

Leasing and SOX Compliance: The Big Picture

Michael Keeler, Ecologic Leasing Solutions - 07 Mar 2006

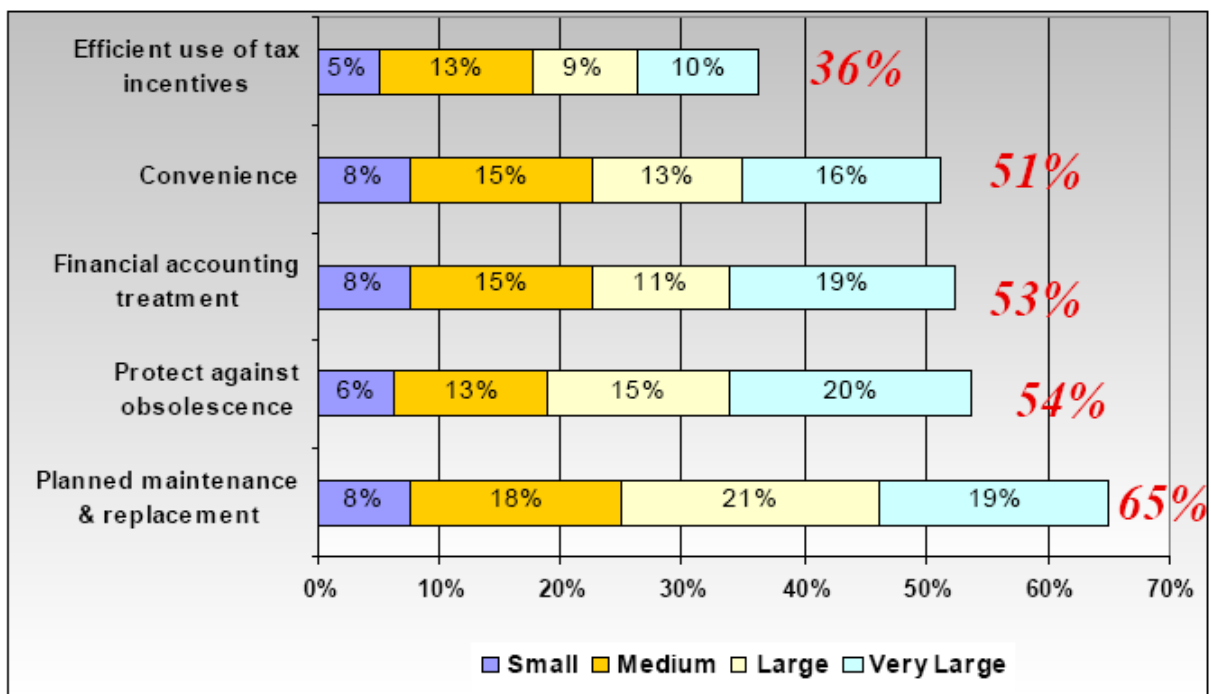
Sarbanes-Oxley (SOX) has had a big effect on the leasing industry and financial executives at lessees are now reforming their leasing operations to improve controls and financial performance. This article examines why companies lease, the convergence of SOX and lease accounting, and the motivation and timing of leasing reform given the other priorities companies face in complying with SOX.

Why Do Companies Lease?

According to a 2004 study by Global Insight commissioned by the Equipment Leasing Association, "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. 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 per cent 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 per cent breaks down by firm size. "Small firms represented 8 per cent 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 Big Business

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)

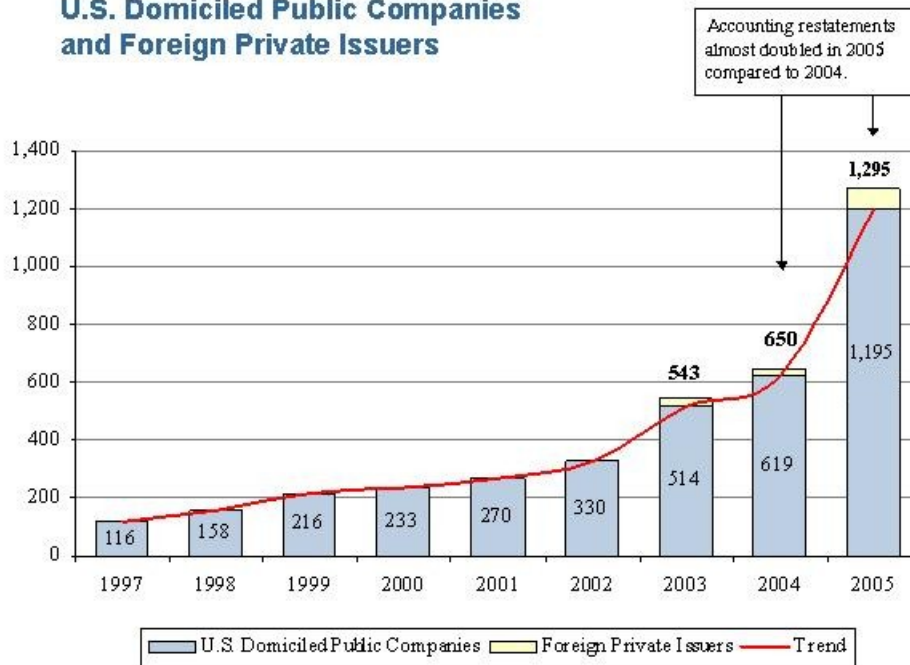
The Sarbanes-Oxley Act of 2002 is complex and demanding. It affects all companies listed on US stock exchanges with a market capitalization more than US\$75m. Furthermore, SOX-related practices are beginning to permeate the world of privately held businesses because many banks and other financing firms 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.

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. According to the SEC (June, 2005), 77 per cent of the 200 companies it reviewed have off-balance-sheet operating leases, with a combined whopping total of \$1.25 trillion in unreported income.

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.

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. 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.
- 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 (GL code, business unit code, etc.) at the asset level.
- Review the financial information required for internal and external reporting and 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. 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. 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.

In subsequent articles over the next several months, this author will explore the compliance requirements for leasing operations, common problems that financial executives at lessees face, examine 20 best practices, and provide a recipe for building a business case to put the best practices to work in your leasing operations.