the determination of whether the arrangement could contain a lease, technologists to manage the machine learning, and both to engage in the iterative refinement of the extraction logic.

Additionally, with respect to relevant contract clauses and content, these platforms only identify and extract the verbatim text from the contract – often entire and numerous paragraphs. While this eases the transition to the new standards, a company will still need to either input the extracted information into the lease accounting software or spreadsheet or convert the extractions to a structured data format for upload to the lease accounting software. Further, the software used to extract information from the lease agreement cannot automatically generate an abstract based on interpretations of, or make judgments about, that information, such as whether the exercise of a renewal or purchase option was reasonably assured at the inception of the lease.

While technology can undoubtedly play a large role in the adoption of the new leasing standards, it does not obviate the need for accounting expertise to make judgments about factors (such as the lease term) that software cannot, to review lease agreements to ensure all significant terms relevant to the accounting under the new standards have been captured by extraction software and converted to desired formats, to conclusively identify leases embedded in contracts to purchase or sell goods or services, and to guide the technology experts in training the extraction software to capture more complex elements of agreements that are needed to properly account for leases under the new guidance.

FTI Consulting can assist with both technology issues and accounting issues encountered in adopting the new lease standards. Our SEC & Accounting Advisory practice assists clients in addressing complex accounting issues, including the resolution of technical issues, and adopting new accounting standards and includes professionals who have served with the SEC’s Divisions of Enforcement and Corporation Finance and in the Office of the Chief Accountant, as well as the Financial Accounting Standards Board. Our Contract Intelligence practice provides a cost-effective solution for a key component of contract lifecycle management, offering organizations a centralized, tech-enabled method to capture critical contract data and facilitate compliance with regulatory requirements.

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