TREASURY&RISK
THE FUTURE OF FINANCE TODAY
An ALM Publication
THURSDAY, MARCH 3, 2016

Get Ready for New Leasing Rules

FASB and IFRS changes will cause challenges for companies with fragmented information on equipment leases. Here's how to prepare.

BY MICHAEL KEELER

They might not admit it, but if you were to ask treasurers and controllers of public companies how many leases their organization has, most of them likely wouldn't know. If you then asked how they generate their future payment obligations in their notes disclosures, they would probably change the subject.

Until now, corporate finance executives haven't felt a burning need to manage their equipment lease portfolio—in part because the current lease accounting standard treats operating leases as expenses that have to be reported only in financial statement footnotes. Accountants and auditors alike have focused on higher-risk compliance items. With limited time and resources, controllers and audit committees are always prioritizing, and leasing has usually not made the cut. That's about to change.

On January 13, the International Accounting Standards Board (IASB) launched IFRS 16 to replace IAS 17, and on February 25, the Financial Accounting Standards Board (FASB) announced ASC 842 to replace ASC 840 (formerly FAS 13). Under the new rules, lessees will account for a lease contract's rights and obligations as an asset and liability, calculated as the present value of the lease payments. Both new standards require that all leases longer than 12 months be capitalized, moving them from the footnotes to the balance sheet, and they share an expanded definition of a "lease." Beyond these similarities, the two standards diverge.

For lessees, all leases are finance leases under IFRS 16. The accounting is straightforward and similar to current accounting under IAS 17. ASC 842 is more complicated. FASB maintains the distinction between "finance leases" (formerly "capital leases") and "operating leases." Accounting for finance leases is the same as capital lease accounting under ASC 840, current U.S. GAAP. Accounting for operating leases is similar to ASC 840 in that the P&L cost is the same—straight-line rent expense. However, if the lease is longer than 12 months, it will now be capitalized. For lease classification testing, the 75 percent and 90 percent tests can be used as a guide, as in the current IAS 17 model.

IFRS 16 also requires front-ending the lease costs and labeling the liability as debt, which means it will have more impact on financial ratios than the FASB rule. While neither gross margin nor net worth calculations will change under either standard, many other common corporate financial metrics will, and that may have far-reaching implications on everything from debt covenants to executive pay structures. (See Figure 1, below.)

Although the implementation date is 2019 for most companies for both new lease-accounting standards, the SEC requires three years of income statement and two years of balance sheet comparables, which means that companies will need complete and accurate data with solid processes and controls in place by January 1, 2017—and very few companies are ready. In anticipation of the rules change, the audit community has already begun to increase auditors' scrutiny of both Sarbanes-Oxley compliance and accounting practices.

Figure 1: How will the new leasing standards impact companies' financial ratios?

	FASB ASC 842	IASB IFRS 16
EBITDA	no change	improve
Operating efficiency ratio	no change	improve
Return on assets (ROA)	reduce	reduce
Return on equity (ROE)	no change	reduce
Quick ratio	reduce	reduce
Current ratio	reduce	reduce
Debt/equity ratio	no change	reduce

Source: LeaseAccelerator.

The challenge to lessees is not in the mechanics of the accounting, nor is there a lack of mature software. Both are readily acquirable for both real estate and equipment leases. The challenge is initially a data problem: collecting the contracts, abstracting the data, creating a benchmark database, and then—most importantly—maintaining complete and accurate data in a sustainable manner.

For retailers and banks with branch networks, it's all about real estate leases. For most non-retailers, tackling the data problem means tackling equipment-lease management. Many finance executives don't know where to start.

Equipment Is a "Big Data" Problem; Real Estate Generally Isn't

If you are a retailer that leases facilities, then real estate contracts will dominate your asset portfolio. For everyone else, real estate leases typically make up around 60 percent of the dollar value of a company's lease portfolio, on average, even though they account for only about 5 percent of the number of contracts. For this reason, many companies already have their arms around their real estate leasing process and portfolio.

Treasury is often explicitly responsible for real estate, and many firms have at least one full-time specialist to manage their portfolio. While real estate leases are generally more complex than equipment leases, there are relatively few internal-process actors, the terms of the leases are longer, and substantially less data needs to be abstracted and tracked. Centralizing the process is easy and offers a good bang for the buck.

The software for managing real estate leases, called integrated workplace management systems (IWMS), is mature, and lots of players compete in the space. IWMS covers the real estate leasing lifecycle, including project management tools for securing new properties and building out new space, and facilities management tools with a focus on reducing the cost per square foot per person. Using this software, CFOs and their teams often believe they have their real estate leases—and so more than 60 percent of the dollar value of their entire lease portfolio—under control.

By contrast, with equipment leases, the decision to lease and the responsibility to transact is usually left to the budget managers. Outside of headquarters, people are generally on their own to select a lessor, negotiate pricing and terms, and then manage the lease over its lifecycle. Thus, decision-making and administration around equipment-lease contracts is globally distributed and involves many stakeholders, who use spreadsheets to manage the leases and related equipment in the margins of their day.

There is a software category for managing equipment leases; it's called equipment-lease management (ELM). Generally speaking, ELM systems automate the equipment leasing lifecycle including the lease sourcing, automated data assurance, portfolio and performance management, and an asset-based lease accounting subledger. ELM has the same dual objectives as IWMS: compliance and cost savings.

"We've reviewed many of the vendors. Their capabilities reflect the variance in management approaches, processes, and controls required for each lease type," explains Anastasia Economos, the EY Financial Accounting Advisory Service (FAAS) partner leading the firm's approach to the leasing standard change. "The terms of a building lease are more complicated, but at the end of the day there is only one asset per lease and it doesn't move. However, that same location could have hundreds of equipment leases covering thousands of assets with a variety of fiduciaries for each lease, many counterparties, and different users for each asset. As companies move from spreadsheets to lifecycle software applications, they need the appropriate strategies for each process, and those strategies should also meet the accounting requirements."

> "With the new accounting standards, both FASB and IASB have clarified what 'materiality' means. This will shift auditors' scrutiny to the lease term, embedded leases, and elements of lease payments."

Unlike real estate leasing, equipment-lease management is a "big data" problem. In multinationals, it's common to have thousands of lease contracts covering tens of thousands of assets. Commensurately, these organizations often have thousands of people authorized to engage in equipment leases, while tens of thousands of people are responsible for using or maintaining leased equipment. But few companies even have a centralized database of equipment-lease contracts or a consistent set of data to represent them.

While treasury may be nominally responsible for the leasing program, this typically manifests itself only in a "lease vs. buy" spreadsheet and a set of policies and procedures to help guide transactors. After a transaction is put in place, it falls into a giant crevasse and disappears.

Compliance Is a Business Process Management Problem

The equipment-lease data problem reflects a larger business process management problem: In most companies, no executive is responsible for the financial performance of the global leasing portfolio. It's an orphaned, fragmented, and decentralized process. In fact, there's typically not much of a standard process at all.

This is true in part because there tends to be great variation in the intensity and frequency with which different business units within the same company engage in equipment leasing. Consider, for example, a plant manager in South Africa who needs to lease only a handful of forklifts once a year. The plant manager has a whole host of responsibilities, and may not have the time to learn a sophisticated software application or master a complex process to track the leased forklifts.

However, if no one has a grasp on the thousands of assets that a company has under leasing contract, the organization is likely not optimizing its leasing effectiveness, which probably unnecessarily inflates the company's total cost of ownership. Without process, controls, system, or owner, businesses overpay for equipment leases. They don't use consistent rigor in negotiating transactions on the front end of the process, nor do they return equipment on time on the back end.

Worse, because they don't have the data, they don't really know how much they are losing, so those who want to improve the company's management of equipment leases have trouble proving that it would be worth their time to fix it. But now, if companies don't improve their understanding of their equipment leasing portfolio, they won't be able to comply with the new accounting standards.

CFOs may see themselves as already doing a good job of publicly disclosing the "material" part of their portfolio—i.e., the 60 percent or so that comprises real estate leases. Given the lax enforcement of ASC 840 by the audit community, they may think that's good enough for their footnotes. But with the new accounting standards, both FASB and IASB have clarified what "materiality" means by drawing the line on what must be capitalized at 12 months and clarifying the definition of a lease. Proportionally, this will shift auditors' scrutiny beyond lease classification to the lease term, embedded leases, and the elements of lease payments—all of which will force companies to do a better job at leased-asset management.

Why the New Standards Require Better Asset Management

Under the new standards, a lease's term will include the non-cancellable period, plus any optional periods in which it is reasonably certain that the lessee will exercise the option to extend, or not to terminate, the lease. As such, the lease term may vary on an asset-by-asset basis.

Let's say a hospital system leases 10 imaging machines on one lease schedule, deploying six to one location and four to another. The non-cancellable term of the lease is 60 months. If the lessee is reasonably certain to hold the equipment at one location for an optional renewal year (ultimately a 72-month term) but to return the equipment at the other location at the end of the original term, then this one lease will have assets of varying terms for accounting purposes. Here, auditors are likely to focus on historical renewal rates (the "hold pattern") and the nature of the assets.

> "Finance executives need to find ways to make it easy to track leased equipment as assets move between business units and between physical locations. They also need to improve end-of-term event management."

Lessees will also need to un-bundle leases and service agreements, and to separate out the assets to be capitalized from the services to be expensed. This means companies will need not only to capture asset-level information, but also to make judgments about what is and what is not able to be capitalized pursuant to the decision tree in the new standard. This is where the hidden and rather insidious work is in the new standard—dissecting every service agreement, including outsourcing contracts and consulting contracts, to break out the components and book them properly. Looking for embedded leases is nothing new; it's been part of the guidance for ASC 840. But no one has actually done it with any kind of rigor before. That's where the novelty is.

Further, under ASC 842 lease payments will be more intensively scrutinized. They will include fixed payments; any payment the lessor can make the lessee pay; variable payments based on index or rate (e.g., CPI or LIBOR) that are calculated using the spot rate; termination penalties if the term is assumed to not be renewed; residual-value guarantees at the amount expected to be paid; and the exercise price of purchase option and renewals included in the lease term if exercise is reasonably assured. Here auditors are likely to focus on heretofore unexamined minimum payments like interim rents, restocking fees, and minimum return requirements.

In response, companies will have to develop procedures for collecting and validating schedule and asset-level data at the time of contracting, applying the appropriate procedures to make the judgments required, and then booking the complete transaction data set into a lease accounting subledger that treats each asset as a lease.

Finance executives will need to find ways to make it easy to track leased equipment as assets move between business units and between physical locations within the business. They also need to improve end-of-term event management (i.e., return, renew, or buy out).

Establishing a database of existing contracts will involve a substantial, one-time data abstraction project and ongoing data validation for new transactions as they happen, preferably without the costs or risks of having humans reading contracts and manually entering information. According to Shane Foley, advanced risk and compliance analytics partner at PwC and part of that firm's lease data and technology team, "When faced with the volume of terms and leases throughout the organization, companies are seeking an efficient and consistent mechanism to collect required data elements. Data extraction technologies leveraging sophisticated optical character recognition and natural language processing capabilities can be utilized to automate the abstraction of data from lease documentation. When combined with the right level of operational review processes, these technologies can aggregate a complete and accurate set of critical lease data across a portfolio.

> "Compliance and savings are inextricably linked in solving the big data problem in equipment-lease management. The savings that result from transforming the process should pay for the project."

"Utilizing natural language processing, these tools can be configured to know where in a document to look for specific elements critical to decision-making, which reduces processing time and increases quality," Foley continues. "Additionally, with machine learning capability, the more these tools are used, the more accurate they become over time, leading to greater reliance on automation. Finally, because the tools can maintain a persistent link to the underlying contract data, ongoing analysis can be performed as needed, and as facts and circumstances require additional data elements to be extracted. Once the data set is complete, the data can be imported into an ELM solution automatically."

CFOs Should Raise Their Standards

In pursuit of compliance with the new lease-accounting standards, CFOs should demand from their teams a return on any investment in new processes and technologies. Unlike other compliance projects, such as revenue recognition, ASC 842 and IFRS 16 compliance should have a significant upside. Controllers can collaborate with procurement and operations leaders in their hunt for quantifiable savings. Together, they can establish a business process management practice for the equipment-leasing lifecycle across the enterprise, shift the work of document assembly to their lessors, automate and control the process using an ELM solution, and then integrate with other internal systems to achieve straight-through processing.

Given the number of contracts and stakeholders involved in equipment-lease management, a top-down mandate alone will not solve this big data problem. The pursuit of savings and continuous improvement are what will motivate ELM stakeholders around the world to deliver quality data on a monthly basis—the same asset-level data that controllers need for public financial reporting under any of the standards, current or new.

In this way, compliance and savings are inextricably linked in solving the big data problem in equipment-lease management. The savings that result from transforming the process should pay for the transformation project and leave a large golden nugget for the bottom line.

Michael Keeler *is the CEO and founder of LeaseAccelerator, Inc., a software-as-a-service provider based in Northern Virginia. Since 2009, Keeler has been the primary force behind the growth and vision for the new software category of equipment lease management (ELM), which enables Fortune 500 companies to generate millions in savings while complying with new lease accounting standards from FASB and IFRS.*