THE LEASE ACCOUNTING TSUNAMI

ARE YOU PREPARED TO WEATHER THE STORM?

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LEASE TECHNOLOGY BY LEASE PROFESSIONALS

LEASE ACCOUNTING: WAVES OF CHANGE

The Financial Accounting Standards Board (FASB) and its international counterpart IASB are expected to release the final version of their Lease Accounting Standards by the end of 2015, with implementation required by 2017-2018. The IASB is expected to release soon, and the US Board is expected to follow suit by the end of this year. Essentially the standard requires lessees to record all leases (of more than 1 year) as both assets (Right of Use-ROU) and liabilities on the balance sheet. These include both real estate as well as equipment leases. Furthermore, the standards will require a restatement of all leases retrospectively going back three years.

The impact of this accounting standard change will have a profound impact on a company's capital structure, leasing practices, and operational processes. It has been estimated that the accounting change will add no less than 1.35 trillion dollars of assets and liabilities to company balance sheets. In a recently published survey by IBM, 92% of companies surveyed indicated that they were not prepared to implement the standard, either in terms of lease information systems, employee training, or leasing practices and policies.

The US and International standard differs in one respect and that is the International standard accounts for all leases as capital leases, classified as Type A leases; whereas the US standard will differentiate between Type A leases (capital leases) and Type B leases (operating leases). In the case of Type A leases, depreciation and interest expense will be recorded on the P&L statement, while Type B leases will only include straight line depreciation. Like mortgage interest expense, Type A lease expenses will be disproportionately front-loaded.[1]

1. See endnotes for the 4 criteria used to define a capital lease

ORGANIZATIONAL IMPACT

These changes in lease accounting will dramatically affect the relationships between accounting, corporate treasury, corporate real estate and asset management. In the past, the financial impact of real estate transactions was relatively invisible to senior management and more importantly, to the investor community. Financial analysts would have to sort through 10-Ks and other disclosure documents to gain insights to the impact of leasing on the company's capital structure and debt capacity. The new standard will shed a harsh light on the aggregate impact of lease liabilities, and force a more disciplined approach to leasing practices, information management systems, and accounting methodologies.

Since the standards will most likely go into effect by 2017-2018, it is imperative that companies begin now to execute a comprehensive plan to prepare for the standards change. As a first step, a project team needs to be assembled with representatives from corporate accounting, finance, real estate, and equipment leasing. The first order of business for the team is to assemble a complete inventory of all real estate and equipment leases. If the company does not have an automated system to track and account for leases, it is imperative that a robust system be acquired.

Once a complete inventory is assembled, a detailed analysis should be completed to assess the total net present value of lease payments, by year over ten years, as well as calculating these values retrospectively for three years. Specific questions should include the following:

1. How does the new standard affect the current lease portfolio? Specifically, what is the total asset value (ROU) and liability value after recalculating the company's lease portfolio?

- Rank each lease from the highest total net value to the lowest, relative to term and annual cost
- Rank leases from lease term remaining, as well as renewal options
- Create a variance analysis between old asset and liability values and new values. Calculate how these values change over time (at least ten years)

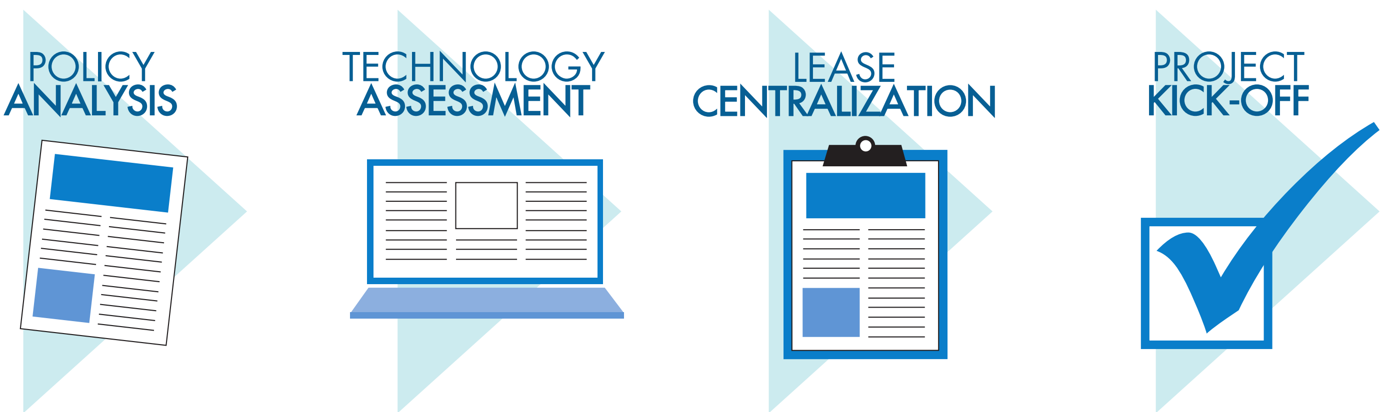
2. How will these new values affect the company's key financial indicators such as ROA (return on assets), Debt to Equity Ratio, and related tax effects?

- Calculate ROA, Debt to Equity, and net tax effects over time, with changes in lease values
- Research how these changes would affect debt covenants and potential impacts on stock values
- Seek input from key lenders on their assessment of accounting changes on company debt capacity and changes in cost of debt.

1. PwC citation required.
2. FEI citation required.

3. **What enhancements are needed to the lease accounting system to comply with the new standard?**
    - Identify specific functionality needed, size the magnitude of the enhancements and range of cost and schedule to implement
    - Determine if the lease accounting system for the new standard can be maintained separately, and integrated as necessary with current system if and when needed for reporting.
    - Review system enhancements with company auditors to ensure compliance with the new FASB/IASB standard.

4. **How will the lease management system integrate with the company's financial and accounting systems and to satisfy the audit requirements of the Sarbanes Oxley Act?**
    - Identify the software functionality to achieve integration (determine if existing systems are adequate or whether a wholesale upgrade is more cost effective)
    - Establish system costs and schedule to implement
    - Review system upgrades with company finance and audit staff for adequacy



5. **What methodologies should be employed to evaluate lease/buy decisions under the new standard?**
    - Segregate major leasing actions anticipated over the next five years, including both new leases, and lease renewals
    - Establish ROI (return on investment) and payback thresholds for purchase scenarios in light of the new accounting standard
    - Determine effects of the new accounting standards on purchase scenarios relative to changes in cash balances, debt and equity values.

6. **How will financial and lease management personnel be trained to adapt to the intricacies of the new lease standards?**
    - Identify training resources, costs and schedule
    - Identify staff to be trained
    - Determine scope of training

7. **What portion of the lease portfolio will be impacted by the international standards which differ slightly from the US FASB standard as it relates to Type A (capital leases) and Type B (operating leases)?**
    - Isolate international leases and rank by length of lease and value
    - Differentiate accounting impacts between US and international leases, and analyze differences primarily in debt to equity levels.
    - Confirm that US capital leases (Type A) meet the four FASB criteria for capital leases. Review values with both internal and external auditors, as well as investor relations (if public company)

    Note: The international standard does not differentiate lease types and requires all leases to be treated as Type A (capital) leases.

8. **How leasing strategies should be reconsidered relative to lease term, renewal options, and other variables which will now impact the balance sheet?**
    - Isolate high impact leases (i.e. leases with multiple years remaining on lease) Consider negotiating shorter lease terms to mitigate balance sheet impact.
    - Establish company guidelines on new lease parameters, i.e. lease term, renewal options, and use of company capital for tenant improvements, versus incorporating in the rent.

9. **What is the schedule and budget for implementing the necessary changes to lease management systems, lease accounting, and training of personnel?**
    - Create a budget and schedule for implementation
    - Consider the lead time necessary to implement the required changes.
    - Expect at least two years to complete all the necessary changes for system updates, training, and process changes.
    - Review the project plan with management to insure buy-in and support as well as insuring adequate resources are provided.
    - Insure sign-off by outside auditors

WEATHERING THE STORM

10. What consulting resources are needed to accomplish the transition to the new lease standards, and how can these services be single sourced for both process and system upgrades?

- Develop an RFP to be used in the selection of consulting/ system resources
- Evaluate the use of separate versus single source consultants and system providers
- Develop selection criteria in terms of competencies, references, fees, and efficiencies

The advent of new leasing standards will have a profound impact on a company's leasing practices, processes, and leasing systems applications and infrastructure. It is clear that most companies are still inadequately prepared to comply with the new standard in a timely fashion. It is unknown how this change will affect commercial markets and landlord practices. It is possible that because of the balance sheet impact of commercial leases, that over-all demand for leased space will recede, particularly for high cost urban office space. It's also possible that equipment leasing will impact equipment pricing and financing.

Despite these uncertainties it is clear that companies need to implement the necessary changes as outlined above to be ready for the changes that will most certainly come into being over the next two years. Those companies that fail to execute a comprehensive transition to the new standard may face severe penalties for non-compliance and excessive costs in attempting to catch up in a reactive and haphazard manner. Those companies who implement in a timely fashion could achieve the added benefit of gaining insight to the company's leasing profile, cost, and processes.

Endnotes:

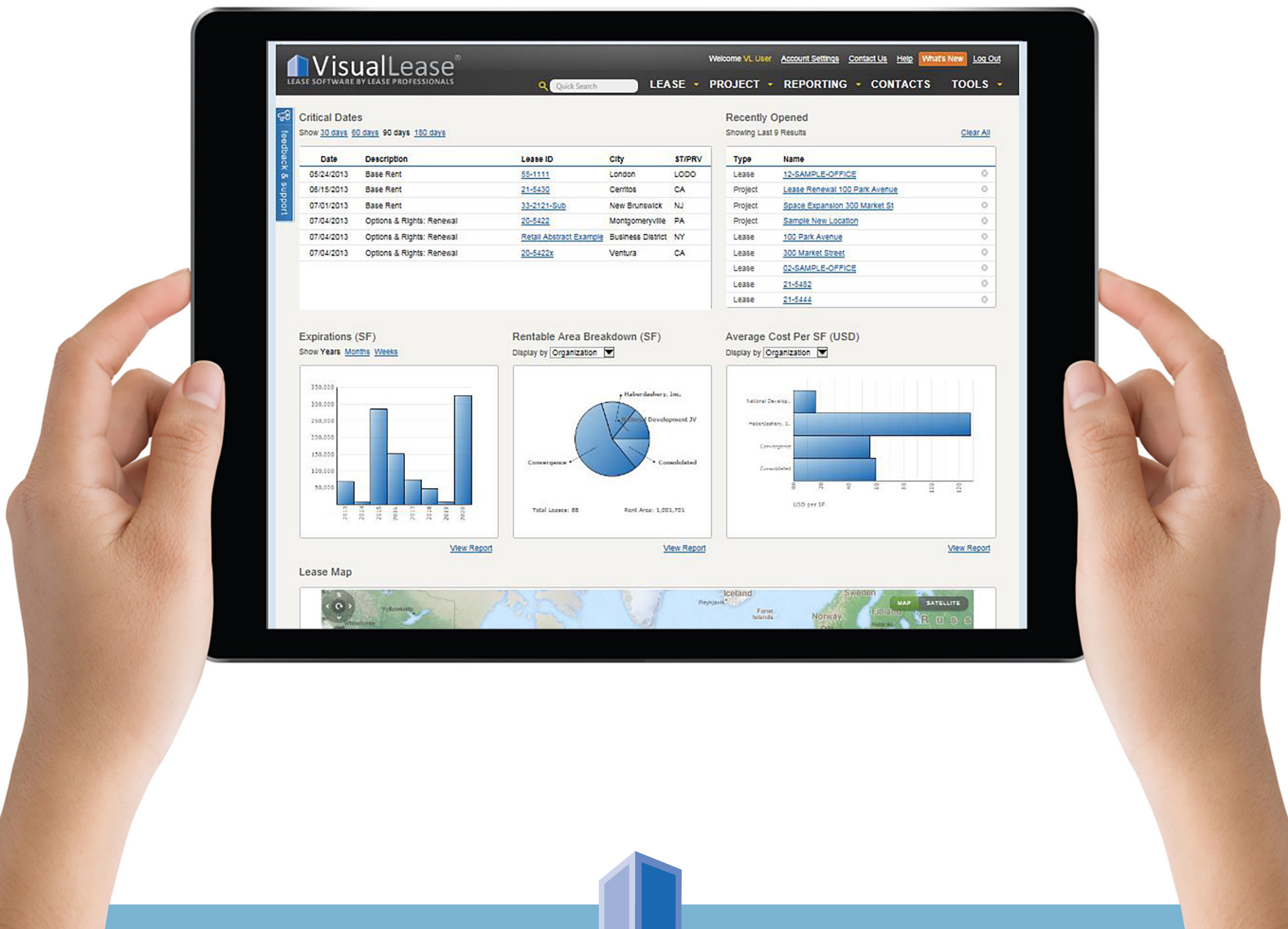
Criteria for determining a capital lease: (Per FASB 13)
1) The lease automatically transfers ownership of the property to the lessee by the end of the lease.
2) The lease contains a bargain purchase option.
3) The lease term equals 75% or more of the estimated economic life of the property.
4) The present value of the minimum lease payments at the beginning of the lease term equals or exceeds 90% of the fair market value of the property.

ABOUT VISUAL LEASE

The lease standard will undoubtedly transform company financial profiles. Estimates have ranged from $2 to $3.5 trillion being shifted onto the balance sheets. The transparency will be helpful when assessing a company's financial health, but the process to get there will be tough.

Fortunately, Visual Lease's 20+ year mission has been to facilitate efficient administration and accounting compliance of lease obligations through world class software and customer service. We are committed to being lease accounting experts by staying in front of industry and technology trends while continually refining our products and services. The values driving us are excellence, diversity, dedication and passion.

We have over 300+ installed clients, along with partnerships amongst leading consulting, accounting and real estate brokerage firms. Please visit our website or contact us at sales@visuallease.com to set up a discovery demo.



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