

Achieving Lease Compliance and Financial Performance: The Equipment Lessee's Handbook

What a Finance Executive Must Do to Satisfy Auditors, Shareholders, and Internal Stakeholders – 20 Best Practices for Your Leasing Operations

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I. Executive Summary

Over the next year, the FASB and IASB are expected to release a new lease accounting standard for lessees of equipment and real-estate, which will capitalize most operating leases longer than twelve months. This will bring new audit scrutiny to the lease portfolios and leasing practices of any company that follows GAAP. For this reason, we are republishing The Lessee Handbook.

Finance executives can use this handbook as a roadmap for updating their processes and controls as they prepare for the new lease accounting standard. It is a worthwhile exercise to reflect on the era of SOX compliance, because it was the last time that the audit community focused on leasing processes and portfolios from a controls and reporting perspective. This resulted in a significant spike in restatements, which lessees can avoid when the new lease accounting standard is issued by applying the recommendations in The Lessee Handbook.

While some of the data are now outdated, the compliance requirements and the many problems companies face managing leases and assets remain the same today and deserve a fresh look. This handbook is intended to be used in tandem with another publication, “How to Prepare Now for the Coming Lease Accounting Changes”, which is available for free here: <https://www.leaseaccelerator.com/whitepaper> Most importantly, the 20 best practices for lessees can help your firm not only with compliance but saving money as well. By following the guidance herein, you can turn a compliance cost sink into a savings-producing, continuously improving process and drive a sustainable ROI for your business.

Despite the Sarbanes-Oxley Act of 2002 (SOX) and the millions that companies have spent on complying with its terms, the leasing process inside most companies remains an opaque, complex area of corporate finance. It is often characterized by poor lease accounting, decentralized management, broken processes, and incomplete systems. Such issues will lead inevitably to numerous control and compliance problems and costly financial mistakes.

In an effort to meet the many compliance standards facing lessees, today's finance executives at lessees must focus on finding ways to maintain the accuracy of their accounts while simultaneously improving the company's financial performance. SOX legislation raised the stakes by introducing criminal penalties for company executives if financial statements do not fairly and accurately represent the financial condition and results of a company. The unfortunate reality is that executives lack the visibility, controls, and resources needed to properly manage their lease and asset portfolios. As a result of the demands of the coming lease accounting standard, as off-sheet operating expenses shift to on-sheet assets and liabilities, most companies cannot afford poor practices that result in compliance exposures. In addition, prudent financial managers understand that poor practices eventually lead to financial mistakes, underperformance, and losses.

This handbook provides timely, practical guidance and insight to lessee finance executives, helping them to:

- > Become familiar with the laws and compliance standards related to leasing and asset management operations
- > Obtain the latest information about compliance impacts on lease operations, accounting, and reporting
- > Identify the problems with leasing and asset management operations typically found in lessees
- > Understand what is required from their team to fix operations and drive bottom-line results
- > Apply the best practices to achieve goals and meet requirements
- > Build a business plan for improving both compliance and the financial performance of leasing and asset management operations

Using innovative practices, finance executives can improve leasing and asset management operations while attaining lease compliance. Leasing represents an aspect of financial management that, in most companies, could benefit from the diligence that results from compliance. Through effective leasing and asset management operations management, businesses can reduce costs, increase efficiency, and comply with pertinent regulations.

If you have any thoughts, suggestions, or criticisms, please send them to me:

keeler@leaseaccelerator.com. Thank you.

II. The Objective: Lease Compliance and Financial Performance

As a result of SOX, the role of lessee finance executives has expanded beyond the traditional duty of simply focusing on improving their company's financial performance. They must now also ensure that corporate leasing operations are managed with the rigor needed for SOX compliance. Ostensibly, complying with SOX is the goal of a SOX control remediation initiative. But, a myopic approach that considers compliance only represents a lost opportunity. Complying with SOX introduces the diligence required to improve financial performance. Compliance alone is a burden; compliance that results in improved financial performance is an investment.

Financial executives at lessees are now reforming their leasing operations to improve both controls and financial performance. The section below examines why companies lease, the convergence of SOX and lease accounting, and the motivation and timing of leasing reform given the other priorities companies face in complying with SOX.

Why is leasing important to those companies that lease?

According to a 2004 study by Global Insight, “the most important value of leasing is in facilitating the acquisition, maintenance, and replacement of equipment in a systematic and convenient way. This is a competitive advantage that leasing has over purchasing.”

Global Insight’s study used survey methods to understand lessees’ perceptions of the leasing experience. The study sought to “determine what factors were most important to those who lease—why leasing was important”? Figure 1 below indicates how respondents ranked a list of factors (provided to them) that are important to making the decision to lease.

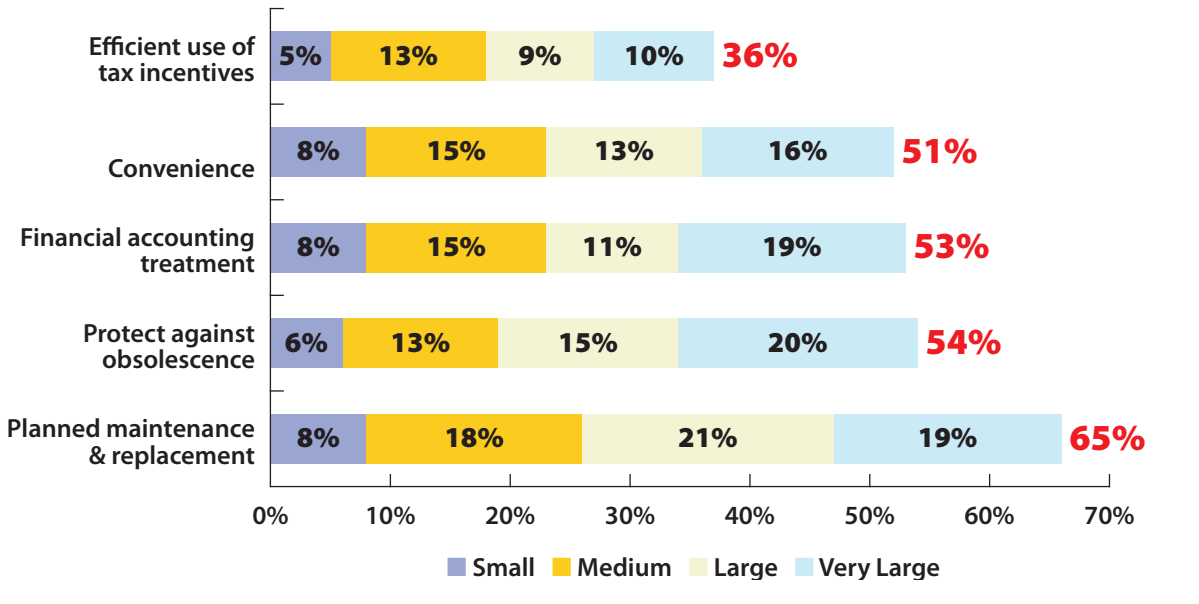


Figure 1. Factors that Are Important in the Leasing Decision by Firm Size

According to the study, 65% of respondents to the survey “felt that the most important factor in the leasing decision was that leasing facilitated maintenance and replacement of equipment as part of a continuing process of equipment management.” The chart indicates how the 65% breaks down by firm size. “Small firms represented 8% of those who valued this factor highest, but, clearly, larger firms saw this as particularly important. Responses to these factors correlate with the responses that lessees made about their preferences for leasing.”

Global Insight also found that certain equipment types were likely to be leased rather than purchased, including IT equipment, health-care (medical, dental) equipment, aircraft, and industrial equipment.

The fact that planned maintenance and replacement and protection against obsolescence are the primary drivers behind leasing, a large segment of the lessees in the market are unlikely to stop leasing even if there is a shift to capitalizing lease transactions. This points to the value of investing in improving leasing operations now to have the controls in place to manage the shift when it happens and drive down costs in the meantime. If your firm also uses leasing for these benefits (other than off-balance sheet accounting treatment), you can use them to set measurable operational objectives, establish corporate-wide leasing policies and procedures, perform buy vs. lease analyses, and structure multi-ticket size and multi-funder programs.

Leasing Is A Big Industry

Annual lease volume in the United States has grown steadily over the years, growing to an estimated \$244bn-worth of new equipment in 2002. For many years, a considerable number of lessees have relied on leases to finance their capital expenditures, executing many successful leasing transactions with a variety of lessors along the way. Unfortunately, most leasing processes are highly decentralized and fragmented because most large companies have geographically distributed operations due to acquisition-driven growth, a need to serve clients and workers locally, and internationalization. This decentralization and fragmentation increases the risks and complexities of leasing and can lead to financial errors, economic losses, audit deficiencies, and fraud.

Fraud and Mistakes (Measured By Restatements) Costs Investors

In October, 2002, Senator Sarbanes, then Chairman of the Banking, Housing, and Urban Affairs Committee, released a General Accounting Office (GAO) report that examined 919 financial restatements made by public companies over the prior five years (before SOX compliance was in force). The GAO found that a significant portion (10 per cent) of publicly traded companies restated financials due to accounting irregularities from 1997-2001. According to the report, the number of restatements due to accounting irregularities has increased by over 150 per cent from 1997 to 2001, from 92 to 225 public companies.

According to the GAO, these restatements cost investors 10 per cent of their stock value in the short term, from the day before to the day after the restatement and the restatements cost investors 18 per cent of their stock value in the intermediate term, from 60 days before to 60 days after the restatement. The GAO found “in a number of the restating companies we identified, corporate management, boards of directors, and auditors failed in their roles, as have securities analysts and credit rating agencies that did not identify problems before investors and creditors lost billions of dollars.”

Enter The Sarbanes-Oxley Act of 2002 (SOX)

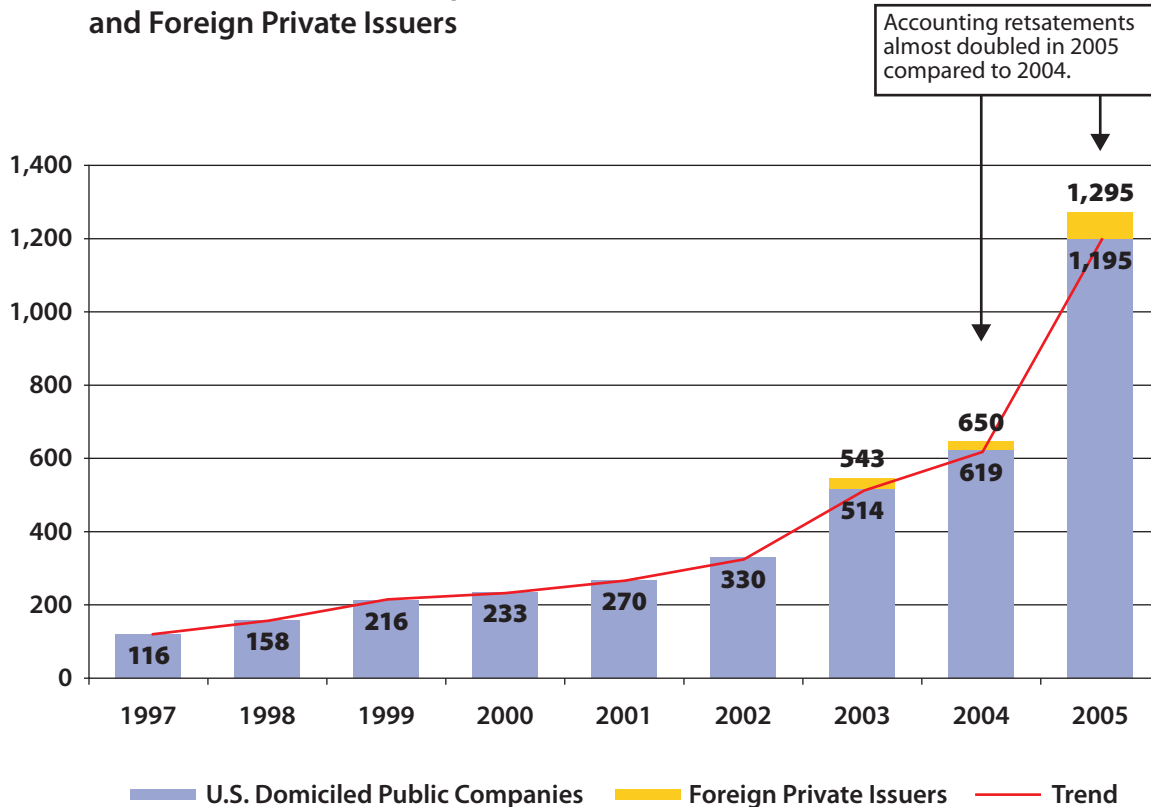
The Sarbanes-Oxley Act of 2002 is complex and demanding. It affects all companies listed on US stock exchanges with a market capitalization more than US\$75m. Furthermore, SOX-related practices are beginning to permeate the world of privately held businesses because many banks and other financing firms are asking for SOX-like controls as a condition of capitalization. To reduce the likelihood of future scandals, such as those at Enron, WorldCom and Tyco, the passage of SOX has resulted in sweeping changes in corporate governance. This act requires public companies to report their financial results in a clearer, more rapid and transparent manner. Section 404 of SOX is one of the most prominent and challenging aspects of the Act. Not only does it mandate that companies affected by the law establish, assess and report internal controls and procedures; it also places a higher level of responsibility and accountability for accurate financial reporting on key executives, boards of directors, and others involved in the corporate financial reporting.

Leasing Is a Proven Driver of Restatements - Which Continue To Grow

Since the GAO report was released, the number of restatements has continued to grow. According to Lynn Turner, managing director of research at Glass Lewis (a firm that provides research to institutional investors), 1,295 public companies restated their earnings in 2005 vs. 650 for all of 2004.

Total Restatements by Year

U.S. Domiciled Public Companies
and Foreign Private Issuers



Source: Glass, Lewis & Co., Huron Consulting

Figure 2. Total Restatements by Year

As depicted in Figure 2 above, in 2005, 249 companies had to restate earnings due to improper lease accounting. Turner says, "In 2005, of the 1195 US restatements, 640 were made by companies with ineffective internal controls including 42 companies that restated twice. If those companies had effective controls and had followed the long standing rules for lease accounting, we would've seen a drop in restatements. Service Corporation International (SCI), which restated in both 2004 and 2005 for revenue recognition, expense recognition, lease accounting, and other errors, identified 13 material weaknesses in its internal controls during their SOX 404 mandated review.

According to Jeffrey Szafran, a managing director at Huron Consulting Group: "Lease accounting restatements caught the financial reporting world by surprise." Recognizing that most companies "believed when they were doing it that they were getting it right", Szafran says that the lease accounting issues have "rippled through the entire financial reporting world" and have been a driving force of restatements since the second half of 2004.

How Does SOX Impact Leasing?

Historically, whether financial reporting errors involved inadvertent miscalculations in footnotes, overlooking a statute, missing a tax filing deadline, or breaching a contract, the cost of non-compliance and poor management has been monetary. With the introduction of SOX, however, criminal penalties result when the information in financial statements does not fairly represent the financial condition and results of a company.

SOX treats current accounting guidelines and public reporting requirements on operating leases with the same scrutiny and skepticism as other off-balance sheet mechanisms such as pension plans, derivatives, and special purpose entities. This off-balance sheet area of lease accounting has been particularly scrutinized in recent years, as analysts and investors have complained that companies purposely structure leases to keep payment obligations and operating lease liabilities off their balance sheets.

SOX directed the US Securities and Exchange Commission (SEC) to study the off-balance sheet leasing issue. In response, the US Financial Accounting Standards Board (FASB) decided to reconsider their guidance on off-balance sheet leasing. FASB is now coordinating closely with the International Accounting Standards Board (IASB) to re-examine lease accounting with the expectation that FASB will move US GAAP away from their traditional rules-based approach, exemplified by the FASB 13 bright line tests, towards the IASB's principles-based approach, which The Financial Accounting Standards Committee (FASC) of the American Accounting Association believes "are more likely to result in transactions that reflect their true economic substance". IAS 17 simply states that a lease "is classified as a finance (i.e., capital) lease if it transfers substantially all of the risks and rewards incident to ownership" to the lessee. This makes it difficult for companies to define a lease that allows off-balance-sheet financing. In the US, this shift to a principles-based approach is likely to lead to a shift from operating leases to capital leases. In any case, because auditors take a "substance over form" approach to evaluating the accounting treatment of lease transactions, understanding the business rationale behind a firm's decision to lease is important. (Look for more on the SEC and this issue below.)

Leasing Compliance is the Next SOX Control Remediation Initiative

The activities of the SEC, FASB, and the penalties of SOX are pushing financial executives and auditors to focus much more on the details of financing transactions in general, and especially, off-balance sheet ones. Many lessee finance executives are only now turning their attention toward making their leasing operations SOX compliant. The lack of compliance effort focused on leasing practices up until now results from the fact that finance executives have seen a spike in workload since SOX was passed. Although a lessee may consider their leasing activities "material", given the SOX deadlines, executives have heretofore focused on other activities that are likely of higher risk and relevance to the company's financial statements than leasing. They have to balance compliance initiatives with the needs of daily finance operations, making resource allocation more challenging than ever.

In short, finance teams have been extremely busy just running their businesses. This is compounded by the fact that they have had to devote all of their spare resources to the new, dynamic, and expensive requirements of SOX compliance. Logically, finance executives have focused primarily on the highest priorities in their financial operations: those that have the highest compliance risks and that revolve around the G/L, its core subledgers, and the flow of cash in and out of the company.

Regardless of the net value of SOX, leasing and lease accounting are significant factors in driving restatements and evidence that many lessees just don't have it together yet and remain at risk. While lessees may want to operate within the law, comply with standards, and honor contracts, most lessees likely do not have the know-how, resources, infrastructure, or time to manage these efforts effectively. This will continue until companies invest in the appropriate people, processes, policies, controls, and systems that will enable them to manage their portfolio of leased equipment with the same discipline that they would use for any other portfolio of investments. As explained in greater detail below, at a minimum,

CFOs, treasurers, controllers, auditors and other corporate authorized lessee stakeholders should have a web-based reporting dashboard that allows them to:

- > Review an up-to-date summary of their leasing portfolio at any time on-line.
- > View the terms of the master lease agreement for any transaction, the related documentation (such as signed and reconciled POs, invoices, Certificate of Acceptance, Notices of Assignment, etc.), and the equipment schedule.
- > Examine their financial and physical characteristics on any asset on the schedule, including debits and credits and corporate coding (G/L code, business unit code, etc.) at the asset level.
- > Review the financial information required for internal and external reporting, compliance, and controls and for competitively managing their relationships with lessors at any point in the term to optimize their economic position.

Leasing compliance is likely the next SOX control remediation initiative for many firms. As public companies complete the second round of intensive SOX compliance projects and issue their annual reports, reforming their leasing operations (i.e. capital expense finance process) is becoming a priority. Financial executives are discovering that fixing problems in their leasing operations can be a difficult and daunting task and that achieving the desired “state of full compliance” means much more than just compliance with SOX. It means complying with the lease agreements and the many other laws and standards that guide leasing, accounting, and asset management (discussed in III). Moreover, any executive who is making changes to meet the SOX requirements in leasing operations must look beyond mere compliance and consider how to leverage any investment to improve the performance of the business (discussed in Section IV). If done properly, changing corporate leasing operations to become SOX compliant and adopting the related best practices can simultaneously improve leasing financial performance and generate savings. Depending on the scale and a variety of other factors, the savings generated by pursuing best practices may be able to pay for costs of SOX compliance, generating a return. Once financial executives understand the value of best practice, it becomes possible to build a clear business case (discussed in Section V), build consensus, and put the best practices to work in leasing operations.

III. Compliance Requirements For Leasing Operations

Corporate lessees can suffer significant economic loss unless they both comply with and manage their master lease agreements while also adhering to regulations such as FASB, IASB and Sarbanes-Oxley. This section looks at the issue of materiality and gives vital checklists to ensure compliance.

The Issue of Materiality

Financial executives of large corporates often dismiss the significance of leasing compliance because, in their view, their leasing activity is ‘not material’. However, they also acknowledge that they do indeed ‘lack the visibility, controls, and resources needed to properly manage leasing transactions’.

Executives must assume a realistic viewpoint when making ‘materiality’ judgments regarding their leasing activities in order to avoid undesirable consequences. The issue of materiality applies to many of the situations in which companies could be non-compliant with the laws, standards, and requirements detailed below. The notion of materiality drives a company’s decision to disclose the risks it identifies - an issue of risk is material if there is a substantial likelihood that a ‘reasonable investor’ would view its disclosure as having significantly altered the ‘total mix’ of information. The US Securities and Exchange Commission (SEC) has warned firms consistently that materiality has no quantitative threshold. Even relatively small numerical differences could influence investors significantly. In fact, the SEC has warned

companies not to make materiality determinations based solely upon quantitative measures, such as 2 per cent or 5 per cent of total assets. The SEC also has stated repeatedly that the purpose of disclosure requirements is to give the investor a look inside the company through ‘the eyes of management’. Please see SEC Staff Accounting Bulletin No. 99 (SAB99) (www.sec.gov/interps/account/sab99.htm). So if a company has \$2 Billion in revenue and a lease portfolio of \$20 Million to which a minimum of \$10 Million in new transactions are added every year – is that prima facie “material” to the company and its financial statements? There is no simple answer. However, if you understand the compliance requirements, you can evaluate the risks and the control environment and begin to answer the question.

The following discussion of compliance requirements is driven by our experience helping clients comply and manage risk in their equipment finance processes in North America. However, the principles apply globally. Considering the current, intensifying collaboration between FASB and IASB, we should expect to see further convergence of the requirements.

Compliance Requirements for Lessees - Use These Checklists

Understanding the many applicable compliance standards, laws, and business requirements and how they impact leasing operations is the first step in changing leasing processes to maintain a predictable, steady state of compliance and strong financial performance. Bringing leasing operations into SOX compliance entails more than simply complying with SOX. To ensure a completely compliant leasing environment, leasing practices must comply with relevant leasing regulations, and these compliance measures must dovetail with SOX controls and other SOX compliance measures. Each law and each jurisdiction – often overlapping – has its own set of explicit rules, underlying principles, and related precedents. The structure of each lease must meet your separate objectives in terms of law, taxes, accounting, and economic treatment. You must analyze from each perspective independently to rule out conflicts, because ‘true lease’ tests can be redundant, confusing or contradictory. More specifically, before you can even worry about SOX, all these elements must be fully under control.

Master Lease Agreements (MLA) – Manage Them Carefully and You Will Save Money

Many companies that participate in leasing programs experience economic losses because they do not properly manage their Master Lease Agreements (MLAs). Complying with MLAs becomes increasingly complex as the number of MLAs and the variation among them grows.

Companies that regularly require different types of equipment may be served by signing a MLA with a lessor. MLAs are established to provide a consistent legal platform which enables companies to lease equipment on a continuous basis according to their needs over a specific period of time. MLAs allow lessees and lessors to negotiate the legal details of their relationship one time up front and then apply these terms to specific equipment as it suits the lessee. For lessors, the “hell-or-high-water” clause in a lease (which reiterates the unconditional obligation of the lessee to pay rent and fees throughout the entire term of the lease regardless of any event affecting the equipment or any change in the circumstances of the lessee) is critically important. Essentially, lessors want to be paid consistently and on-time – that is a lessor’s core motivation and, obviously, it is a reasonable one. Depending on the leverage of the lessee (credit rating quality, transaction size, degree of competition), in principal, many of the other dimensions of a lease are negotiable to varying extents. The other legal details found in a MLA include each parties obligations, covenants, representations, warranties, fees, terms of default, remedies, ownership, insurance, and acceptance and return of equipment.

Additions of new equipment to the lease are typically made in the form of a lease schedule, which specifies the financial terms such as the commencement date, term, residual, and rate, and lists the equipment along with the appropriate necessary details. Schedules are added to the MLA and then become subject to the terms of the agreement.

Lessees maintain compliance with their lease agreements if they perform the following in accordance with MLA stipulations:

- > Pay lease payments and any fees on time regardless of the circumstances. Lessees often allow lessors to automatically debit their checking accounts to reduce administrative burdens and ensure consistency and compliance.
- > Make sure the lessor has calculated your payments correctly. Given the thousands of jurisdictions, make sure your tax calculations are accurate; make sure they go to the right tax authority, and make sure they come from the right authority within your firm (more on this below).
- > Pay and file all personal property taxes as specified (more on this below).
- > Maintain adequate insurance.
- > Carefully manage assets. This includes tracking asset changes, such as changes in location or enhancements, upgrades, and other alterations; properly notifying the lessor of changes pursuant to the MLA; and testing for the appropriate classification of assets (this will help improve the accuracy of annual insurance premiums based on replacement value of assets within a certain geographical area and/or legal entity, if the lessor's book values are requested).
- > Maintain equipment in good working order. Lessees are typically responsible for any damage, loss, or repairs. Maintenance agreements may be required.
- > Adhere to the "material adverse change" clauses and financial performance requirements in the MLA, if any exist.
- > Complete all notifications as specified prior to the deadlines. This is especially important prior to the end-of-term to avoid penalties and/or being locked into further "evergreen" payments beyond the term.

Taking a consistent approach to managing the lease and asset "portfolio" will facilitate compliance and improve corporate leasing operations management investments. We will discuss this in detail later in the Handbook.

Uniform Commercial Code (UCC) in the US

If lessors are filing inappropriate liens on a company's equipment or failing to release liens in a timely manner, they in effect create unnecessary obstacles to closing new financing deals with new lessors. If potential lessors find it difficult and costly to register new liens, there is a significant risk that they will back away from future finance transactions or increase their pricing to offset additional costs. It is imperative that companies routinely manage the security interests that lessors and other lenders have in their assets.

The Uniform Commercial Code (UCC) was created by two private institutions, the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI), in order to streamline and standardize the law of sales and other commercial transactions in the United States. The Code represents "model legislation" = recommended measures for each state to provide a uniform legal framework across the country. Consequently, the Code only has the power of law once it is enacted on the state level (it has now been enacted in 49 of the 50 states – Louisiana is the exception). For lessees, conforming to the Uniform Commercial Code (UCC) is dependent upon the terms of their MLA. Lessees should ensure that their lawyer structures the agreement to leverage the sections of 2A that will protect them.

1. UCC 1-201(37)

It is essential to ensure that the company's attorney properly positions the firm with regard to UCC (1-201(37)). UCC (1-201(37) defines "Security Interest" including the tests to determine whether a transaction should be construed as a "true lease" or a "lease intended as security" (disguised security agreement), which is fundamental to a lessor's protection in bankruptcy

2. UCC Article 2A: Leases

Article 2A of the Code addresses leases. Lessors are adamant about ensuring that their lease agreements and contracts conform to the sections of 2A that protect them. In fact, they will often refer to the specific language of the applicable US state's UCC within their MLA. Of course, lessors are not likely to look out for the interests of lessees. Lessees must ensure that their lease agreements and contracts conform to the sections in 2A that protect them. The lessees' attorney should have sufficient knowledge of the UCC and Article 2A to ensure compliance and protection.

3. UCC Article 9: Secured Transactions; Sales of Accounts and Chattel Paper

Article 9 relates to lessees in terms of compliance with their MLA. A lessor must comply with Article 9: Secured Transactions; Sales of Accounts and Chattel Paper in order to declare and perfect a security interest in the equipment they are leasing for outside use. MLAs tend to require that the lessee assist the lessor in protecting its interest, and the lessee may additionally be asked to assist in the search and filing processes. More importantly, the lessee may also be required to assist the new lessors in obtaining waivers stating that the former's existing lessors and lenders have no security interest in the new equipment being financed. For example, a mortgagor may hold blanket liens on the lessee's assets; in which case it would be necessary to "carve out" leased assets from other agreements. This administrative burden can be lessened by monitoring the outstanding liens that lessors and lenders have related to agreements that have come to term.

IRS Guidelines

IRS federal tax "Guidelines" in Revenue Procedure 2001-2811 establishes criteria for obtaining an advance ruling from the IRS that a lease is a "true lease" (i.e. "true tax lease") and not a "conditional sale". This is fundamental to effective and accurate lease tax accounting.

Sales Tax

The tax compliance process can become complex, tedious and time-consuming, increasing the likelihood of lessor's error. If the lessor miscalculates –especially if they have under billed the lessee– the lessor will come back and expect the lessee to pay the difference. This lessee obligation is typically captured in the MLA. If this is a systemic and recurring mistake by the lessor, then it could potentially become a significant liability for the lessee. To mitigate this risk, the lessee should calculate the sales and use taxes independently. Automating this control as an extension of lease accounting is the easiest, most cost-effective way to mitigate risk and maintain compliance.

To accurately calculate sales tax, it is necessary to track the current sales and use tax rates for every taxing jurisdiction in the U.S. and Canada (more than 7,000 locations and 60,000 potential jurisdictions as several may apply simultaneously). Additionally, each transaction should be analyzed to determine whether it is intrastate or interstate, which taxing jurisdictions are involved, and the applicable maximum tax base and excess amounts. Taxable, nontaxable and exempt amounts should be calculated separately at every state and local level. Both the order-acceptance location and the ship-to and ship-from locations must be tracked in order to ensure that the taxing rates for each jurisdiction are being applied. Finally, it is important to track credits and adjustments.

Lessors typically have the option to pay tax to the vendor at the time property is purchased, collect use tax from lessees on lease receipts, or to pay use tax on the purchase price of the property leased in a timely manner. In the last two scenarios, lessors assume the responsibility of calculating the sales and use taxes charged to the lessee and remitted to each jurisdiction. Most lessees are content to rely on the lessor's calculations. Lessees of tangible personal property cannot elect to pay tax on the lessor's purchase price or lease payments. Lessees are governed by the reporting procedure chosen by the lessor. It is important to note that lessees cannot extinguish their tax liability unless they have

receipts demonstrating payment of tax to lessors. In many states, regulations require that lessors who hold a seller's permit issue receipts to their lessee. A lease agreement granting the lessee an option to purchase the property results in a sale when the option is exercised; the corresponding tax applies to the amount paid by the purchaser when the option is exercised. The tax applies to the sale regardless of whether or not the lessor has paid tax on the cost of the equipment at the inception of the lease or on rental receipts.

Property Tax (US) or Capital Tax (Canada)

Given the tens of thousands of jurisdictions in the United States alone, property taxes present similar challenges to those of sales tax management. With property taxes, the lessee sometimes has the added burden of filing. In addition to tracking the changing tax laws and remaining up-to-date with assessment and filing deadlines, the lessee must also ensure that each filing is accurate and complete. In order to remain compliant, it is essential to establish the fair market value of property, manage appeals, create and accrue tax estimates, and process property tax bills.

Ad valorem property taxes are based upon ownership alone; regardless of whether or not the property is used and generates income for the owner (although these factors may affect the assessed value) property taxes must be paid. Under state law, municipal governments are authorized to generate revenue through such taxes and are, therefore, the most frequent recipients of these monies.

Generally, machinery, equipment, fixtures, and furniture are considered personal property unless permanently affixed to real property. Leased equipment (including equipment acquired through a lease transaction) is subject to personal property tax and must be listed with the assessor for each jurisdiction. Depending upon the specific terms of a lease, either the lessor or the lessee is responsible for listing the equipment. Under a lease transaction, the legal owner of the property is ultimately responsible for filing and paying property taxes, although most leases pass the financial burden back to the lessee. The lessee is also required to report information relating to leased equipment on their personal property tax return, including the lessor's name and address. Failure to file most often results in scrutiny by the state.

Corporate Tax

To achieve corporate tax compliance, it is imperative to track organizational and asset changes, and to test for the appropriate classification of assets and transactions. Tracking and testing will reduce allocation errors between legal entities (overstatement and understatement of sales and corporate tax liability) and allocation errors arising from incorrect physical location or coding, as well as ensuring continued auditability of the lease and asset portfolio. Many lessees lack the corporate tax reports and related accounting reports that would enable them to determine deferred income taxes in a cost-effective manner. Maintaining supporting evidence of deferred income tax entries related to lease transactions (which are often highly complex) is a fundamental requirement that is often overlooked.

FAS 13, CICA Section 3065, and IAS 17

U.S. Financial Accounting Standards Board No. 13 (FAS 13), Canadian Institute of Chartered Accountants (CICA Section 3065), and the International Accounting Standards Board No. 17 (IAS 17) explicitly detail the manner in which companies must fully disclose lease obligations in the footnotes of their annual reports. In order to maintain compliance, lessees should strictly follow these standards. Many lessees rely on their lessors to perform the FAS 13 tests for ownership; unfortunately, though, lessors easily can make mistakes that result in misclassifications and misstatements for which the lessee ultimately is responsible. Most lessees struggle to maintain accurate accounting records. Though common, using spreadsheets to prepare disclosure information is insufficient. This practice of recreating accounting records in spreadsheets prior to publishing financial statements can lead to human error, particularly in the case of companies that lease tens of millions of dollars in assets throughout several

geographic locations. From an auditor's perspective, it is crucial that the high-level numbers reported in financial statements are supported by the details of each transaction to the asset-level. Prior to SOX, most lessees did not need to achieve this degree of accurate detail and therefore do not have the necessary infrastructure to meet compliance standards.

The Financial Accounting Standards Board (FASB) publishes the Statement of Financial Accounting Standards No. 13, and the International Accounting Standards Board (IASB) publishes the International Accounting Standard No. 17. Both publications are entitled "Accounting for Leases" and establish the financial accounting and reporting standards for lessors and lessees. Using specific criteria, these two statements provide the methodology through which lessees can determine whether a lease is an operating lease or a capital lease and, from there, detail how each lease classification should be accounted for and reported.

The basis for the aforementioned classification criteria is ownership of the asset in question. FAS 13 provides well-established and commonly accepted tests to determine ownership. If a lessee does not own the property in question, the lessee does not capitalize the equipment under lease; to do so would be a misrepresentation. If FAS 13 tests of ownership indicate that the lessee is the owner, the company must capitalize the equipment.

Rigorously performing and documenting these tests is fundamental to maintaining FAS 13 compliance. Bear in mind that the calculations involved in this testing process require the company's incremental borrowing rate, which is typically confidential information. This means that although many lessees rely on their lessors for these tests, the lessor may not have all of the information necessary to accurately perform them.

FAS 13 requires detailed disclosure of lease terms including duration, obligations, options and any other lessee guarantees. Up-to-date financial accounting for the entire lease portfolio and summary reports for every financial statement are also necessary. On a quarterly basis (at least), an accurate note disclosure for minimum lease payments must be produced.

By automating the capture of portfolio information, accounting, and reporting, a lessee can use available technology to simplify controls, mitigate risk, and ensure compliance. Although most Enterprise Resource Planning systems have a fixed asset subledger associated with the G/L, subledgers are typically not a reliable method for recording lease information. It generally takes considerable human involvement to aggregate the data required for disclosure. Public disclosure of five-year minimum lease payments should be fully auditable with detailed evidence supporting even the debits and credits for each asset. A company's compliance status should be easily viewable through key performance indicators and reports. Remember, with SOX, incorrect disclosures may well cost the CEO and CFO their jobs.

Generally Accepted Accounting Principles (GAAP)

Financial accounting for leases (FAS 13) has been in place as US GAAP for over 25 years.

Compliance Issues Related to Asset Disposal

The combined effect of increased public attention to financial disclosures, corporate governance issues, and SOX is a greater scrutiny of the methods used for quantifying and disclosing potential environmental and data security liabilities related to the disposal of assets. The Gartner Group writes that many companies are opting to store their retired technology assets rather than facing up to the complex task of disposing them in an environmentally-friendly manner. Further, the SEC mandates that publicly held companies evaluate and disclose environmental liabilities from actual or threatened legal proceedings and any potential financial repercussions that may result from emerging trends.

In most cases, liability is not related to ownership, so lessees cannot bury their heads in the sand and write it off as the lessor's problem. For lessees, the bottom-line is this: make sure all assets (no matter who owns them) are tracked through their complete lifecycle until they are returned to the lessor. When dispossessing or disposing of assets, make sure the liabilities are properly transferred to the next owner, or obtain the appropriate documentation of their destruction to ensure compliance with federal, state and local laws. Following is a survey of the laws and compliance requirements for the disposal of assets as they apply to leasing operations.

1. Environmental Laws and Disclosure Rules

- a) *Resource Conservation and Recovery Act (RCRA)* – RCRA grants the EPA the authority to control hazardous waste from “cradle-to-grave.” This includes the oversight and regulation of the generation, transportation, treatment, storage, and disposal of hazardous waste. Not only companies but also “a corporate officer who is either personally involved in actual company decisions regarding the handling of solid or hazardous wastes, or in charge of and directly responsible for a company’s operations with the ultimate authority to control the disposal of such wastes” can be held liable.

Please note: the EPA is not required to prove that the person had control over the activities that create endangerment or show negligence or willful misconduct.

- b) *Toxic Substances Control Act (TSCA)* – TSCA authorizes the EPA to secure information on all new and existing chemical substances and to control any of these substances that may cause an unreasonable risk to public health or the environment.
- c) *Comprehensive Environmental Response Compensation and Liability Act (CERCLA) and the Superfund Amendments and Authorization Act (SARA)* – CERCLA and SARA provide the federal government with the broad authority to respond directly to releases – or threatened releases – of hazardous substances that may endanger public health or the environment. Subchapter I of the 1983 amendments establishes a comprehensive system for reacting to the releases of hazardous substances and determining liability and compensation for those affected. The U.S. Fish and Wildlife Service is responsible for conducting assessments to establish injury and the dollar equivalent of that injury for the collection of damages from parties responsible for releasing hazardous materials. Further, many landfills will not accept toxic waste; this includes certain kinds of electronic waste – like monitors and computers – because of the toxic chemicals involved. Computers can contain toxins including lead, mercury, and even arsenic, all of which can seep into the soil if they are disposed of in landfills. Lessees must focus on their potential liability from the responsibility placed upon “owners and operators.” Under CERCLA, owners or operators of a facility at the time of a disposal, transporters of hazardous substances, and generators of hazardous substances are strictly liable for cleanup costs in the event that a hazardous substance is released.

In certain true lease cases, the EPA has determined that the lessors are liable for cleanup costs. The EPA amended CERCLA a few years ago to codify an EPA enforcement rule that exempts lessors from much of the liability. The amendment provides an exemption to lenders and lessors from the strict liability provisions of CERCLA if: 1) lessor’s retained interest in leased property is primarily for the purpose of securing the repayment of the lease obligations, rather than speculation on the residual value, and 2) the lessor does not participate in the management of the equipment. Nonetheless, two concerns remain if the lessor takes possession of the financed collateral: 1) the lessor must attempt to resell or re-lease the property at the earliest practicable time after foreclosure or other repossession (the EPA has deemed this period to be twelve months), and 2) the lessor may still be held accountable if it transported or arranged for the disposal of a hazardous substance.

Almost every state has enacted similar legislation, albeit on a much smaller scale. Many state laws similarly hold a lessor accountable only if it is involved in the management of and/or cause the contamination. Conclusion: The potential liability for a lessor for any repossession or return of the equipment may still exist. However, at both the federal and state level, a lessee acting as the “owner and/or operator” bears the brunt of the liability for proper disposal and needs to manage risks accordingly.

- d) **Electronic Waste** – Several states, including California, have already passed laws intended to ensure the environmentally safe recycling and disposal of electronic equipment. The legislation identifies which equipment is covered and clarifies the recycling fee collection and remittance process with much of the burden placed on lessors and lessees rather than manufacturers. The Council of State Governments - Eastern Regional Conference (CSG-ERC), comprised of 15 member jurisdictions within the United States and Canada, however, has prepared model legislation that relies on manufacturers to compensate the government for expenses incurred during product recycling and disposal (with allowance given to manufacturers with “product take back” programs). State legislators have planned to release the final draft bill on October 1 2005, for immediate introduction in Connecticut, Delaware, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont.
- e) **SEC Environmental Disclosure Requirements, Regulation SK** –
 - ii. Item 101 of Regulation S-K, 17 C.F.R. § 229 requires a company to disclose material effects of compliance with environmental laws.
 - iii. Item 103 of Regulation S-K requires a description of “any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party.” Item 103 specifically requires that a description of any administrative or judicial proceedings arising under federal, state, or local environmental laws or regulations be included if the proceeding is material. It also requires the disclosure of any enforcement proceedings that may be reasonably expected to result in sanctions of \$100,000 or more, regardless of materiality.
 - iv. Item 303 of Regulation S-K, concerning MD&A, contains a general requirement to disclose “any known trends, demands, commitments, events or uncertainties” that are reasonably likely to have a material effect on a company’s bottom line. The SEC has developed a two-part test to aid companies in determining whether disclosure is required in MD&A. Management must determine first whether or not the trend or event is likely to occur; if it is not likely, then no disclosure is required. If management cannot make that determination, disclosure is required unless management can determine that, assuming it occurs, such trend or event is not reasonably likely to be material.

2. Data Protection and Privacy Laws and Data Erasure Standards

- a) **Gramm-Leach & Bliley Act** – This law imposes stringent requirements intended to protect consumer data. It includes three key rules related to asset disposition and disposal. The Privacy Rule governs the collection and disclosure of customers’ personal financial information. The Safeguard Rule requires all financial institutions to design, implement and maintain safeguards to protect customer information. The Pretexting Rule protects consumers from individuals and companies that obtain personal information under false pretenses. Most important to lessees is not to let company-issued palm pilots or laptops go to resale or disposal without ensuring proper hygiene, i.e. thorough and correct deletions.
- b) **Health Insurance Portability and Accountability Act (HIPAA)** – HIPAA imposes privacy obligations on healthcare and insurance companies. An essential component of data risk mitigation is erasure verification and an audit trail.

- c) ***Department of Defense (DOD) and National Security Agency (NSA) Data Erasure Standards*** – Data that has been overwritten only once or twice is susceptible to recovery. Consequently, the DOD and NSA have promulgated secure delete standards, which specify how to overwrite disk drives to render data completely unrecoverable. Conventional manual erasure techniques at the desktop or in the data center will leave data on most of the systems. Deleting the sensitive files will not protect them from recovery; operating systems may maintain unidentified copies of these files and passwords in unused parts of your computer. The potential civil and criminal liabilities are significant, not to mention the possible damage to a company's reputation, if a full hard drive were to be used for impropriety or fraud. The erasure of a hard drive is not sufficient unless the corporate owner can prove that the drive was erased thoroughly.

Securities and Exchange Commission (SEC) – the latest on SOX and Leasing

In its report on the use of off balance sheet financing arrangements by public companies, the SEC identified lease accounting as an area in particular need of increased transparency (June 15, 2005). The SEC asserted that accounting authorities should reconsider their current practices for reporting the financial results of leases and consider the possibility “of reporting all financial instruments at fair value.”

The report was mandated by Section 401c of the Sarbanes-Oxley Act of 2002 and prepared by the Office of the Chief Accountant, the Office of Economic Analysis and the Division of Corporation Finance. It includes an analysis of the filings of issuers, pertinent U.S. accounting principles, and Commission disclosure rules. The report encourages the U.S. Financial Accounting Standards Board and the International Accounting Standards Board to pursue a joint project to specifically reconsider the accounting process for leases. In the report, the SEC recognizes that such a project “would also likely take a significant amount of time as well as necessitate a substantial commitment of FASB resources.” However, the SEC believes this project is nonetheless necessary to eliminate the “bright line tests [that] have served to facilitate significant structuring of leases to obtain particular financial reporting goals.” According to the report, 100 companies moved nearly \$8 billion in assets with outstanding liabilities off their balance sheets. By contrast, retained interests reported on the balance sheets of those same companies equaled about \$1.6 billion.

The report observes that current rules treat lease contracts as if either all or none of the performance occurs at the beginning of a lease. With this approach, the balance sheet does not reflect the fact that both parties in a lease agreement have some interest in the assets, receivables, or payables associated with the lease. The upshot of this method is that companies with similar economic arrangements receive different accounting treatments dependent upon which side of the all-or-nothing performance each party falls. The results of this are significant. In the companies studied, about \$16 billion in cash flows related to capital leases were undiscounted. Seventy-seven percent of the 200 companies the SEC reviewed had off-balance-sheet operating leases in the amount of \$1.25 trillion.

In the report, the SEC identified four goals for improving transparency in public reporting and disclosures:

1. Discourage transactions and transaction structures motivated primarily by favorable accounting and reporting implications rather than economics
2. Expand the use of objectives-oriented standards
3. Improve the consistency and relevance of disclosures
4. Focus financial reporting on communication with investors, rather than just compliance with rules

The report acknowledged that such changes would be a complex and controversial undertaking for FASB and did not set a timetable for implementing a new standard. While both FASB and IASB presumably intend to revise the current lease accounting framework globally, for the moment neither FASB nor IASB have planned a formal project.

For lessees, the conclusion is clear and imperative: the compliance environment is challenging, and new requirements may soon make it even more so. So get your leasing operations into compliance now. That requires both a thorough understanding of all the regulations, robust new control systems, and automation where appropriate.

Sarbanes-Oxley Act (SOX) – How NOT to get Scorched

The Sarbanes-Oxley Act (SOX) (Sections 302, 401, 404, 801, 802, 803, and 906) puts a hot spotlight on the risks of decentralized or fragmented leasing processes. In an uncontrolled leasing environment, for example, renegade individuals can (and do) execute improper or fraudulent transactions and keep them hidden from the company's financial stewards. SOX mandates that situations such as these are avoided and leasing operations must now, therefore, be controlled with clear, documented policies, processes, controls, and authorities. Achieving SOX compliance is best achieved by standardizing, centralizing, and automating leasing operations, while still enabling users to complete transactions in distributed geographic locations.

Section 302: Corporate Responsibility for Financial Reports: The “principal executive officer and principal financial officer” shall prepare a statement along with the quarterly and annual report to certify the “appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer.”

Section 401(a): Disclosures in Periodic Reports; Disclosures Required: Each “financial report . . . shall disclose all material off-balance sheet transactions” with “unconsolidated entities” that may have a material current or future effect on the financial condition of the company.

Section 404: Management Assessment of Internal Controls: Requires each annual report to include an “internal control report”, which shall: (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Section 802: Criminal Penalties for Altering Documents: “Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States shall be fined under this title, imprisoned not more than 20 years, or both.” More importantly, it directs the SEC to establish “rules and regulations, as are reasonably necessary, relating to the retention of relevant records such as work papers, documents that form the basis of an audit or review, memoranda, correspondence, communications, other documents, and records (including electronic records) which are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review, which is conducted by any accountant who conducts an audit of an issuer of securities.”

Section 906: Criminal penalties imposed if information does not fairly represent the financial condition and results of the company.

The new standards for corporate accountability and penalties for financial fraud and misconduct defined by SOX have altered interactions between executives, directors, and auditors. CEOs and CFOs are now held accountable for the accuracy of financial statements. SOX also defines new financial reporting responsibilities, including adherence to internal controls and procedures designed to ensure the accuracy of corporate financial records.

Under SOX, all financial reports must include an internal control report, designed to provide investors with confidence in the accuracy of its financial data. Annual financial reports must now include an assessment of the effectiveness of the internal controls. The company's auditing firm is then required to attest to that assessment by reviewing controls, policies, and procedures in a Section 404 audit, completed alongside a traditional financial audit.

Non-compliance penalties vary anywhere from the loss of D&O insurance and the company's exchange listing to fines and long-term imprisonment. On a more theoretical level, non-compliance can also easily result in a lack of investor confidence. If a CEO or CFO were to submit incorrect certification, he or she may be subject to a fine up to \$1 million and imprisonment for up to ten years. If a CEO or CFO were to submit an incorrect certification "willfully," the fine may be increased up to \$5 million and the prison term could go up to twenty years.

Apply COSO ERM to Your Leasing Activities, Too

To lower the risk of fraud and to protect shareholders, SOX demands a firm accounting control framework. SOX does not go so far, however, as to offer guidance on standards for fraud risk mitigation and compliance. COSO's Enterprise Risk Management (ERM) framework has become the commonly accepted model for discussing and evaluating an organization's risk management processes and is the most widely accepted tool for Section 404 remediation among all publicly traded companies. It is designed to raise a consistent "risk and control consciousness" throughout the enterprise.

The COSO ERM Framework can be used to bring leasing operations up to SOX compliance standards. If a firm already uses COSO, their compliance experience can be leveraged simply by applying the principals of COSO to leasing operations processes and controls. According to the COSO ERM, "internal control" is a process designed to provide reasonable assurance that objectives in the following three categories will ultimately be achieved:

- > Effectiveness and efficiency of operations
- > Reliability of financial reporting
- > Compliance with laws and regulations

By using the COSO framework effectively, a company can expect an acceleration of controls development and the Section 404 compliance process, simultaneously reducing costs and achieving compliance more rapidly. Relevant to our discussion about changing leasing operations to achieve compliance and improve financial performance, the COSO framework recommends that a company must have all of the following capabilities for effective internal controls:

- > Control environment – characterized by the tone at the top, this represents the general climate of control in an organization
- > Fraud risk assessment – an examination of business aspects that are most likely to lead to fraudulent activity
- > Control activities – specific measures that reduce the risk of fraud, generally an outgrowth of the fraud risk assessment
- > Information and communication – gathering and disseminating business information primarily through the use of information systems facilitates the use of controls for ongoing management through automated means
- > Monitoring – general oversight of a company's control framework to ensure its continued relevance and effectiveness

In our experience, through effective compliance management, our clients have reduced costs and risks, increased efficiency, and complied with pertinent internal and external authorities. They use the checklists

above and apply the best practices we will discuss in Section V. Above all, they have been successful because they have adopted this thinking: manage leases and assets like you would any investment portfolio (because that is what they are); comply; analyze competing options for the best returns; and be shrewd.

IV. Problems with Lessees Leasing Operations – What About Your Company?

This section looks at how the leasing function is treated within firms and the lack of attention and resources that are often assigned to this process. The result of this fragmented approach to leasing is serious and can lead to financial problems. There are several areas within the company where leasing processes could be improved, such as asset and lease portfolio management, transaction execution and an over-dependence on spreadsheets for tracking data and performing routine calculations.

The leasing process at most companies does not garner the same amount of attention, resources, or automation as other finance functions. As a result, corporate executives have little or no visibility into the leasing process. As stated in earlier articles, the weaknesses associated with leasing operations include poor controls and accounting, decentralization with inadequate accountability, ineffective or inconsistent business processes, and incomplete information systems. The result of fragmented leasing operations is an increased probability of financial error or impropriety.

Consequently, mending leasing operations involves overcoming challenges of expertise, policy, process, technology, and corporate politics. This section looks at common problems faced by medium, large, and very large corporates and analyzes their origins and significance. This will enable financial executives who manage these firms to evaluate the gap between current standards and corporate reality, and then discuss best practices and the benefits of instituting them.

Current Situation

Most problems related to leasing operations involve problems of omission – information inadvertently excluded – simply because financing capital expenditures typically is viewed as an ancillary functions in corporate finance. In reality, many finance executives lack the visibility, controls, policy, technology, and resources needed to attend to their leasing operations, resulting in suboptimal economics, cost leakage, and compliance exposure. In most companies, leasing is a decentralized activity lacking any universal controls. In some companies, the financing model does not align effectively with the business strategy. Accounting details for each transaction are often either inaccessible or widely distributed over many spreadsheets. Often, the lack of standardization and error-checking leads to poor data quality and unusable reports. Consequently, finance executives often have no idea who is leasing what to whom, lack the confidence that the right decision-making is in place for incremental financings, and do not have the information required to measure and communicate effectively. In some cases, employees actually have purchasing authority but are unclear about company financial requirements regarding capital expenditures and authorization rights. Less frequently, leasing is managed by a specific department, such as IT, without a clear financing strategy.

Decentralized management and fragmented systems translate to disarray in controls and compliance management. Transactions lack traceability. Policies, procedures, and controls tend to be poorly designed, incomplete, and unclear – yielding an environment in which opportunistic individuals pursue inappropriate transactions not in the company's best interests. At its worst, these individuals intentionally bypass budget limits through financing. In many situations of this sort, financing decisions are based upon personal relationships rather than shrewd economics. Costly errors may result from this situation. Questionable off-balance sheet structures, for example, could lead to unreliable financial reporting, which is the type of problem that internal controls can help companies avoid.

Lack of Executive Attention and Visibility

Let's start with you – the lessee “finance executive”. In companies of all sizes, leasing lacks executive attention and visibility. Quite often, leasing transactions “just happen” with no overarching strategy or policy. Because leasing has grown organically based on local relationships, management of the leasing process is decentralized and executives do not know who is leasing what with whom. Those actually executing the leases may be unclear about the extent of their authority. As a result, finance executives are not confident that the incremental decision-making about economics and the terms and conditions of transactions are being carried out properly.

A company that has a decentralized financing process for capital expenditures, lacks controls, and is not automated restricts the effectiveness of executives. The company's executives will not receive the information necessary required to:

- > Understand needs related to leasing and form policy
- > Improve policies and procedures incrementally
- > Measure performance of the leasing process
- > Effectively communicate the leasing strategy to the rest of the company

Insufficient Lessor Management

Most lessees do not manage their lessor relationships effectively. Typically, this results from a leasing financing model that does not fit the business strategy. For example, lessees may have an exclusive relationship with one large lessor based on convenience, ultimately resulting in monopolistic rates and terms. Others may use 30 or 40 different lessors, each with different terms in the MLAs, resulting in a higher cost of capital, poorly negotiated terms and conditions, and unnecessary inefficiency, complexity, and administrative costs. Problems with the lessor-lessee relationship, the lessor model, and transaction economics are interrelated and may result from a lack of expertise, experience, or interest on the part of whoever is negotiating agreements. They may also result from the lack of sufficient time and resources required to successfully manage the process. Regardless, poor management of the financing relationship can lead to a host of problems, including:

- > Lack of access to capital due to unforeseen exposure issues with a particular lessor
- > Vendor payment issues that may impact the credit rating
- > Insufficient customer service which increases errors and inefficiency
- > Incorrect invoices or tax calculations

Poor Transaction Execution and Contract Management

A common symptom suffered by many companies is poor transaction execution. If nobody is charged with regularly and thoroughly performing FASB 13 tests (and documenting/archiving the math) at the time of transactions, for example, off-balance sheet transactions can be called into question. Even when a confidential source within the company determines that a transaction passes the FASB 13 test, if the other terms of the transaction do not substantively support the lessor's ownership and economic risk, an auditor can force a company to recognize the transaction on their balance sheet. For example, a lessor can require that equipment be returned in its original packaging – how realistic is that? In addition, poorly tracked and managed documentation can result in significant cost leakage. For example, if the line items on purchase orders, invoices, and the certificate of acceptance are not properly reconciled at the time of the transaction, a lessee might overpay unwittingly.

Insufficient Asset and Portfolio Management

When managing individual assets throughout their lifecycles, as well as managing the entire lease portfolio, several critical problems are endemic in companies. Assets often are encoded incorrectly (e.g. serial number, G/L code, business unit, legal entity, cost center). Assets also can be misclassified, leading to complications in accounting, tax, and budgeting, inappropriate disclosure on financial statements, and significant exposure issues with lessors and external authorities. If the lessee upgrades or moves the asset to another location and does not disclose these changes to their lessor, the lessee will likely be out of compliance with their MLA and have tax exposure from the change in jurisdiction.

Many companies depend on their lessors to document transactions, calculate taxes and payments correctly, and provide reports. Several problems arise with this approach to portfolio management. If a lessor makes a mistake in their calculations, it could result in the company overpaying for the lease or underpaying the taxes, both of which would not be internally controlled. If the lessor is performing the reconciliation of the PO-invoice-CofA, the lessee is subject to the discipline and quality controls of each lessor. If the lessor makes a mistake, the lessee suffers the exposure, resulting in overpayment, underpayment, or paying for something not received. If a lessor does not provide easy access to all of the documents and data related to the transaction, it becomes difficult for the company to develop compensating internal controls and the transaction is then fundamentally unauditible. If a company uses multiple lessors, it must then access the stovepipe system of each lessor to aggregate and report their overall portfolio. Within the lessee's organization, there exists no centralized source for all leases and assets, as each lessor uses different systems, creating undesirable complexity and bureaucracy for the company's treasury, controllers, users, and auditors.

Many companies encounter problems because they cannot access necessary information. On one hand, some lessees rely on their lessors to provide them with the information they need, only to find that there are severe limitations with the lessor's systems. Typically, the lease accounting system of lessors only records transactions at the schedule level because it is necessary only to track the basic financial terms of the lease (such as original cost, lease rate, date, and term) in order to send the bill. On the other hand, some lessees generate schedule level information internally and capture it in the G/L. In this case, the information is created with a scenario similar to this:

1. An accounts payables clerk receives PO information from the purchasing department with the basic lease information
2. The clerk calculates and inserts a monthly expense payment in the G/L for the term of the lease (such as 36 months)
3. The A/P clerk writes a memo in order to record the basic lease information along with the entry

In either case, schedule level information is insufficient for controlling the leasing process and ensuring compliance. For example, when an asset is moved, lost, or damaged and these changes are undocumented and undisclosed, a lessee may not be in compliance with their Master Lease Agreement or can face sales and/or property tax exposure. If there are any interim events, such as a partial buyout, either the lessee will have to depend on the lessor's calculation (which was done by hand outside of their "schedule-based" lease accounting system), make a change to their G/L without the ability to back up the calculation with the proper asset detail or the change will simply not be reconciled properly with the G/L. Moreover, if the lessee does not properly manage organizational changes such as reorganizations, mergers, and acquisitions, assets and lease payments can be misassigned or misallocated, or overlooked, resulting in problems with internal budgeting, P&L analysis, and balance sheet integrity.

Finally, the poor management of the end-of-term of the lease or the end-of-life of the asset – especially its disposition – may result in significant risk exposure and economic loss. Most lessors make their money at the end of term. In a decentralized leasing process with poor controls and documentation, it is easy to miss required end-of-term notifications, resulting in automatic extensions or renewals, penalties, and overpayment. Even if a lessee executes the required notification and chooses to pay the "fair market value" at the end of a lease, if the lessee does not have the resources to negotiate that "fair market value," the lessor will demand and receive terms that are favorable to them – sometimes at egregious, abusive rates. Also, lessees that buy some or all of the assets at the end-of-term and fail to perform the proper inventory accounting may face audit and compliance challenges. Further, there are many state and local regulations designed to address environmental pollution, data security, and data privacy. If a leasing operation does not adhere to the rules, both individuals and the company could be exposed to punitive measures that even could include imprisonment.

Ineffective and Inefficient Leasing Operations and Dependence on Spreadsheets

Many modern companies suffer from fragmented systems, such as homegrown software applications created to solve narrowly defined problems. Microsoft Access databases created to track key lease terms, third party ERP systems, asset management software, and ad hoc spreadsheets are by far the most prevalent. The fragmentation may result in the following:

- > Dependence on spreadsheets as the core analytical tool and data store
- > Lack of an overarching leasing strategy and process
- > Missing functionality necessary to close the gap between the functionality of the components and the automation requirements of the overarching process
- > Absence of integration of the components
- > Lack of a centralized database for data
- > No process for reconciling with key internal systems (like the G/L) and external systems, like the lessors lease accounting systems
- > Multiple employees performing identical tasks and functions in different parts of the organization, resulting in duplication of work (like re-keying data) and costs

Process and system fragmentation and missing automation result in redundant data entry, poor data quality and integrity, and insufficient data security – all of which reduce productivity. This breeds a challenging decision-making environment, as the reporting and analytics are then inconsistent and the data suspicious, serving to further degrade company performance.

Many firms run their leasing operations on spreadsheets. This involves checking and rechecking homegrown financial calculations, considerable maintenance, and, because of errors or omissions, constitutes a source of risk. Spreadsheets alone do not work. Spreadsheets also fail to provide executives and stakeholders with insight into operational performance or control risks that could result in financial restatements or fraud.

As mandated by SOX and other related standards, public company executives must evaluate the effectiveness and efficiency in their capital expense finance/leasing process and, furthermore, provide reasonable assurance relating to the business' achievement of objectives. Those executives who fail to address the operational and automation requirements of their leasing process may be at risk.

Poor Controls and Compliance Management

One of the most significant thrusts of recent corporate legislation is the clear accountability of individuals for their decisions and actions. Poorly designed, incomplete or unclear policies and processes, technology systems, internal controls, and audit procedures for leasing operations create ambiguity and a vacuum of accountability. These conditions may foster a climate of irresponsibility or fraudulent activity. Under these conditions, management has only limited visibility into company leasing operations at best. This can lead to the intentional dodging of budget limits such as transactions driven by personal relationships with lessors rather than objective financial motivation, failure to comply with laws and agreements, and in the worst cases, fraud and embezzlement.

Sole accountability then rests with the CFO and CEO. Historically, a company's executives have only been required to disclose their five-year minimum lease obligations in the notes of their public financial statements, enabling them to properly account for capital and operating leases on their balance sheets. By contrast, today's executives must also evaluate their internal controls, audit procedures, governance, and ethics in their capital expenditure financing process, then update them to ensure SOX compliance, and disclose any material risks or failures to comply. The bottom line is this: executives that are not able to track and trace every person, event, document, asset, all related communications for on balance sheet or off balance sheet lease transactions, provide lease accounting at the asset level fully reconciled with their G/L, and demonstrate the reliability of their financial reporting face risks, material deficiencies or non-compliance, and the potential for litigation, fines, and imprisonment.

V. Apply the 20 Best Practices: What Financial Executives Must Demand

SOX initiatives should do more than merely bring a company into compliance; SOX efforts also should produce measurable improvements in general corporate performance. In order to manage lessors, transactions, leases, assets, and portfolios throughout their lifecycles, finance executives should adopt best practices that aid them in deploying their lease accounting expertise, policies, procedures, processes, and technologies. When best practices are applied, leasing operations, too, will benefit in terms of savings, visibility, insight, controls, change management, compliance assurance, and stakeholder fulfillment.

In this section, we will examine the 20 best practices for lessees and how they meet financial executives' demands for the following:

- A. *Process Clarification and Controls* – make the process and policies function properly
- B. *Automation and Asset-level Coding, Tax and Accounting* – deploy the workflow, data capture, accounting, and reporting to meet business needs and objectives and enforce controls
- C. *Visibility, Insight and Transparency* – extend information to the entire company so that all employees can perform their duties as accurately and efficiently as possible
- D. *Lifecycle Accountability* – make sure people meet performance standards and practices
- E. *Improved Financial Performance* – demand improved economics, efficiency, and savings

It is imperative that lessees continuously apply –and improve– best practices in order to consistently drive company performance and meet corporate objectives. Once such systems are instituted, finance executives have the freedom to focus on their strategic objectives with the confidence that leasing operations can and will deliver.

A. Process Clarification and Controls

Best Practice #1: Clarify, document, and communicate strategy, processes, and policies.

Financial executives first must define and document a leasing operations strategy. Important questions to consider include:

- > Why is equipment being leased?
- > Why do leasing operations exist?
- > How does the practice of leasing work within the bigger corporate picture to support the CEO's company strategy and the CFO's finance strategy?

For example, clarify your principles and strategy behind buy vs. lease decision-making and specify when and how the analysis must be performed. Once the strategy is defined, it is imperative that every member of the finance team is able to clearly and accurately translate this information to the company's stakeholders. This information transfer can be most easily accomplished by publishing the strategy on the company intranet; in fact, this is the simplest way to align leasing operations with the rest of the company and, subsequently, begin to drive value.

Best Practice #2: Identify the key processes of your leasing operations.

Next, identify the key processes of the leasing operations. Key considerations for public companies include:

- > How does a lease flow through the company?
- > Who is authorized to initiate a lease?
- > Who is responsible for making a lease vs. buy decision for each asset and lease type?
- > Is it the treasury, the controllers in each business unit, or the IT department?

Formulate the framework of the processes by defining the “who, what, when, where, why and how” and be clear about objectives.

As processes are defined and documented, simultaneously define the policies that will control them. It is also important to assign individual employees as the “owners” of specific processes. From here, link the processes to the financial statements that they ultimately affect. For example, one common misconception is that capital lease processes, policies, controls, and responsibility allocations are identical to those that apply to purchased assets. This oversight is the result of virtually identical accounting and disclosure treatments for capital leases and purchased assets. However, much like operating leases, capital leases create unique issues at the end of lease term. While purchased assets steadily passively depreciate, leased assets require proactive measures. If equipment is returned or bought out at fair market value, adjustments to the capitalized Financial Statement values are necessary.

Existing processes and appropriate authorities must handle end-of-term reconciliations such as arms-length determination of FMV, auditable support of re-capitalized amounts, approved G/L entries, communications with lessors of intentions, and determination of revised depreciation methodologies. These events must have controls in order to guarantee management’s attestations to the accuracy and completeness of corporate financial records, and demonstrate to all stakeholders that the company is working to reduce unnecessary costs such as overpaying FMV’s (overstating balance sheet) or going on month-to-month lease charges after the normal lease term (impacting long term profitability).

Best Practice #3: Identify risks and controls in your leasing operations.

For each activity in the leasing process that is relevant to financial reporting and business performance, a company must identify the risks and develop controls for each risk. Extensive literature has been written about the risks faced by lessors, but little is written about lessee risks. Leasing companies have, over time, acquired a lot of knowledge. The result is that individuals with intricate knowledge of leasing contract terms (lessors) attempt to mitigate their own risk by passing it along to a lessee, who is typically far less knowledgeable. Lessors may provide competitive monthly lease rate factors, but they may also attempt to make their profit on the before-term (such as documentation or due diligence fees), or end-of-term events. Often, the lessees’ total cost of ownership (TCO) is dramatically higher than originally calculated. The controls needed to mitigate these risks are often complex, requiring a standardized approach to selecting reputable funding sources for long term relationships, and adhering to strict guidelines for legal, operational, and accounting elements.

To ensure consistent and reliable financial reporting, individuals should be given ownership of specific controls and charged with the responsibility of regularly evaluating the effectiveness of each control. For example, a V.P. in the legal department may be responsible for approving lease contracts, after they have been approved by department heads for operations, tax and accounting. Next, detailed procedures should be defined for each control in order to guide its process owner in determining whether his or her control is effective and efficient. For example, a contract review checklist that requires the review team to identify specifically areas that significantly impact the company and its financial reporting may be implemented. This will help key leasing stakeholders perform their tasks more effectively. The CFO may be responsible for ensuring that all leases are structured as operating leases and that the terms of a lease contract meet the operating lease criteria before entering into a lease transaction. The asset management team may be responsible for initiating and monitoring systems that track and report assets as required under the terms of the master lease agreement, and documenting the specifics of those procedures, before the company enters into an agreement.

Following a defined schedule, the control owner must judge whether or not a specific control is ultimately successful. Processes and controls can then be evaluated consistently throughout leasing operations. Based on this information, financial executives can then connect controls to financial statement assertions. The information gleaned from this process can then be analyzed to track key operating metrics and performance criteria. Through this, financial executives can gauge how successful their efforts to meet compliance standards have been while, at the same time, determining how valuable leasing operations are to the business as a whole.

Once the processes, policies and controls for company leasing operations have been defined, they should be published on the intranet. This information will serve as the initial set of requirements for automation. By linking processes to statements, the elements of leasing operations that are critical for accounting, financial reporting, and, ultimately, business performance can be monitored and secured.

B. Automation and Asset-Level Coding, Accounting, and Tax

Best Practice #4: Simplify processes and automate to test compliance and improve efficiency.

To ensure that controls are being applied consistently, that compliance is being tested constantly, and that leasing operations can scale efficiently (without getting mired in paper and spreadsheets), it is vital to redesign, simplify and automate processes whenever possible. Automation is essential to controls enforcement, the elimination of spreadsheets, and tracking the audit trail of each transaction. Using web-based workflow automation, document management, transaction processing, and lease accounting software, these systems should accelerate all processes.

In order to effectively use SOX compliance initiatives as a means of improving business performance in leasing operations, it may be necessary to redesign processes and institute powerful tools that reduce the company's administrative burden. This may require a leasing automation and accounting system. The leasing automation software/systems deployed, and the processes they automate, should achieve the following objectives:

- > Allow decentralized purchase requests with optional leasing programs
- > Facilitate centralized procurement with optional leasing programs
- > Enable centralized document management (including all signed documents required by auditors),
- > Allow decentralized asset management, wherever the assets are located
- > Enable centralized leasing, lease accounting and portfolio management in a shared services model
- > Create and maintain synergies among divisions and detect exceptions and correct errors before they spiral out of control

It is essential to determine how these capabilities impact the entire technology infrastructure – otherwise a company may find itself with ineffective stovepipes of information rather than the desired central repository. This can be avoided by planning for and adopting a leasing automation and accounting system with a centralized database as early as possible. The system should support a centralized database model that captures and stores detailed transaction data and enables comprehensive lease accounting at the asset level (more on this below). The centralization of data and asset-level accounting simplifies the collection and sharing of data in a consistent manner, a fundamental element in building trust in report accuracy. Data centralization and accounting also enable companies to take advantage of the economics and effectiveness of a shared services model. When web-based workflow and reporting services are implemented, it becomes much easier for users to take advantage of leasing programs to finance capital expenditures wherever they may be, geographically or organizationally. By assisting in the documentation, testing and assessment of business controls and processes throughout the entire enterprise, automation of the leasing process will help achieve SOX 404 compliance and can potentially

transform and optimize business at the same time. In short, with these best practices, controls and productivity can be improved simultaneously.

At a minimum, any automation infrastructure should have the following capabilities in order to facilitate compliance and continuously improve financial performance:

- > Adapt to your business processes by design. Every company employs different business processes, especially in their leasing operations. Many software vendors, including installed software and application service providers, offer software that forces their clients to adapt their business processes to those encoded in the software. Software vendors focus on a “one-size-fits-all” software application in order to reduce costs and maximize margins and then convince as many companies to subscribe as possible. By contrast, a few vendors provide software that was designed to be highly configurable, recognizing the link between business process differences and competitive execution, efficiency, and flexibility, especially in larger companies.
- > Support the end-to-end process of ordering and receiving equipment, establishing a lease, and tracking assets. Users should be able to quickly and efficiently work on their appropriate tasks and then resume their day-to-day work activities. Users should be able to create, send, and track acquisition requests, purchase orders, asset assignment and notification documents, certificates of acceptance, and lease schedules. These capabilities reduce paper, accelerate lessor review and acceptance, and improve overall productivity because all stakeholders – internal and external – can collaborate at any time in the lifecycle of a lease or an asset.
- > Link all documents in the supply chain into a coherent audit trail and enable access to documents and data to authorized users through browse and search techniques. Traceability must exist for all people, events, docs, data, and communications related to every transaction. By aggregating this data, it becomes possible to drill down and explore the data. These capabilities provide fast, high-level visibility into the effectiveness of controls and reduce audit errors and compliance deficiencies.
- > Facilitate step-by-step line item reconciliation and coding to eliminate overcharges, budgeting, profitability analysis, and preparation of financial statements.
- > Track and manage the financial dimensions of all leases and assets, individually and as a portfolio, through an asset-based lease accounting and portfolio management system. This will enable the leasing team to perform accounting at the asset level, including sales and property tax calculations.
- > Support web-based reporting and analysis. This makes sure it is possible to easily create dashboards that provide a deep view of the lease portfolio and the quick identification of leases, assets, leasing business processes, subprocesses, controls, owners, and risks.
- > Enable quick and effective evaluations from staff with little or no interference with their primary responsibilities. With the controls, processes, and systems in place, the leasing team should be able to evaluate their controls consistently. Control owners should be able to access the system, execute evaluations, log out and continue with their work.
- > Support the currencies, languages, and accounting requirements in every country in which business is conducted.
- > Support easy integration with internal systems (e.g. purchasing, asset management, ERP, G/L) and external systems (e.g. lien management, tax management) using standards like XML and Service Oriented Architecture (SOA). Integrating with internal systems reduces keystrokes and errors, and improves productivity by eliminating duplicate data entry. It also reduces the significant risk of error due to the manual, ad hoc integration of data from different data sources.
- > Ensure security at the data, application, system, and network levels and reliability with sufficient fail-over and back-up services.

Best Practice #5: Closed-loop, asset-level accounting using a lease accounting subledger.

To ensure accounting and tax accuracy and demonstrate compliance –particularly with SOX and FASB– a series of accounting processes and controls must be executed consistently throughout the lifecycle of leases and assets, regardless of whether or not the transactions are off or on balance sheet.

Throughout the execution of the leasing process, a lessee should pursue line item reconciliation and coding. Please see Figure 3 below. The purchase order, invoice, and goods received should be reconciled prior to the generation of the Certificate of Acceptance. Also, all assets should be encoded with appropriate accounting references (such as serial number, G/L code, legal entity, business unit, department, cost center, etc.). This will eliminate any allocation work after the accounting is performed since the expenses are automatically allocated to the appropriate code when a stakeholder generates a report.

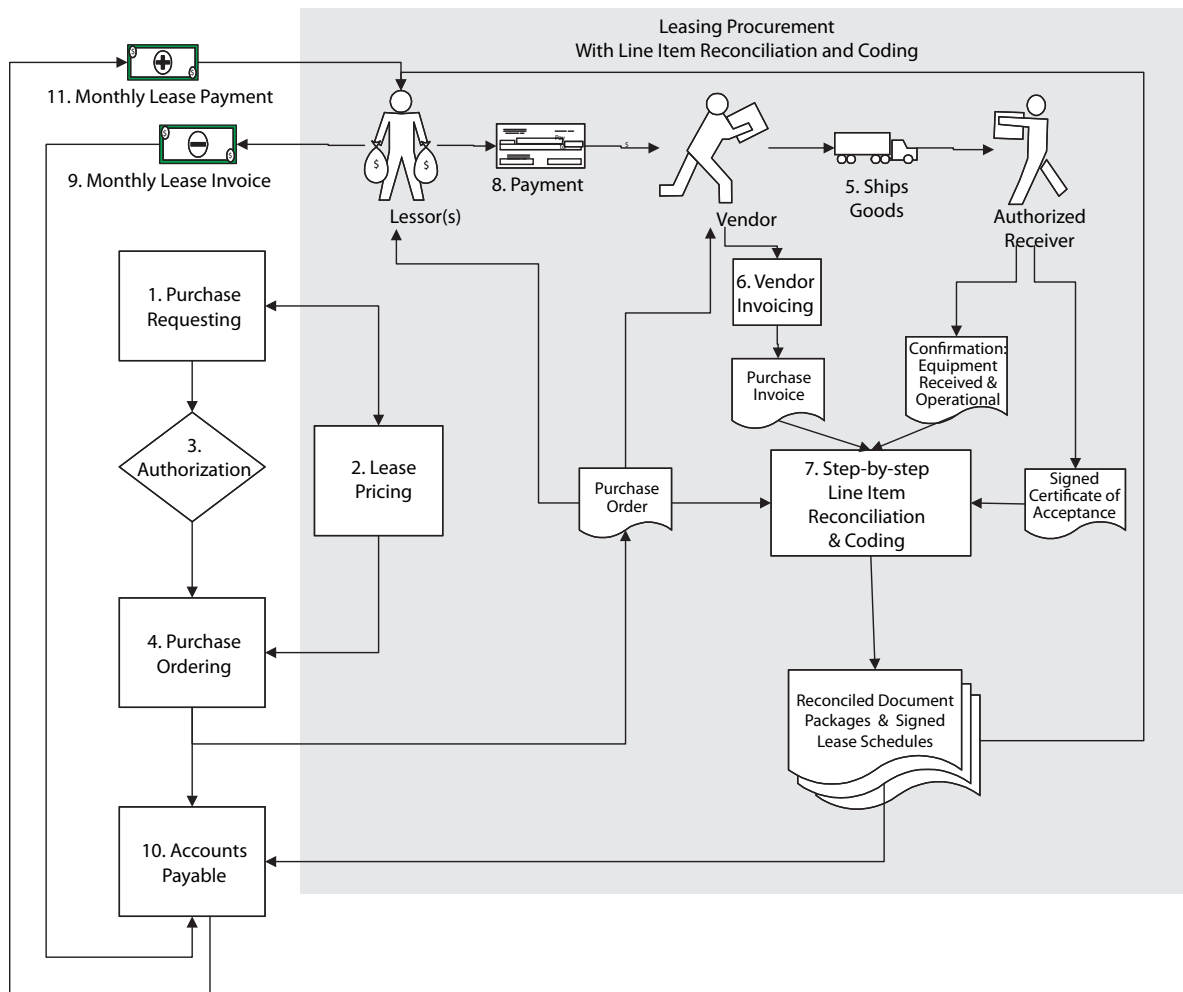
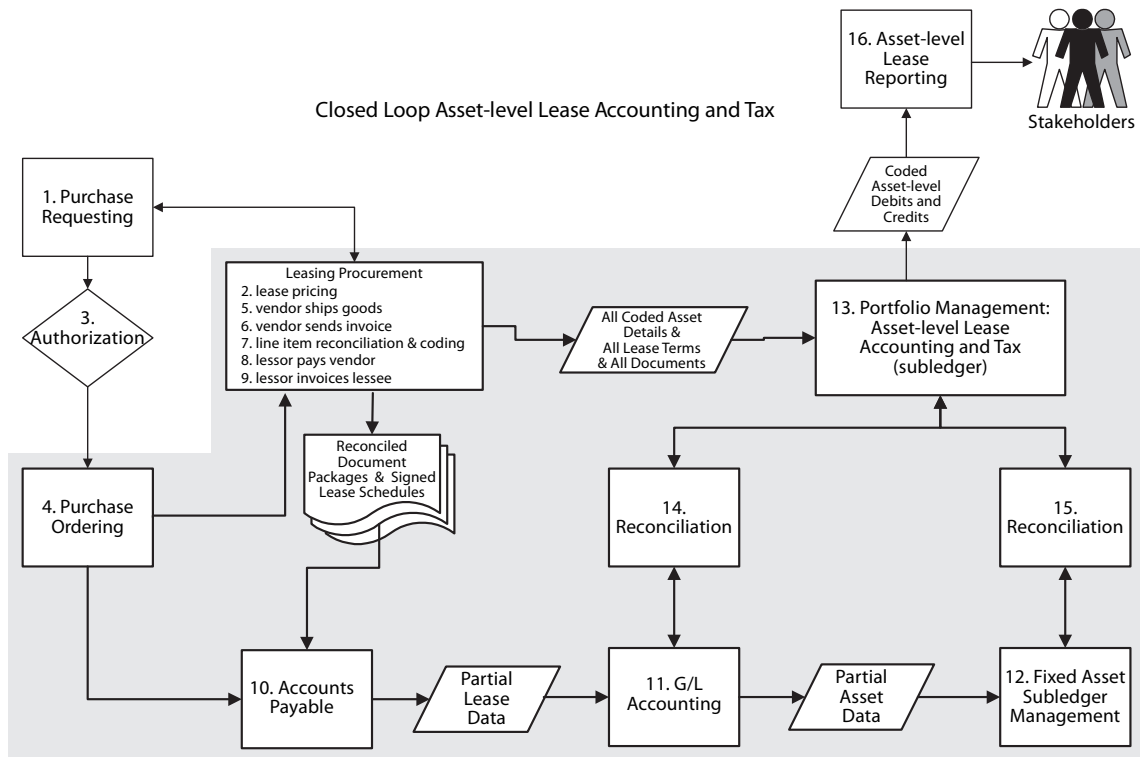


Figure 3. Step-by-step Line Item Reconciliation and Coding

Leasing operations processes and controls must integrate with other internal processes and controls, including purchase requests, authorization, ordering, and receiving, on the front-end of the leasing process and accounts payable, G/L, fixed asset subledger, and consolidation and reporting on the back-end of the leasing process. Connecting these processes with a seamless flow of data, documents, and the controls to ensure the integrity of all transactions effectively “closes the loop” in accounting for each transaction.



Closed-loop asset-level accounting (the grey box above) involves reconciliation for all lease types and assets providing detailed backup to the G/L and Fixed Asset subledger that all calculations are correct at the asset-level and back-up detail is immediately accessible for each transaction and the entire portfolio

Figure 4. Closed-loop Asset-level Lease Accounting and Tax

This “closed-loop” asset-level accounting is most easily achieved through automation of the leasing process and integration with other existing systems. See Figure 4 above. As previously discussed, unless the ERP can handle all of the compliance aspects of leasing (including asset-level lease accounting), plans for automation should include the deployment of a lease accounting subledger (a software application that is designed for asset-level accounting and portfolio management). This sort of subledger generates debits and credits at the asset-level for any type of equipment financing transaction. It allows costs (including taxes, insurance, etc.) to be spread over the assets proportionally, ultimately providing accurate “all-in” accounting for each asset and schedule.

By performing closed-loop, asset-based lease accounting with step-by-step line item reconciliation, all documents and G/L entries through the entire lease and asset life cycle can be accounted for. This eliminates spreadsheets, ensures proper the calculation of taxes, eliminates the inefficient and inaccurate process of allocating assets to budgets, and results in a clean and efficient audit. A fully supported balance sheet and income statement, with reporting and drill down capabilities, for all internal organizations (corporate, divisional, project, and cost-centers) can then be produced. It also provides G/L schedule-level entries support, by reconciling with asset-level accounting entries. Reporting at all levels is facilitated via consistent data element flow through the entire enterprise. It enables financial executives to demonstrate their stewardship function of assets, with the appropriate level of accounting detail. Finally, if it is ever required by FASB (given the SEC’s recent push for capitalizing lease assets), management will have the ability to reclassify leased assets from operating leases to capital leases (either prospectively or retroactively).

C. Visibility and Transparency

Executives and other authorized stakeholders should have quick and easy access to the data, original documents, audit trails and reports needed to make decisions and run leasing operations. This data must be accurate, relevant, timely and available to only approved authorities in the company.

Best Practice #6: Connect owners within your organizational structure with controls and reporting.

Identify the parts of the organization that are material to the business controls and reporting efforts of leasing operations. Most companies have defined the structure or hierarchy of their organization and maintain a central electronic record of this in one core system (a.k.a. the system of record), such as in their ERP system (e.g. PeopleSoft, SAP or Oracle), consolidation and reporting software (e.g. Hyperion), or LDAP server. In this system, the hierarchy of business units and subunits are mapped to demonstrate the flow of operations, and the “owners” of each business unit are designated.

Whether a company's lease automation software is proprietary or purchased from an outside vendor, it should allow the approach to internal controls for lease financial reporting to be defined around existing corporate structures. In fact, lease automation software should be easy to integrate with the core reporting platform (e.g. ERP, Hyperion, etc.), and automatically update and reconcile changes to the core system that involve reorganizations or acquisitions. If it is not imported from the core system, the lease automation software should in some other way enable the identification of individuals who are assigned ownership of divisions, processes, controls and control evaluations. The lease automation software should aid in the classification of business units considered to be key contributors to the overall assessment of business controls and reporting, and which individuals within those business units are accountable for each component of the assessment. Such classification assists in determining the required resources and skills necessary to properly evaluate underlying business controls.

Best Practice #7: Capture your historical portfolio.

When starting from scratch, it is important to collect and organize the original lease documentation for lease transactions. Technically, this documentation should go back far enough to include all assets that still have economic value (economic life). In practice, it is generally only necessary to capture transactions from the past five years. Once the documentation is collated, it should be scanned into a central repository and the minimum data elements from each document package required to meet portfolio management and internal and external reporting requirements should be scraped from the documents and inserted into the database.

Best Practice #8: Capture complete audit trail.

Once the historical portfolio has been captured, a new process should be created that will electronically secure the remaining data in a single, centralized, up-to-date database which includes all lease transactions and related lease and asset portfolios. In order to build a clear and complete audit trail, make sure to capture all of the documents, data, events, communications, time-stamps, statuses, and authority information related to each transaction. With a comprehensive portfolio, managing leasing operations and compliance becomes much simpler.

Best Practice #9: Build customized dashboards for all stakeholders.

With the documents and data in one place, each group of stakeholders must have the ability to access the data necessary to make decisions and advance their work. Interviewing and surveying each stakeholder group (such as controllers, treasury, procurement, or IT) will help to identify the most important information that each group needs to use on a daily, weekly, monthly, and quarterly basis. Based on this analysis, a dashboard that updates in real-time can be built for each group, allowing them to track key performance indicators through a high-level report. From their dashboard, stakeholders can then drill down to explore and download more detailed, related data as needed, providing valuable decision-support. Giving each stakeholder group their own dashboard into a centralized, automatically

updated repository at once eliminates ad hoc spreadsheets and databases and gives all of the authorized stakeholders easy access to the leasing processes, controls, and portfolios they need to do their job correctly and efficiently.

Improved visibility translates into better and faster budgeting, allocation, reporting, forecasting, profitability analysis, decision-making, and business performance. These innovative practices should improve the accuracy of the budgeting process by providing projections of monthly lease payments and buyouts automatically – no spreadsheets are required. It also provides an accurate projection of anticipated lease transactions based on the pipeline of purchase orders and invoices that have not yet been attached to a lease schedule. Finally, data can be used to support key company analysis measures such as unit costs.

D. Lifecycle Accountability

Executives who take a strategic view of SOX can use the compliance requirements as an opportunity to improve visibility, transparency, and accountability in their leasing operations and lease accounting across the lease lifecycle and to improve business processes along the way.

Best Practice #10: Engage competent, experienced experts to manage leasing operations.

Great business starts with great people. The equipment financing process should be managed by experienced leasing professionals. While many companies cannot afford to hire a dedicated leasing expert, whoever is involved in the leasing process – experienced or not – should be held accountable for their role and responsibilities in the overall process. The appropriate employees should be held accountable for negotiating lease agreements, analyzing transactions, managing any mid-term events, and managing the health of the portfolio through the end-of-term and end-of-life for every transaction.

Whether a company's existing team is trained from the inside or hired from outside, a team that is experienced in managing leasing operations makes a significant difference in the effectiveness and efficiency of general leasing operations. Lease agreements should be managed and negotiated by trained financial executives with the appropriate expertise. Key capabilities to seek out are: a strong lease accounting background; working knowledge of how the leasing industry uses credit analysis, pricing, structuring, and syndication to manage risks and make money; an understanding of how to use policy, controls, and technology to manage financial processes; experience managing lessor relationships; good communications skills; and a positive, service-oriented disposition. Running an effective leasing program requires an understanding of the language, priorities, and motivations of the corporate controller, treasurer, head of procurement/global sourcing, and the many stakeholders who will take advantage of the leasing programs.

Best Practice #11: Ensure leasing workflow is designed with role-based security and reporting.

Ensure that the leasing workflow and the software applications that support it are capable of providing role-based security and reporting. This will guarantee that stakeholders are only allowed access to the workflow and data that corresponds to their level of authority and role in the overall leasing process. This, in turn, establishes a consistent, organized approach to leasing operations that will help a company quickly identify issues, hold individuals accountable for their actions, and mitigate risks. Once role-based security and reporting are in place, key roles and targeted risks for each process in an organization can be established. Processes can be linked to corresponding financial statements and controls can be applied to test cases to gauge the effectiveness of financial reporting. Finally, individuals at each level in the system can be given ownership over delegated areas so that stakeholders are tied to the specific controls and processes for which they are ultimately accountable. In this manner, role-based security and reporting will help companies respond to SOX quickly and efficiently with the benefit of improved productivity across the enterprise through role-based interaction and integrated collaboration.

E. Better Financial Performance

Improving financial performance requires sophisticated economics and consistent efficiency. The cost of capital and terms of financing must be demonstrably competitive and the best the market will bare.

Best Practice #12: Lessor model designed for business strategy.

Generally, every lessor's requirements are different – there is no one-size-fits-all solution. Lessors do, however, have one thing in common: lessor competition is fundamental. There are many ways to systematically and consistently compete with lessors. However, a blind auction approach will rarely –if ever– deliver the desired results, especially by large, Fortune 1000 companies. The bottom-line is this: each lessee needs a lessor model that supports their corporate strategy and will measurably improve company performance.

Best Practice #13: Lessor selection and performance management driven by strategy and value.

In order to achieve maximum financial performance, it is necessary to compete lessors and manage ongoing performance to ensure the best terms available. Many lessees still work with only one or two lessors, while others have MLAs with more than 30 or 40 lessors. In either case, finance executives are concerned that the people in their companies carrying out leasing transactions are leaving money on the table because they are not demanding the best terms and the lowest cost of capital from the market.

Initially, it is important to develop a financing strategy that is linked to the goals and objectives set by the CEO and CFO. This financing strategy should then be used to design a financing process that will cater to the objectives of this strategy. The process should always be competitive. The number of lessors in the process, how and why lessors are selected and engaged, the nature of the transactions, and the volume are key factors in determining the degree of appropriate competition and the number of lessors that should be engaged. These factors will also determine the effectiveness of a financing process, in terms of meeting the objectives of the strategy.

Competition amongst lessors will help lessees break the reigns of a monopolistic relationship in which one leasing company dominates them with uncompetitive rates. However, it is important to note that competition comes at a cost. If lessor competition is thought of as a spectrum, on the left end of the spectrum is the exclusive relationship with a monopolistic lessor and on the right is a pure auction. Holding all other factors equal, as you move from left to right – from monopoly to pure auction – the cost of capital should decline, however, the cost of engaging in competition should increase. See Figure 5 below. As ticket and program size increase, the movement of these costs will only intensify since there is an expectation on both sides of the transaction that an increasing number of terms will be negotiated. Also, as the number of lessors expands, volume must grow commensurately or volume per lessor will decrease, which may weaken the lessee's negotiating position.

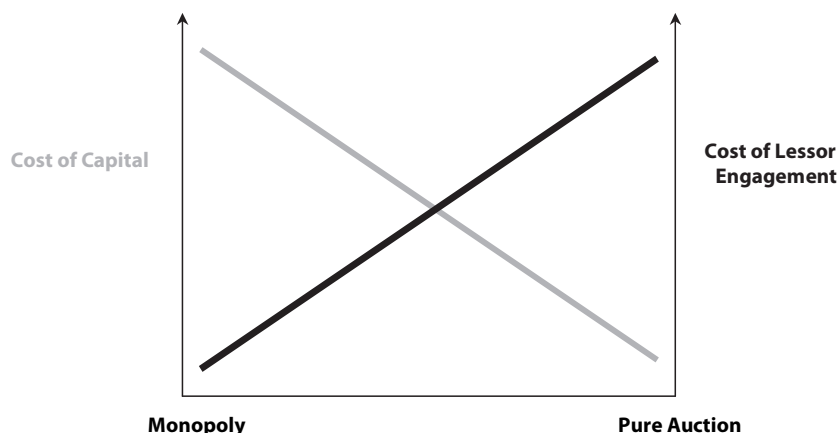


Figure 5. A Spectrum of Alternatives Between Monopoly and Pure Auction

It is therefore important to strike a balance between these countervailing costs that will drive the best value for leasing operations over time. For example, a company who has Master Lease Agreements in place with 25 different lessors may want to strengthen relationships with their bankers in order to honor mutual commitments by limiting the competition to their banking syndicate. In this case, the company will pursue a consolidation strategy and actually reduce the number of lessors with whom they are engaged, gaining the benefits of a lower cost of engagement. In another example, a company with rapidly growing leasing volume needs to move from a duopoly (working with two lessors who specialize in different assets classifications) to a more broadly marketed, competitive process over a multi-year period in order to systematically use their increasing volume to drive better pricing. Striking a balance with a focus on value would plot most companies' competitive funding strategy somewhere in the middle of the spectrum between these two extremes.

Best Practice #14: Involve those lessors that can best compete for business.

In order to achieve the best value, it is also important to know the lessor landscape and involve those lessors that are most qualified to compete. There are thousands of lessors (also known as “funders”) in North America, including banks, independents, niche, captives, brokers, hedge funds, and insurance companies. Each lessor has a different appetite that varies depending on geography, credit, transaction size, asset type, structure, portfolio exposure, documentation, transaction processing infrastructure, and go-to-market strategy.

For example, if a firm has a “B-” credit rating but needs to acquire and finance a high-volume of low-priced assets from a variety of vendors, it will want to involve those lessors that have the infrastructure to manage a small-ticket, multi-vendor program that can support storied credits. In another example, if a firm has an “A –” credit rating and acquires and finances a volume of small and medium transactions that includes computers and networking equipment, specialized manufacturing equipment, and an industrial vehicle fleet, it will have to engage a variety of different lessors in order to exploit each lessor's competitive advantages in ticket size, asset type, and likely geography. Those lessors who have organized themselves to serve the specific market segments that match the aforementioned company's needs are likely going to have the deepest understanding and experience with its leasing requirements and should therefore be able to serve them at the lowest cost and with the best terms.

Whenever possible, lessees should avoid the traditional origination channels by contacting the lessor directly and asking if they have a “buy-desk.” If successful, lessees can expect to pay less overall since the lessor will avoid paying the internal origination fees to sales people and will presumably pass the savings along in the form of a lower rate.

Best Practice #15: Manage a professional competitive process to get the best results.

When presenting a transaction or program opportunity to the funding community, it is most effective to use a Request for Proposal (RFP) that requires all respondents to provide an identical set of information. The clarity and thoroughness with which expectations and standards for performance are set forth—especially in longer term leasing programs—will tremendously impact the quality of responses. In addition to the key financial terms, it is important to get samples of their documentation, as key terms and conditions can change the economics and accounting treatment significantly. Once the proposals have been received, prepare a transparent, side-by-side (“apples-to-apples”) comparative analysis and team discussion. This will ensure that the optimal path forward is identified. Also, write down the rationale behind the ultimate decision and save it (along with the comparative analysis) for compliance and audit purposes. If the commitment of resources is affordable, it pays to negotiate and document relationships with multiple lessors simultaneously because every lessor's best terms can be used to drive negotiations forward.

Best Practice #16: Manage the end from the beginning.

Properly managing all dimensions of leases and assets throughout their lifecycles will save money over the long-term. However, the value of negotiating during the contracting process cannot be understated. This upfront opportunity is what lessees overlook most and the point at which expertise can have the greatest impact on the total cost of leasing programs. Lessors make most of their money at the end of term when lessees miss their notice requirements, continue to pay invoices beyond the term on a month-to-month basis, or extend the lease. Additionally, when lessees do not read or understand the details of their lease agreements, they can often be forced to pay steep penalties for mid-term or partial buyouts, end-of-term balloons, unjustifiably high fair market value quotes, or onerous return provisions.

It is vital to minimize any penalties or risks by carefully negotiating the lease agreement language. The more terms or whole agreements that can be standardized amongst all engaged lessors, the better; this will ultimately further reduce the cost of managing the lease and asset portfolios. The degree to which such standardization is possible will depend in part on the lessee's credit rating and the volume of leasing business – essentially how much muscle a company has in the capital market – and how many lessors are competing for the type of leasing the lessee requires. In any case, there are techniques – such as requiring the lessor to notify the lessee when the lease is coming due, rather than the other way around– that can have a significant impact downstream once the lease is booked. When the agreements are completed, as mentioned above, it is wise to automate the compliance with the terms of lease agreements to ensure that nothing will be overlooked somewhere down the line.

Best Practice #17: Understand and evaluate lessor performance.

Once lessors are engaged, it is important to manage their performance over the life of the program. If a company is putting a longer-term program in place, lessor performance can be vital to the health of the leasing operations. If a lessor is slow in paying the lessee's vendors, it could have a negative impact on the latter's credit rating. If the lessee depends on the lessor for calculating taxes and they make an error, it is likely to result in lessee exposure. If a company works exclusively with one lessor, the latter could experience a lack of access to capital when their portfolio becomes saturated and the lessee may have to scramble under pressure to find a new lessor.

If significant volumes are generated, and the lessors are assigning lessee transactions widely in the lessor community, it is important to track the assignments and know who is holding lessee debt and equity on their balance sheet. In this case, even though the lessee might be engaged with only one lessor, if the volumes are large enough and the primary lessor is assigning transactions to other lessors, the other lessors could run into exposure issues. The key here is to be clear about performance metrics upfront and manage the lessors along the way. Do not be shy about asking for references in the RFP process (preferably from peers at similar firms) to gain a clear view of each lessor's performance, hold/sell record, and intentions. It is also worthwhile to evaluate lessor performance on an on-going basis and to share metrics with the lessors so they understand how they can better serve the lessee. This will not only improve lessor performance and lessee economic value, but will also bring objectivity and transparency to competitive leasing programs, reduce risks, and further improve productivity.

Best Practice #18: Routinely compete lessors for best long-term results.

When managing a competitive process on an on-going basis, consider the nature and frequency of transactions. If there are routinely mid- or large- ticket straight lease transactions or sale lease backs, it may be wise to negotiate master lease agreements with several lessors that specialize in these asset types and transaction sizes and routinely compete these kind of transactions among them. If a high-volume, small-ticket program is called for, it may be prudent to engage multiple lessors in a long-term program, given the intensive servicing required to keep stakeholders and vendors satisfied. In this case, it is desirable to compete among lessors selected on a quarterly basis, rewarding the most competitive lessors with the most volume. In this case, it is wise to compare the program with the general market place every one to two years.

Best Practice #19: Manage the end-of-term and end-of-life rigorously.

It is true that most fair market value lessors attempt to make their margins in leasing at the end-of-term. Assuming the lessor has been properly notified as to how the end-of-term should be handled, at the end of term the lessee should have the information necessary to ensure that the lowest cost possible is being paid for the equipment. If the equipment is purchased, comparable third-party bids should be used to negotiate the lessor's proposal down. In addition to reducing the lessors quote, this same information enables the lessee to determine if it would be cheaper to buy-back and resell the equipment.

If the lessee chooses to buy out the lease and use the equipment, depending on the lease accounting treatment, it will be necessary to either capitalize and depreciate or adjust book values and reassess depreciation methodology. Just prior to an asset's end-of-life, competitive bids should be obtained from companies that specialize in asset remarketing and disposal under the assumption that they would acquire and proactively market the assets.

Throughout this process, be careful to manage risks related to the waste stream, while maximizing the residual value that can be extracted from the asset. Some of these providers will assume the environmental and data security liability and take full legal responsibility for the asset from the moment they pick the equipment up at the shipping dock. In these cases, the provider becomes responsible to investigate, litigate, settle and pay claims related to the asset as required.

Reading the fine print is imperative, as some assume more liability than others. It is vital to collect a "certificate of destruction" for any assets disposed and file them in your electronic portfolio with links to the related lease documents. This will deflect any later claims that environmental or security laws were violated, ensuring that reputation and goodwill are protected. Attention to these end-of-term and end-of-life issues will decrease the cost of ownership, bring additional revenue opportunities from the resale, eliminate penalties and disposal risks, and improve inventory and end-of-life accounting and controls.

Many firms like to donate old computers to employees or charity organizations. In numerous instances, this has resulted in a significant liability to the company. At the end-of-life of an asset, the remarketing process must be tracked. The transaction must be documented to stave off the risks of litigation and fines related to regulations governing environmental waste, confidential information, and data security that are appropriate for the given asset type. Even if the asset has no resale value, the same protections should be obtained for the disposal process.

Best Practice #20: Explicitly pursue shared services for savings and effectiveness.

Finance and procurement executives have pursued shared services for non-strategic functions, such as leasing operations, due to a number of external and internal converging forces. These factors include the pressure to improve shareholder value, new regulatory requirements, and advances in technology (such as broadband internet) mean that finance executives are better able to deliver business processes and policies across a company with widely distributed geographic locations. With more capable service providers in the market, executives have more choices in outsourcing a variety of functions. According to a survey by Harris Interactive, Finance and Procurement are the third and fourth most popular support functions to target for shared services, behind human resources and IT. Finance has an adoption rate in excess of 77 percent and procurement of 61 percent. "Roughly 80 percent of respondents in North America indicate their support functions serve the entire company."

Shared services is a centralized activity within an organization that delivers a range of services that stakeholders value, at a cost, quality level and speed that are competitive with or superior to alternatives. Shared services are different from simply centralizing operations because it's focus is on providing the services the business units need, at the quality and cost they require. In most large companies, operations still happen at the business unit level. For example, local controllers need detailed asset-level accounting for their lease obligations so they can properly track budgets and prepare financial statements. They need specialized information that only a shared services organization can deliver consistently with the proper integrity and controls.

Executives must design and manage a shared leasing operations service according to an integrated and, when possible, standardized model. This framework allows for necessary geographic, cultural or regulatory differences, while allowing optimal control and management. The leasing operations must also leverage employee expertise and achieve economies of scale. To avert unexpected costs, establish clear objectives, set a realistic timeline and remain focused.

You can choose to establish an internal service provider, outsource to full-service providers, or establish geographically focused shared services centers. Choose the operating model that best fits you're your company based on your corporate and functional objectives, cash flow projections, risk assessments, and potential return on investment. Regardless of the model, the effectiveness of a shared services organization is rooted in its ability to thrive based on an economic model - like any business. (Building a business case is addressed in the next section.)

Cost reductions from implementing shared services average about 14 percent globally. A study by JP Morgan found that 10% to 15% of the cost savings possible with shared service organizations came from lower labor costs, while 60% to 65% came from re-engineering processes. Savings that results from building shared services for leasing comes from consolidation of operations, standardization, and automation. For example, rather than have many people, places and centers managing the lifecycles of leases, assets, and funders, companies with shared services models consolidate and adopt centrally managed services models. By standardizing leasing processes and systems, lessees can begin to realize the benefits of economies of scale. Ensuring that people work off the same processes and standard software applications, lessees will more quickly achieve cost reductions that come through critical mass. This also leads to smoother processes, improved policies, and data consistency. Above all, applying technology to automate is the single most important tool for effective and efficient shared services. The internet's ability to connect various parts of the business through the web enables companies to share processes and information more quickly and inexpensively than ever before. The overall result is increased transparency and improved management.

The governance model that lessees employ is also important to the success of a leasing shared services model. Manage your shared services from the appropriate levels of your organization. Reporting to a single, top-level executive, such as the Treasurer or Controller, will ensure the right overall oversight, control and accountability. Further, you should include mid-level management in order to ensure proper implementation. Build a cross-business steering committee that brings together executive stakeholders and key internal customers. Use performance measures to ensure that the support function behaves as a professional, independent, and internal/integral organization (whether you outsource or not). Demand defined costs and defined performance targets to enforce a transparent system that holds managers responsible for all dimensions of the leasing function.

Within this decade, outsourcing likely will become a functional necessity in deploying leasing operations in a shared services model. As service providers mature, outsourcing a lessee's leasing operations will become commonplace. Based on the economic theory of comparative advantage, a leasing operations outsourcing provider that services many lessees has a far lower cost than an internal function that provides a service to a few. The end result is an economic advantage for both the lessee and the service provider. Progressive lessees will integrate outsourcing of their shared services for leasing – both full service and discrete – into their business strategies, thus perfecting their make-versus-buy decisions.

No matter where the center is located, a focus on performance and meeting customers' needs is key to success. The people that lead shared services for leasing have to have a passion for process efficiency, delivery, and customer service.

VI. Make the Business Case: How to Get Your Company Behind You

Lessees that are ready to improve the financial performance of their leasing operations while bringing them into compliance should create an internal business case. The business case should explore specific problems (see section III and IV above) that will have an impact on the viability and quality of chosen solutions. Through an initial analysis of the organization's situation, business requirements can be identified and vision, strategy, and policy can be developed accordingly. Creating a business case to support a change in leasing operations management ought to include three basic stages: voice-of-the-customer (the user requirements), ROI analysis, and pilot implementation.

What are a company's requirements?

Voice-of-the-customer prioritizes the company's needs and expectations about ways in which changes to leasing operations can improve compliance, reduce costs, improve productivity, and offer strategic benefits. The voice-of-the-customer tool, a component of the Six Sigma methodology, provides a structured approach for gathering and quantifying company requirements. This approach includes an examination of the following:

- > Who uses and is involved in leasing and leasing operations?
- > What features of leasing and leasing operations do they use and benefit from?
- > What needs to change in order to improve leasing operations?
- > What is the value of those changes to the business performance?
- > Customer interfaces and business strategies
- > Compliance issues and impacts
- > Support processes and service levels

ROI Analysis – How does this help us perform financially?

Ideally, the approach to formulating a business case will pursue the disciplined Six Sigma methodology, including the customized, total cost of ownership (TCO) and ROI analyses that accurately identify relevant costs and benefits over the lifetime of the company's investment in leasing operations. As an exercise, create a list of relevant expense categories, estimate the financial impact for each category, explain the benefit and then perform your financial analysis. Important benefits of leasing operations management fall into the following three categories:

- > Hard-dollar savings – for example, reduced costs of capital, reduced costs of portfolio management
- > Increased staff productivity due to advanced features and services – for example, elimination of paper processing, head count reduction, consolidation in the number of lessor relationships
- > Life cycle benefits that are difficult to quantify – for example, compliance with all laws and standards and the resulting reduction in liabilities, confidence in reporting and disclosures

It is important to focus on hard-dollar savings in the ROI calculation, as well as to estimate and quantify less-tangible benefits that may be relevant to the company's specific business environment. Factors to consider include:

- > Cost reduction
- > Reduced risk and improved controls
- > Performance improvement
- > Increased productivity
- > Better functional technology
- > Increased collaboration and teamwork
- > Higher satisfaction from stakeholders

Pilot Implementation – What does the end-to-end process look like with our data and documents included?

Pilot programs are vital to gaining stakeholder acceptance of leasing operations. For a pilot of target leasing operations to be successful, the financial team must not only demonstrate the value of the service but also affirm its propriety and understand any issues regarding the underlying operating model and the readiness of the existing people, processes, and infrastructure while providing proof of buy-in within the organization.

A pilot should go beyond the basic transaction walk-throughs which have already been completed in most cases. Everyone should play a role in the success of the pilot. The finance executives, in close coordination with other department heads, must prepare an overview of ideal leasing operations management strategy and stakeholder requirements (voice-of-the-customer). The financial team responsible for delivering the leasing operations management solution must then identify opportunities, conduct the ROI analysis and create the business case. The team should also address program management, creation of the historical portfolio, software selection, installation, integration, management of lessors, transactions, and the portfolio, the deployment of new services, and ongoing support.

About the Author

Michael Keeler is an entrepreneur, business leader, and author with more than 15 years of experience in building successful services businesses involved in finance, outsourcing, and software development.

Since 2003, Michael has served LeaseAccelerator, LLC as the President and CEO. With offices in Northern Virginia, Montreal, San Francisco, and Mumbai, LeaseAccelerator offers cloud-based software services that automate the end-to-end leasing lifecycle for lessees. The software enables lessees to create, manage, and account for their lease portfolio at the asset level. Using LeaseAccelerator, lessees can source capital competitively through The Global Lessor Network, a community of more than 500 lessors around the world who are registered in LeaseAccelerator and ready to bid for your business. Lessees can also use automated notifications to improve their end-of-term performance. Lessees can also generate their accounting and financial reporting under current GAAP and the new accounting standard discussed in this paper. The company also offers data and document loading and lease administration services delivered by an expert, multi-lingual team. Today, LeaseAccelerator serves Fortune 1000 companies in many industries, managing transactions in more than 45 countries that cover a wide variety of asset types. Michael welcomes any questions or comments about this document. You can reach Michael by email: keeler@leaseaccelerator.com or phone: 703-791-1931. You can learn more about LeaseAccelerator by visiting: <http://www.leaseaccelerator.com>. To perform your own return-on-investment analysis for adopting LeaseAccelerator, please use the model here: www.leaseaccelerator.com/ROI.

Michael lives in Virginia with his wife, three children, and his Portuguese water dog, named Marley. You can connect with Michael at: <http://www.linkedin.com/in/michaelkeeler>

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Practical Know-how About Equipment Leasing Operations

<http://www.lesseeadvocate.com>

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