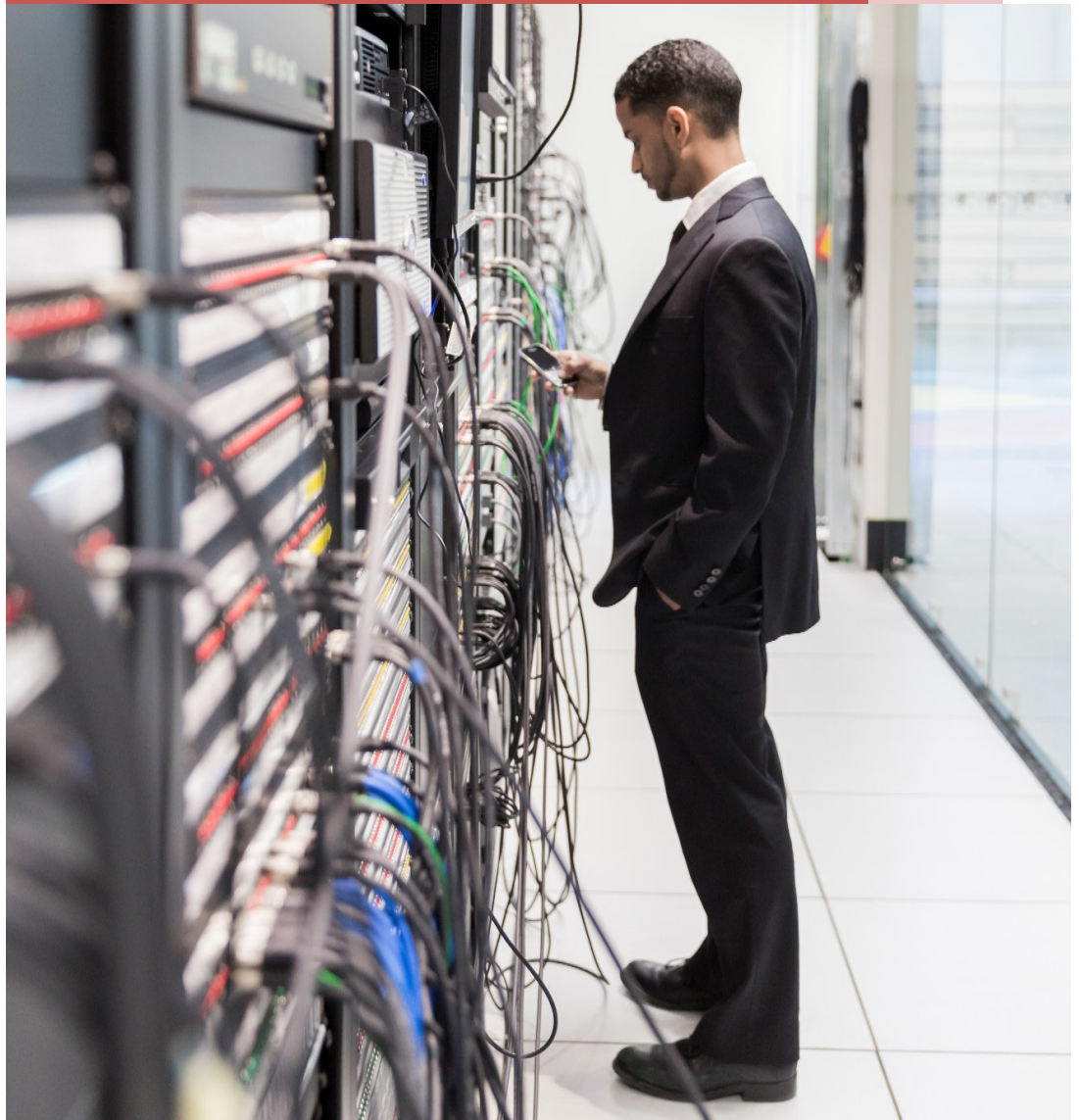


Equipped for success:

The right equipment lease management solution can provide benefits beyond compliance

December, 2016

**lease
accelerator™**



pwc

Impact of lease accounting changes

The vast majority of companies lease equipment and real estate, with many of them leasing more assets than they realize. The kinds of assets they lease can vary widely—from airplanes, medical devices, and construction equipment to furniture, laptops, and printers. And if the leases are well managed across equipment life cycles, leasing can serve as a cost-effective method whereby companies acquire the equipment they need to run their businesses while minimizing the risks of owning assets outright.

In an effort to present increased leasing-activity transparency, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly issued new guidelines for lease accounting. The guidelines could affect almost all entities to some extent. Lessees will likely see the most significant changes because they will

become required to recognize virtually all lease-related assets and liabilities on their balance sheets for leases with terms of more than 12 months. (See sidebar “What are the main changes?”) Implementation deadlines for the new standards start in 2019, but companies that are calendar-year-end filers will have to provide three years of comparative income statements beginning on January 1, 2017.¹

Traded companies using International Financial Reporting Standards (IFRS) or US GAAP are estimated to have \$3.3 trillion of lease commitments, more than 85% of which are not shown on balance sheets.²

¹ Financial Accounting Standards Board, Accounting Standards Update, Leases (Topic 842), February 2016 (http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167901010&acceptedDisclaimer=true)

² <http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/archive/Pages/IASB-shines-light-on-leases.aspx>

What are the main changes?

From the lessee's perspective, virtually all leases are going to have to come onto the balance sheet, with assets and obligations that are similar to today's capital leases. In addition, for companies using generally accepted accounting principles (US GAAP), there is a dual-recognition model requiring that leases be classified as either operating leases or finance leases. Supporting that is the need for enhanced qualitative and quantitative disclosures—including significant judgments made by management—which will be required to provide greater insights into the extent of revenue and expense recognized and

expected to be recognized from existing contracts. The determination of whether a contract contains an embedded lease will now focus on the existence of decision-making rights to indicate control of the underlying asset, impacting the identification of embedded leases within service contracts. Companies may need to establish new procedures to determine what components to capitalize.

From the lessor's perspective, the accounting will be similar to the current model but updated to align with both (1) certain changes to the lessee model (e.g. certain definitions,

such as the definition of initial direct costs, have been updated) and (2) the new revenue recognition standard. Similar to today, lessors will classify leases as operating, direct financing, or sales type.

The standard is effective for public companies filing under US GAAP in their fiscal and interim reporting periods beginning after December 15, 2018, with early adoption permitted. The new standard must be adopted using a modified retrospective transition, with reporting under the new standard reflected as of the earliest comparative period presented (e.g. 2017).

The process of gathering, validating, and reporting leases might take considerable time and effort depending on the volume, complexity, and availability of existing data and system capabilities. Some companies may have to modify their existing systems and processes, thereby lengthening the timeline. Indeed, fewer than one in 10 financial professionals at Fortune 1000 companies says the right systems are currently in place to comply with the new requirements, according to a survey conducted by LeaseAccelerator³.

The impact of the new standards goes beyond financial reporting; changes to the balance sheet may have implications for companies' debt covenants, factors impacting state and international taxes, and for their lease-versus-buy decision making.

³ <http://explore.leaseaccelerator.com/new-study-finds-companies-lack-systems-processes-comply-new-lease-accounting-standards/>.



The complex world of equipment leasing

Property versus equipment leases

Traditionally, equipment leases have been treated differently from property leases. Property leases tend to be large in size but few in number, with centralized data and information technology solutions to manage their portfolio. Equipment leases tend to be of smaller value but much more numerous. A typical corporate office, where the property is under one lease, will likely have many additional leases covering photocopiers, computers, office furniture, and other equipment. While the property decision is left to real estate portfolio specialists—most likely in the corporate real estate function—equipment lease decisions are usually decentralized and handled at the business unit level or by the local plant or office.

The US equipment-financing industry grew to \$946 billion in 2014 and was estimated to reach \$1.046 trillion in 2015.⁴

Equipment leases, including embedded leases, can have complex and variable lease payment structures, processing life cycles that span corporate functions, and are typically used by multiple departments covering different assets. It is no surprise that there are a wide variety of stakeholders and decision makers, who are distinct from those involved in real estate transactions.

Diverse structures, terms, and stakeholders

In its effort to meet customers' needs, the leasing industry has not been hesitant to innovate. Lease payments can be structured in myriad ways to accommodate the wide variety of industries and businesses that lease equipment. For instance, companies with seasonal cash flows, such as resorts or agricultural companies, may have what's called skip payments incorporated into their leases so they can align payments with their busy seasons. Usage payments are another kind which often occur with equipment such as printers or medical devices whose base pricing is determined by estimated usage, with additional charges incurred for excess usage.

And it isn't only payments that can vary: lease structures and lease terms can be nuanced too, and they may even change over time. Consider a single lease for multiple assets such as computer servers in a data center. Each server could be owned by a different business unit; and further, components of the servers could have individual owners in different departments. Even further complexity can accrue if one business unit decides to upgrade its server or move the server to a different data center, which could result in a coterminous lease or in assets with varying terms for accounting purposes. In addition, at the end of the lease term, all stakeholders have to decide whether to return, renew, or buy out the assets. That's why it's imperative to treat each asset as its own lease: so that it can be tracked and accounted for accurately throughout the lease's life cycle.

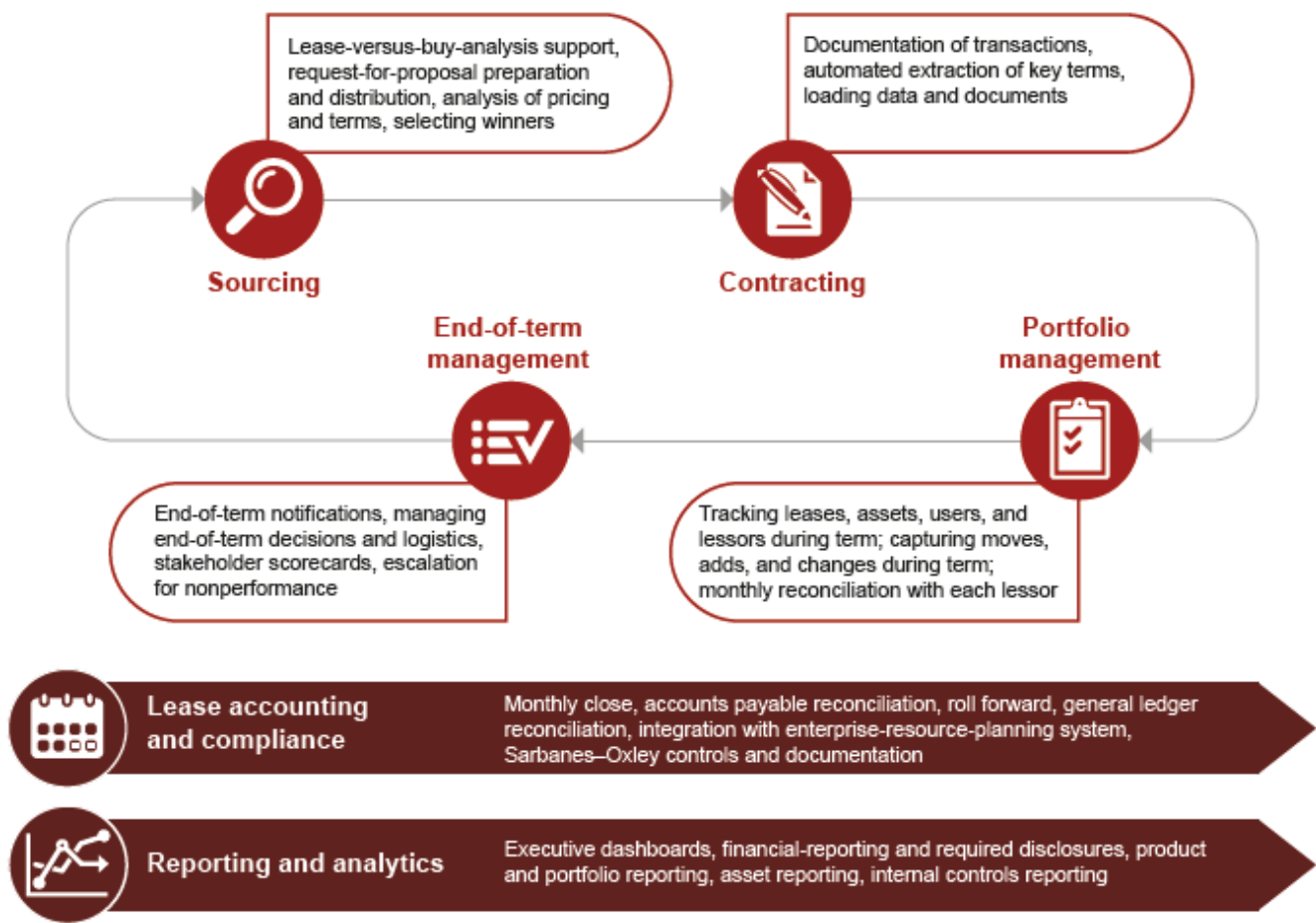
⁴ https://www.leasefoundation.org/positive/index.cfm?fuseaction=display_article&artID=22205

At many organizations, the decision to lease equipment lies at the business unit, division, group, or department level. Each stakeholder is responsible for its equipment acquisition and financing processes. The leasing transaction life cycle (Figure 1) encompasses many processes and

functions, including procurement, asset management, and accounting. And the ease with which changes can be made midway through a lease agreement presents further challenges to tracking and maintaining leasing data.

Given the complexities and potential variables during the life cycle of a lease—in addition to the often unknown quantities of equipment leases throughout an organization—adjustment to the new accounting standards poses a significant challenge.

Figure 1: The equipment-leasing life cycle is inherently cross-functional and interdepartmental



Challenges of managing equipment leases

Equipment leases often lack centralized management processes, controls, and visibility. Most companies use manual processes to manage and track their equipment leases. The LeaseAccelerator study found that some 65% of respondents depend on spreadsheets or “a little of everything” to track assets.⁵ Such systems are problematic because organizations will have to have a complete understanding of their equipment-leasing portfolio—with access to asset-level data—in order to become able to comply

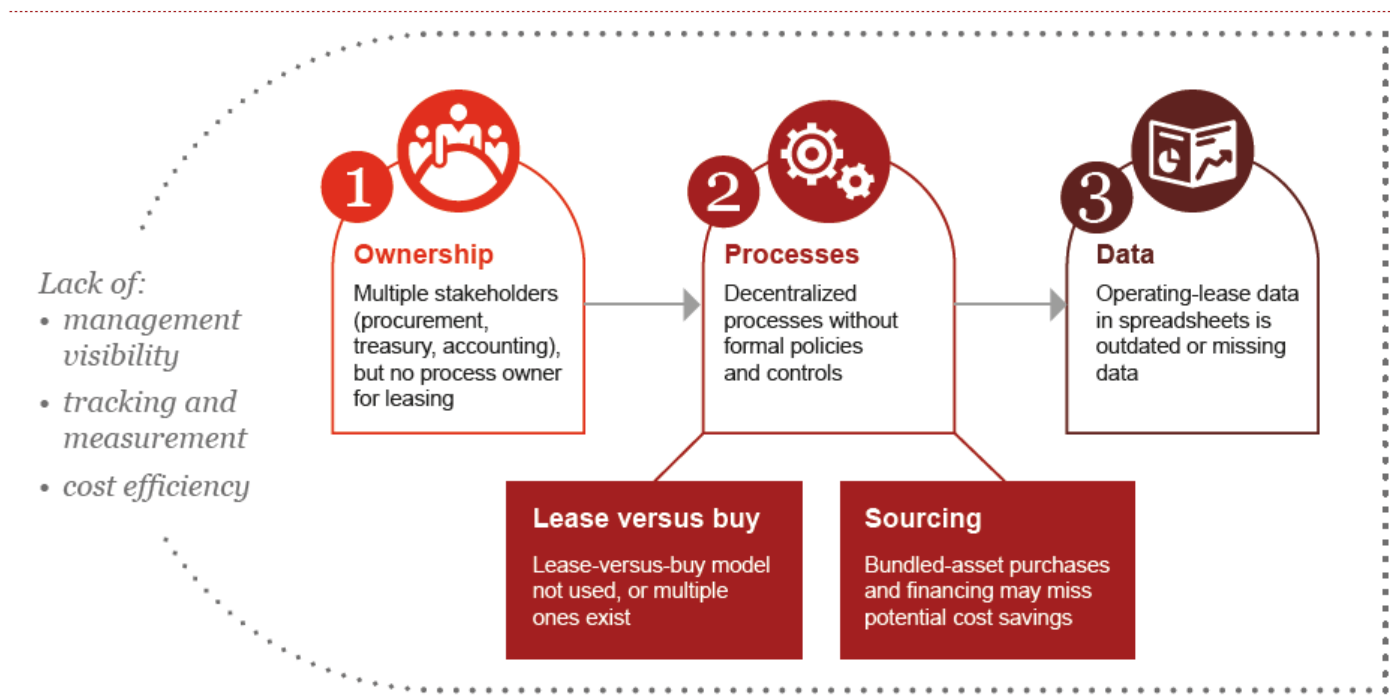
with the new standards. The volume of leases, the number of stakeholders, the lack of centralized processes or ownership, and inconsistent data practices all complicate the process (Figure 2).

Whose lease is it, anyway?

At many companies, no one function is responsible for the success and good performance of the equipment-leasing program. Treasury helps stakeholders evaluate whether they should lease or buy equipment. Procurement gets involved to

negotiate the equipment lease. But treasury and procurement lose visibility with regard to leases once equipment arrives. Accounting pays the invoices and tracks leases but depends on end users to send notification if equipment gets returned, purchased, exchanged, damaged, stolen or lost. Groups like IT, logistics, operations, and facilities management typically control the equipment during the lease, but they view themselves as users—not owners—of the corporate leasing program.

Figure 2: Without cohesive solutions, companies are struggling to effectively manage their equipment leases



⁵ <http://explore.leaseaccelerator.com/new-study-finds-companies-lack-systems-processes-comply-new-lease-accounting-standards/>.

When more process is good

Many companies have neither documented nor consistently enforced either the processes followed or the controls in place for leased equipment; nor have they established procedures for evaluating service agreements for embedded leases. Decisions about which equipment gets purchased versus leased differ across business units. Many of the hundreds, or, possibly, thousands, of people authorized to initiate leases within a company are *managers* of the equipment, not finance or accounting experts. And without controls in place there is ample opportunity for mistakes.

Once a decision has been made, the sourcing process selects the make and model of the equipment and designates who

should provide the financing for the lease. Competitive-bidding processes are time-consuming and for that reason sometimes skipped altogether. Another common area of weakness is called *end of term*, and few companies track which equipment is due to come off lease in the immediate future. Plus, few take a rigorous approach to notifying lessors about their intentions to renew or return or purchase the equipment. Even fewer companies track the equipment during the term of the lease—despite that the equipment might move to a new location or cost center or become the “property” of a new internal owner or get damaged, lost, or stolen. That lack of tracking can lead to inaccuracies in insurance coverage, lease compliance,

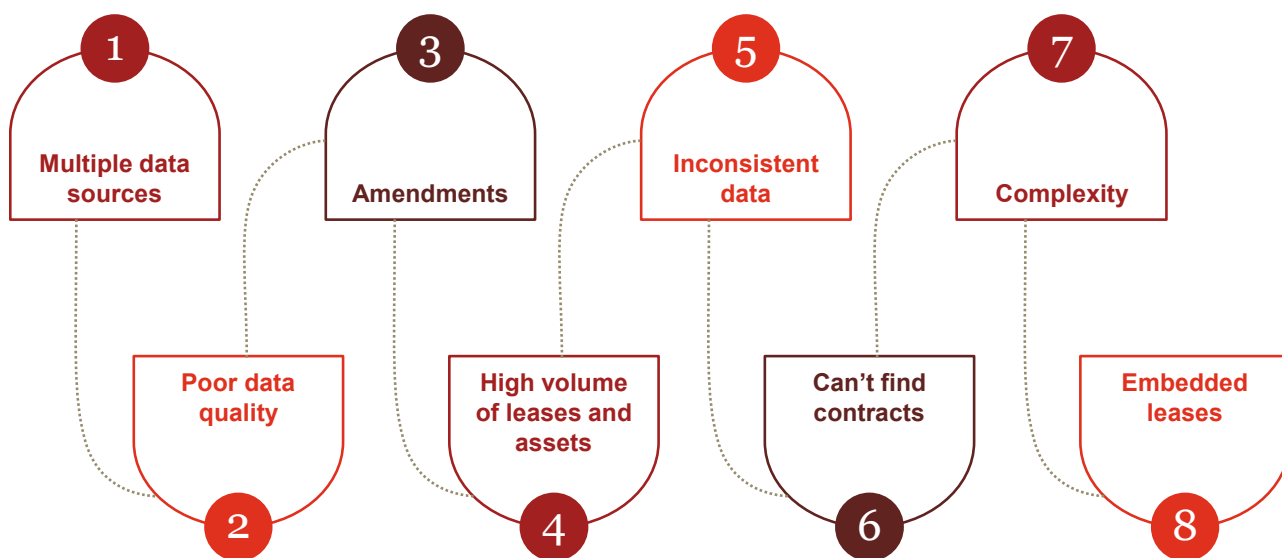
taxing, and accounting; and it can undermine decision making.

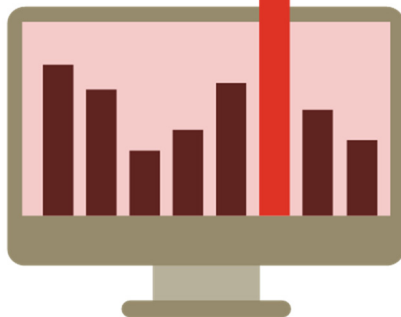
Where’s the data?

Many companies are challenged even to simply *locate* all of their equipment-leasing data—especially if they have no centralized solution (Figure 3). Although some basic leasing data is stored in enterprise-resource-planning (ERP) applications, the data for each individual piece of equipment is normally at the contract or schedule level rather than at the asset level. Procurement applications may have equipment lease data but that data is usually limited to information used in negotiating the deal. Asset management systems and contract management repositories, too, can hold limited amounts of lease data.

Figure 3: Potential data issues add further complexity to equipment lease management

Data gaps





Without a single database to house all of the information available about an organization's leased equipment, inconsistent data and data quality issues can occur as different lease information gets captured—sometimes incorrectly. The best source of data on a specific equipment lease is the original contract, which is typically stored in a file cabinet or as a pdf file on a file server. In a poll during a recent PwC Webcast, roughly half of the respondents said either they stored their lease contract data in filing cabinets or they simply didn't know where the contracts were stored. Spreadsheets represent the de facto application for the tracking of equipment leases, which results in challenges at large companies where different spreadsheets are used in different departments. Further complexities can arise when amendments to leases get issued—often in the form of new contracts—because they must get linked back to the original in order to create a full central repository.

Lack of clear and cohesive solutions for managing equipment lease portfolios may cause challenges with:

Management visibility:

The company has no clear overall ownership for leasing, and leasing data is not stored in one software application. As a result, most chief financial officers don't know what equipment is being leased, where it's located, or when the leases expire.

Tracking and measurement:

The use of spreadsheets to track equipment leases is not a scalable or reliable solution for the tracking of thousands of assets in hundreds of locations. Without clear processes throughout the life cycle of a lease, the tracking of individual assets becomes even harder.

Cost efficiency:

Organizations may find themselves unable to realize the expected savings from their leasing programs because of ineffective or nonexistent competitive-bidding processes for the financing of equipment. They might also incur extra fees for not returning leased equipment on time, which often happens absent a process for notification of upcoming ends of terms.

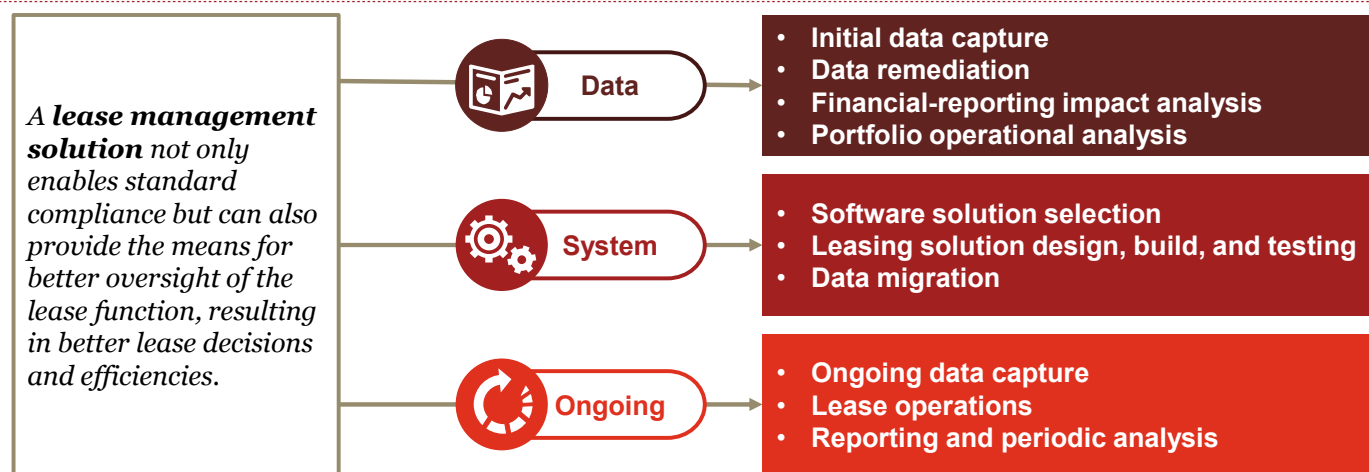
More than just a compliance solution

The new leasing standards will require visibility into all leases, thereby presenting a compliance challenge at many companies given the current equipment-leasing

environment. Companies will have to (1) collect all equipment leases across their organizations, (2) extract and validate key data terms, (3) load the data into systems so

they can conduct financial and operational analytics, and (4) establish an ongoing process to maintain the information for compliance purposes (Figure 4).

Figure 4: Steps to create a robust lease compliance solution

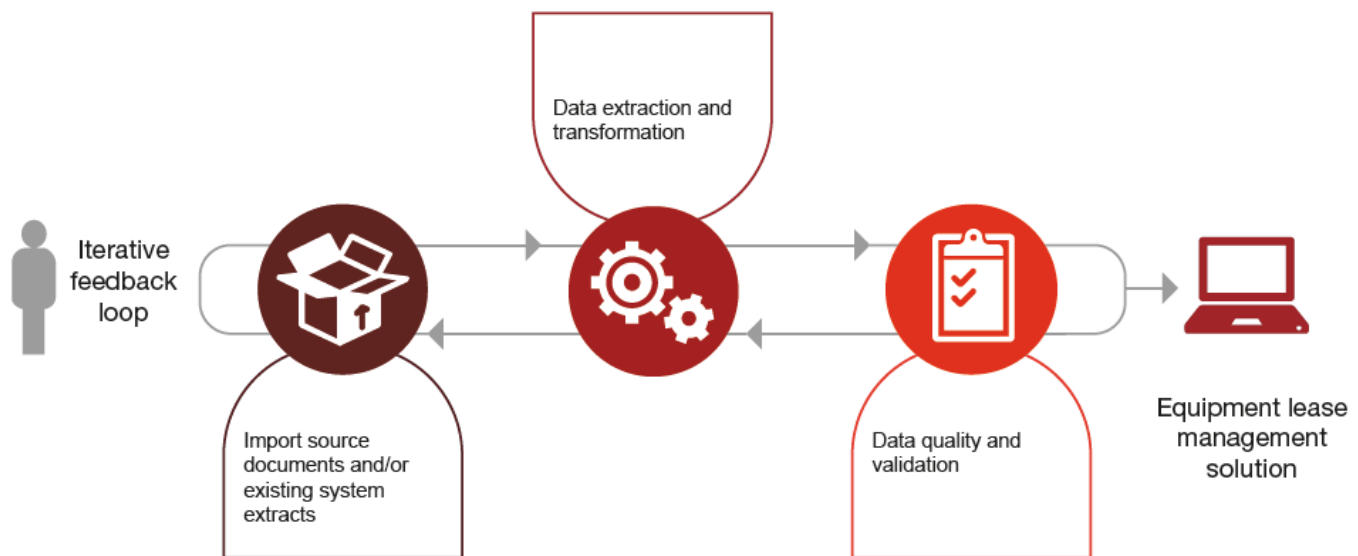


Data: Initial data collection and entry are important steps in obtaining a cleansed data set for the equipment lease management system (Figure 5). A wide range of tools and technologies are available for preparing data for migration—not only for initial transition into a system but also for use on an ongoing basis to maintain the data quality of any new leases a company acquires. Digitized leases can minimize the amount of manual effort needed and reduce the potential errors that can occur in the handling of such large amounts of data.

More-sophisticated technologies such as character recognition, natural language processing, and machine learning can extract relevant information from a lease based on a company’s customized set of rules, thereby further reducing potential inefficiencies, but manual review of data before it gets migrated into the equipment lease management system is necessary to confirm the quality of the data.

System: Equipment lease management platforms (ELMPs) provide an integrated solution that automates each stage in an equipment lease life cycle. From a technology perspective, ELMPs are solutions that help track lease sourcing, lease performance management, and lease accounting. From a process perspective, the visibility that ELMPs provide into the equipment lease portfolio can facilitate new tactical and strategic handling of the end-to-end leasing life cycle.

Figure 5: Data collection and quality represent a critical component of the equipment lease life cycle



The true value of an ELMP is its capacity to reduce manual effort and eliminate unnecessary steps, thereby enabling straight-through processing of equipment leases. To realize that advantage, the ELMP should be configurable and flexible and offer end-to-end management of the equipment lease life cycle. The system should also integrate with an organization's general ledger, accounts payable, and asset management systems; and it should provide work flows for process adherence, with automatic notifications for end-of-term leases. For leases with multiple assets, judgments about the accounting life and decisions about midterm and end-of-term options are made at the asset level and require the ability to (1) calculate debits and credits on a monthly basis at that asset level (which is the fundamental building block of an ELMP) and (2) roll up to journal entries at the schedule (contract) and portfolio levels. This enables the ELMP to function as a self-standing subledger, maintaining the link between assets and liabilities such that the controllership can determine what level of journal entries to push into the general ledger, which can greatly simplify the accounting environment.

The equipment-leasing solution will vary by company given the diversity of existing leases,



Benefits of equipment-lease-management-platforms solutions

- They establish a consistent framework from which to manage the overall equipment-leasing process, and they offer management visibility into the equipment-leasing portfolio.
- They reduce long-term costs by providing a better platform from which to negotiate lease agreements.
- They maximize the value gained from leasing by improving end-of-term management (buyout, return, renew).
- They reduce short-term costs by minimizing inefficiencies such as duplicate manual entry into accounting and ERP systems.

processes, and systems, but companies that decide to implement an ELMP will have to take time to select the right software for their needs. The selected leasing automation solution must be compatible with the company's existing enterprise architecture and align with the IT department's strategic plans. And the implementation of a leasing automation solution should be treated like any other enterprisewide transformational change. In addition, any new initiative to update technologies will also have to consider how leasing data will get moved to enterprise-resource-planning, accounting, or asset management systems.

Ongoing: To support the standard requirements, an ongoing process must be in place to capture data for new leases as well as data involving day-to-day lease operations and maintenance. Ongoing reporting

and analysis will generate insights into potential areas of operational improvement and, together with ERP systems, will allow for necessary financial reports.

The good news is that in addition to managing compliance, improvement opportunities may result from transforming and automating the leasing process. Some of these opportunities may yield lease cost reduction, with better lease rates and timely end-of-term action; better leasing decisions about portfolio reporting and analytics; and improved transaction efficiency and data quality, with centralized processes and controls supported right within the equipment lease management platform. (See sidebar "Case study: Benefits of a centralized equipment-leasing program.")

Case study: Benefits of a centralized equipment-leasing program

The challenge

The equipment-leasing process at a global industrial manufacturer was highly decentralized, with local budget owners throughout the world and in different departments making lease or buy decisions, transacting, and then managing the leases and assets themselves.

In 2010, the chief financial officer and treasurer began to scrutinize the company's equipment lease management program as part of a companywide initiative to achieve operational excellence and financial-reporting compliance. The challenges going in included:

The lack of a single source of truth for the equipment-leasing program. Multiple sources limited visibility into the global leasing portfolio and the portfolio's economic performance.

Excessive up-front payments for lease capital. The procurement organization had a mature process that succeeded in getting rival equipment vendors to reduce cash prices, but there was insufficient bidding by leasing companies for lease pricing. The company's relationships with captive lessors were too tight, and the economics of many leases weren't being closely scrutinized.

Poor tracking and ineffective management of leases. At the front end of the lease-tracking process, spreadsheets and an outdated software product were the primary solutions for lease management. On the back end, a complex, fragmented enterprise software environment was supporting the end-to-end equipment-leasing process, requiring manual data transfer between the major systems.

Deficient end-of-term practices. The company was making unnecessary evergreen payments because it had no process for management of leases approaching end of term. In many cases, the company was being forced to buy out the equipment at the end of term because it could not return the equipment on time.

The solution

Treasury collaborated with IT, shared services, and procurement to find a solution. Together they decided to explore automated solutions for equipment leasing, and they also realized they would require a contract repository to house the original leases. Once an equipment lease management platform (ELMP) was chosen, leases got collected, cataloged, and analyzed. Schedule-level and asset-detail information from those leases then got uploaded into the system.

The outcome

The new process and technology solution helped the company identify and execute opportunities to reduce evergreen payments and simplify the leasing portfolio. It also led to more-established policies and controls, enhancing visibility into the leasing portfolio and providing a more robust overall governance structure.

More than **7,400** leases in **51** countries were added to the ELMP and then analyzed to identify opportunities for cost savings. In parallel, the company upgraded its leasing process to incorporate lease-versus-buy decision making, to appoint regional lease coordinators, and to use end-of-term performance metrics in the ELMP.

Getting it right

Complying with the new standards will likely require organizations to make significant changes in the ways they currently manage equipment leases. Business processes, management approaches, and strategies for dealing with data will all have to evolve if companies are to succeed with the updating of their equipment-leasing programs.

Update business processes

Organizations should reassess business processes across the entire equipment-leasing life cycle. And because most service agreements with embedded leases involve equipment, service agreements should also be included in any reassessment.

Including them will not only make sure that all required information gets captured in the right format for accounting and compliance purposes but will also incorporate proactive management of costs. A centrally controlled process with compulsory steps such as lease-versus-buy analyses and competitive sourcing for equipment financing may increase transparency and efficiency. The archiving of related documents can also aid in Sarbanes–Oxley audits. And providing standardized requests for proposals and contracts can further simplify both the process and downstream compliance.

Reassessment of business processes also opens opportunities to address cost leakage stemming from poor end-of-term management. In particular, automatic alerts can notify stakeholders of upcoming end-of-term deadlines, and automatic stakeholder scorecards can improve return performance, thereby curtailing unnecessary evergreen fees. Updating the equipment lease process also means new practices for gathering leasing data, for ensuring its completeness and accuracy, and for lease calculations.

Define strategies and policies

As with real estate, equipment leasing should have an executive sponsor who clarifies the purpose and strategy of the equipment-leasing program and is accountable for the portfolio's financial performance and related compliance. Equipment leasing is inherently cross-functional and interdepartmental and needs the proactive collaboration and buy-in of all stakeholders such as accounting and finance, procurement, and technology. Defining a unified and structured approach with documented processes, policies, and controls gives stakeholders an understanding of what is required and sets forth their roles and responsibilities in the enterprisewide leasing program.

A program management office (PMO) should be established to lead governance of the integrated program and to manage interdependencies. A PMO also serves to ease transition to the new program by ensuring that all business units' requirements get included, that milestones get set, and that the initiative gets completed on schedule.



Make data accessible

For careful accounting and compliance, all relevant information about existing and new equipment leases will have to be collected. The information should include schedule-level data about transactions as well as asset-level data about equipment. Definitions of lease terms, information describing end-of-term options, lists of notification deadlines, and lessor contract information should also be collected. Because subsets of equipment-leasing data may reside in ERP, procurement, asset management, and fleet management

systems, it is important to routinely reconcile that information with what is held in the equipment-leasing system. Such integration between systems facilitates that process and reduces the risk—and the cost—of manual reconciliations.

Data assurance across the equipment-leasing life cycle is critical because it ensures the validity and quality of data loaded into the system. Consistent procedures that abstract and verify data, along with controls and periodic audits, help achieve data assurance.

Opportunities for cost savings and operational improvements typically emerge from the analysis of collected data. Historical transaction data enables procurement to negotiate more-favorable deals, and the economic implications of end-of-term decisions empower cost center owners. The effectiveness of an overall equipment-leasing program can be measured by key performance indicators, such as measurement of the percentage of total leasing payments that are in evergreen fees, which will establish an environment of continuous improvement across the equipment-leasing life cycle.

The time is now

The new standards pose more than a technical accounting challenge: they pose technology and business process challenges based on the need for improved data collection, more-competent governance, and expert analytics. Because of equipment leases' inherent complexities and the challenges that arise in the ongoing management of a lease portfolio, many companies may find it a difficult task to successfully implement

equipment lease management solutions—and maintain them.

There is no one-size-fits-all solution for meeting the new standards and tackling the challenges of equipment leasing. For many, the most challenging aspect of the transition will lie in identifying and then deploying the right combination of technologies and processes to accommodate the new requirements. However, the benefits of getting it right extend

beyond compliance requirements because an improved equipment-leasing process can drive value across the organization based on increased transparency and resulting from operational efficiencies.

Your company must prepare and adequately plan for the potential changes to processes, systems, data, and controls that will be needed across the business. If you have not already begun, now's the time.

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Acknowledgments



About LeaseAccelerator

LeaseAccelerator offers the market-leading SaaS solution for Enterprise Lease Accounting, enabling compliance with current and new FASB and IFRS standards. Using LeaseAccelerator's proprietary asset-based Global Lease Accounting Engine, customers can account for all categories of leases including real estate, fleet, IT, material handling and other equipment at an asset-level.