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Lessee Compliance: Rationale and Requirements Checklists

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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 article looks at the issue of materiality and gives vital checklists to ensure compliance.

Compliance and Financial Performance

Despite Sarbanes-Oxley 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.



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In an effort to meet SOX and other compliance standards, 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 has 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.

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 measure 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'

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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'. 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, optimize economics, and minimize risk 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

Even without government oversight, leasing is complex. Like all corporate lessees, you can suffer significant economic loss unless you both comply with and manage your master lease agreements (MLAs), while also understanding and adhering to all applicable laws and standards. Each law and each jurisdiction - often overlapping - brings its own set of rules and 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.

Manage your Master Lease Agreements Very Carefully - That's Where the Savings Are

1. Make your lease payments, and pay any fees, on time, regardless of the circumstances.
2. 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.
3. Pay and file all personal property taxes as required. Under most leases, the legal owner of the property is ultimately responsible, but most leases pass the financial burden on to the lessee.
4. Maintain adequate insurance.
5. Manage your assets carefully. Keep close track of changes in location, enhancements, upgrades, any alteration at all. Make sure the lessor gets proper notice of changes in accordance with the MLA.
6. Maintain equipment in good working order. Lessees are generally responsible for any damage, loss or repairs. Separate maintenance agreements may be required by the lessor.
7. Adhere to the "material adverse change" clauses and any financial performance requirements.
8. Deliver all required notifications ahead of the deadlines. This is especially important as the end of term approaches - avoid penalties or 'evergreen' payments beyond the term.

Conform to Laws and Standards (Without Getting Lost In the Process)

1. Make sure your attorney properly positions your firm with regard to Uniform Commercial Code (UCC)(1-201(37)). This is where 'security interest' is defined, including the tests for whether a transaction is a 'true lease' or a 'lease intended as security' (disguised security agreement). That question is fundamental to the lessor's protection in the event of bankruptcy. Your attorney must also position you strongly as to Article 2A: Leases. Look for your lessor to require your assistance in establishing their security interest pursuant to Article 9: Secured Transactions; Sales of Accounts and Chattel Paper. At the end-of-term, it is crucial that you, the lessee, make sure the liens are fully extinguished.
2. Follow IRS federal tax "Guidelines" in Revenue Procedure 2001-2811. This lays out the criteria for an advance IRS ruling that a lease is a true lease (aka 'true tax lease') and not a 'conditional sale'.
3. Track changes in organizational structure as well as assets, and be sure you correctly classify both assets and transactions. Being careful in this regard has many benefits:
 - o It reduces allocation errors between legal entities.
 - o It ensures continued auditability of your lease and asset portfolio.
 - o It provides evidence of deferred income tax entries (which are often highly complex).
 - o It improves the accuracy of insurance premiums based on replacement value.
4. FAS 13 (US GAAP), CICA Section 3065, and IAS 17 provide the accounting tests for operating leases. Follow them strictly. Adhere to the standards, not just for disclosure in the footnotes of your annual reports, but to maintain an accurate and consistent accounting of your lease portfolio. Avoid dependence on spreadsheets. They cannot capture the true complexity of a lease portfolio and are highly susceptible to error. And don't rely on lessors for this; they can easily make mistakes. For instance, they may not have the right incremental borrowing rate to test accurately.
5. Comply with all laws related to the management, disposition and disposal of assets. Here are some examples of the myriad of environmental laws and disclosure rules, data protection and privacy laws, and data erasure standards:
 - o Resource Conservation and Recovery Act (RCRA)
 - o Toxic Substances Control Act (TSCA)
 - o Comprehensive Environmental Response Compensation and Liability Act (CERCLA) and the Superfund Amendments and Authorization Act (SARA)
 - o Electronic Waste Laws - state and local requirements vary widely
 - SEC Environmental Disclosure Requirements, Regulation SK - Item 101 of Regulation S-K, 17 C. F.R. § 229, requires a company to disclose material effects of compliance with environmental laws. Item 103 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 303, 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.
 - Gramm-Leach & Bliley Act - Only applies to finance and related industries
 - Health Insurance Portability and Accountability Act (HIPAA) - only applies to health care and related industries
 - Department of Defense(DOD) and National

Security Agency(NSA) Data Erasure Standards -
applies to asset disposal of all companies

The Latest on Leasing, the SEC, and SOX

The SEC is paying special attention to leasing, as mandated by Section 401c of the SOX Act. In June of 2005, in its report on off-balance-sheet practices, the SEC identified lease accounting as an area in particular need of greater transparency. The Commission said that FASB and IAS should reconsider the current guidance on financial reporting for leases. Further, they proposed the possibility of 'reporting all financial instruments at fair value'. These measures may be necessary, said the SEC, to eliminate the 'bright line tests [that] have served to facilitate significant structuring of leases to obtain particular financial reporting goals'.

The report explains that current rules treat lease contracts as if either all or none of the performance occurs at the beginning of a lease. Therefore the balance sheet does not reflect the interest that both parties have in the assets, receivables and payables. Thus economically similar arrangements receive different accounting treatments. The impact of this policy shift is significant - of the 200 companies the SEC reviewed, 77 per cent have off-balance-sheet operating leases totaling \$1.25 trillion.

The SEC set four goals for improving transparency:

1. Discourage transactions and structures motivated more by favorable accounting than by economics;
2. Expand the use of objectives-oriented standards;
3. Improve the consistency and relevance of disclosures; and
4. Focus financial reporting on informing investors, not on complying with rules.

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.

Don't Get Scorched by SOX

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 requires that you tightly supervise leasing with clear, documented policies, processes, controls, and authorizations. SOX demands, for example, that all financial reports include an internal control report; this is designed to ensure that the company's financial data is accurate because the company has adequate controls in place to protect the data. Annual financial reports must also include an assessment of the effectiveness of those internal controls, and the company's auditing firm must then attest to that assessment.

FASB/CICA requires public disclosure of minimum lease payments. That means a lease and asset portfolio maintained in a dedicated information system. Depending on the asset classes, this may also include accounting details down to the debits and credits for each asset. Pulling all that together often takes considerable manpower without outside help. Worse, and all too often, it leads to the use of ad hoc tools (like custom spreadsheets) and undocumented processes.

SOX disclosure mistakes can be seriously costly; in fact, they can cost the CEO and CFO their jobs. If a CEO or CFO signs off on incorrect certification, they may be subject to a fine up to \$1m and imprisonment for up to 10 years. If errors are committed willfully, the fine can be as high as \$5m and the prison term can stretch to 20 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. The Committee of Sponsoring Organizations (COSO) Enterprise Risk Management (ERM) Framework has become the generally accepted standard for evaluating an organization's risk management processes. The ERM Framework is also a very useful tool for remediation under Section 404. It states its purpose as raising 'risk and control consciousness' throughout an enterprise. The Framework recommends all these capabilities as necessary for effective internal controls:

- a control environment
- risk assessment
- control activities
- an information system
- communications and monitoring.

It is vital to simplify controls, mitigate risks and ensure compliance. The key to those objectives is automating the capture of essential information: portfolio data, reconciled documents across the leasing financial supply chain, asset-level lease accounting and reporting. Reduce keystrokes by integrating with your internal procurement systems on the front-end and requiring electronic invoices from your vendors for easy reconciliation. Finally, close the loop on your acquisitions and accounting by also reconciling internally with your G/L and fixed asset subledgers of your ERP software.

Manage Leases and Assets Like an Investment Portfolio Ostensibly, complying with SOX is the goal of a SOX control remediation initiative. But, a myopic approach that only considers compliance 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. In our experience, through effective management, our clients have reduced costs, increased efficiency, and complied with pertinent internal and external authorities. They use the checklists above and apply the best practices we will discuss in subsequent articles.

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.