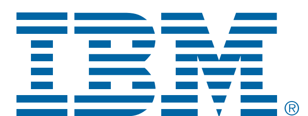
Beyond the Balance Sheet

ASSESSING THE IMPACT OF THE NEW LEASE ACCOUNTING STANDARD

A REPORT PREPARED BY CFO RESEARCH SERVICES, IN COLLABORATION WITH IBM



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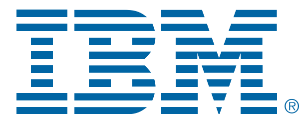

Contents

Transparency and comparability for lease agreements 2

Understanding the scope of change 3

Far-reaching changes in lease processes 6

Opportunities for better asset management 6

Information systems to support change 8

Defining an optimal role for real estate management 10

Getting a jump on the game 10

Meeting the challenges, reaping the benefits 12

Sponsor's perspective 13

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Who should read this report

This report will have the most relevance for finance executives and real estate executives from public companies that are governed by the U.S. Financial Accounting Standards Board (FASB) or the International Accounting Standards Board (IASB).

About this report

In an electronic survey conducted during the summer of 2011, CFO Research Services gathered responses from 179 senior executives on their plans for dealing with changes in lease accounting proposed by FASB and IASB. All of the respondents were employed at companies with annual revenues in excess of $1 billion.

Respondents work for companies in a broad range of company segments, as follows:

Annual revenue (in US$)	
$1 billion–$5 billion	59%
$5 billion–$10 billion	17%
$10 billion–$20 billion	13%
$20 billion+	12%

Titles	
Director of finance	25%
Chief financial officer	17%
Controller	16%
VP of finance	16%
EVP or SVP of finance	7%
Treasurer	6%
Corporate real estate executive	5%
CEO, president, or managing director	1%
Other	7%

Region	
United States	55%
Asia	26%
Europe	18%
Other	2%

Note: Percentages may not total 100%, due to rounding.

Respondents work for companies in nearly every industry. The financial services industry (including real estate and insurance) and industrial companies (including manufacturing and auto) are particularly well represented.

In addition, we interviewed the Chief Accounting Officer at FedEx to gain insights into the implications of a revised lease accounting standard for a multinational corporation with an extensive leasing program.

Transparency and comparability for lease agreements

At many companies, real estate and asset leasing are a central component of financing strategies. For these companies, leasing can be used to optimize cash flow, maximize liquidity, reduce cost, and improve return on investment. Yet, the way in which leases are reported by public companies is currently under review, and in some cases substantial changes are expected from the financial accounting standards boards that govern the U.S., Europe, and many countries.

The proposed FASB/IASB lease accounting standards changes are expected to be finalized in 2012 and to go into effect in 2015. FASB and IASB have issued drafts of jointly proposed changes which essentially eliminate all operating leases from the income statement and move them onto the balance sheet as a capital expense. Therefore, companies with many operating leases should begin now to understand the impact that the changes may have and how best to prepare.

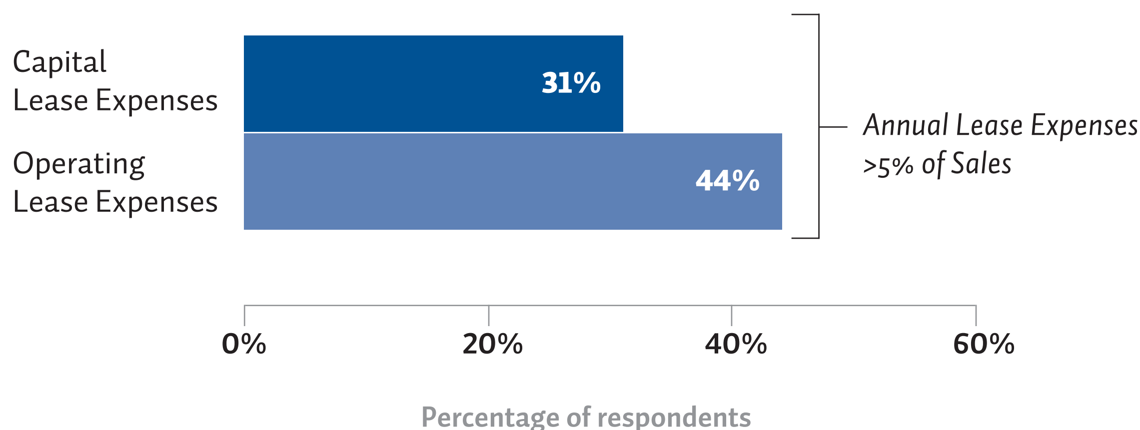
By eliminating the distinction between operating and capital leases, the new standard will move all lease agreements onto the balance sheet for the first time. Under the proposed changes, all lease agreements will be treated as "right-to-use" assets—essentially converting all operating leases under the current standard to capital leases. These changes will impact lease-heavy companies, in particular, as they gather and report financial information from their leasing activities.

The rationale behind the proposed changes is to provide "users of financial statements … a complete and understandable picture of an entity's leasing activities."[1] The practical result is that lease payments would no longer be treated as operating expenses, and instead would appear on the balance sheet, with depreciation and interest expenses offsetting the "right to use."

How will large companies prepare for the changes, and what effects do senior executives expect a revised lease accounting standard will have on the way they manage leased assets to optimize financial performance? CFO Research Services, in collaboration with IBM, conducted an online survey to better understand the challenges and opportunities senior finance, real estate, and other executives anticipate will result from the implementation of a new lease accounting standard. We were interested in larger companies that are likely to have a large number of leasing arrangements.

[1]Discussion Paper, dated March 19, 2009, available at http://www.fasb.org/draft/DP_Leases.pdf.

FIGURE 1: Companies that currently rely heavily on operating leases will be affected the most by the change in the lease accounting standard.



Our survey examined the impacts that the new leasing standard may have on how senior executives understand and manage their businesses. We asked senior finance, real estate, and other executives what effects they expect the new lease accounting standard will have on their companies—in particular, the effects on how they measure and manage company performance—and how they are preparing to manage those effects. What changes might companies have to deal with beyond the balance sheet? How do they plan to cope, for example, with the need to track lease transactions more closely, and which corporate systems are likely to require investments?

In our research, most respondents (92%) from large companies indicate that they believe that, at this point in time, their companies are not completely prepared to manage the transition to the new lease accounting standards being considered by U.S. and international accounting boards. Moreover, survey respondents are looking for economical solutions to the expected increase in accounting requirements to avoid adding or extensively retraining staff. Our research also shows that executives have mixed responses as to whether or not the anticipated lease accounting changes will have the desired effect of providing more financial transparency.

Understanding the scope of change

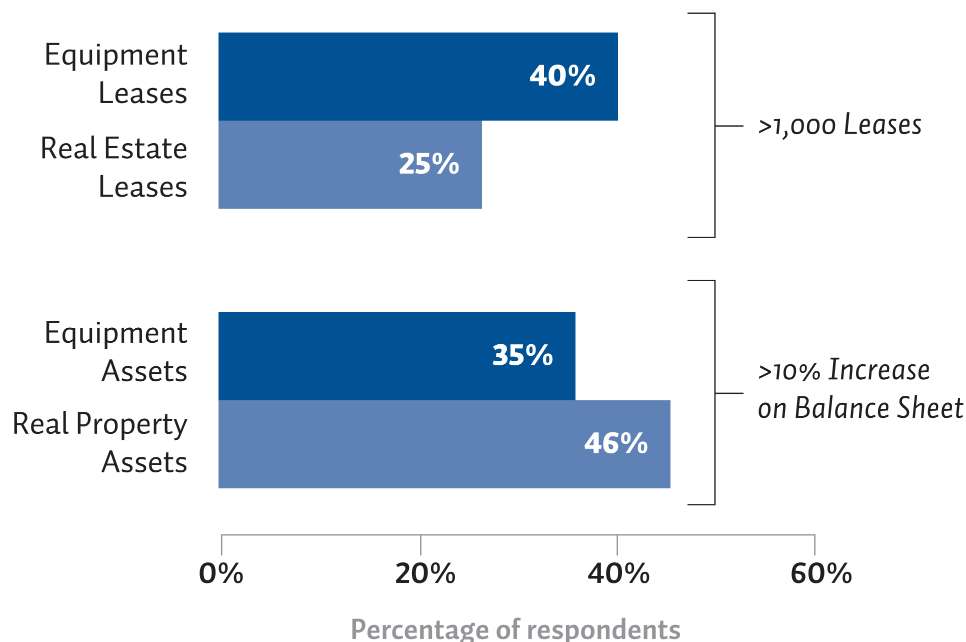
Companies that rely more on operating leasing than on capital leasing, of course, will need to spend the most effort to understand the consequences of moving all operating leases onto the balance sheet. Existing capital leases will be treated no differently, but on day one of the implementation (as currently envisioned in the FASB/IASB drafts) all outstanding operating leases will move off the income statement and onto the balance sheet for the remainder of the lease term.

In our survey responses, operating lease expenses on average total more than capital lease expenses. (See Figure 1.) For 44% of the companies in the survey, current operating lease expenses exceed 5% of sales while only 31% of respondents value their companies' capital lease expenses that high.

Companies that have higher percentages of capital leases will experience less disruption with the new standard. Based on survey responses, these companies tend to have a more positive view of the change than companies with higher percentages of operating leases. This may be attributable

> Companies that rely more on operating leasing than on capital leasing will need to spend the most effort to understand the consequences of the proposed change.

FIGURE 2: At many companies, the number of equipment leases that will be managed is disproportionate to the value represented by those leases.



to the lower levels of disruption—and cost—that capital-leasing companies expect.

At many companies—especially those with a greater share of value tied up in operating leases—financial officers are starting to plan for collecting and assessing existing lease portfolios, in order to get their arms around the magnitude of change they will have to cope with. Businesses with substantial portfolios of real estate leases—retail, financial services, and telecommunications services, for example—may be particularly concerned, as real estate leases are likely to involve relatively large expenses that must be capitalized.

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But survey respondents also indicate that it would be a mistake to simply ignore the impact of equipment leases. For a number of the companies in our survey, equipment leases were top-of-mind. For example, a vice president from the manufacturing industry states simply, "Our leases are equipment, not real estate," while the CFO of a construction company acknowledges, "Equipment leases are our biggest problem."

One issue is that the number of equipment leases for most companies is greater than the number of real estate leases, but the average value of individual equipment leases is almost certain to be lower than for real estate. (See Figure 2.) As a result, executives appear to be concerned that their companies will derive little, if any, payback on the investment that will be required in systems and processes to transition to the new standard. For example, a company with a larger number of smaller leases (e.g., office equipment, copiers, printers) may find their costs to track, evaluate, and monitor their portfolio of leasing arrangements rising, with little tangible or financial benefit from the change.

Simply put, companies tend to have more equipment leases than real estate leases, and so it may take more time and effort to catalog and categorize all equipment leases to prepare for conversion. As a CFO in manufacturing writes, "It will be a waste of time capitalizing immaterial, small items that will now require our time to book and our auditor's time to review."

However, in environments where small assets are technologically intensive, mission-critical, and widely deployed across an enterprise (e.g., medical devices, IT servers), companies may wish to continue to consider leasing to reduce the risk of technological obsolescence.

Overall, very few executives responding to our survey expect a positive impact on any financial metric we asked about, aside from EBITDA. (See Figure 3.) Almost one in five (19%) think that EBITDA will improve permanently, presumably as a consequence of replacing a large amount of operating expense with debt and amortization. One respondent from the financial services industry writes that he expects that "debt/assets ratio will be temporarily improved, amortization will be increased, [and] operating cost will be reduced."

Not surprisingly, the greatest concerns are over the impact on financial ratios such as debt-to-equity (D/E ratio) and return on assets (ROA) as more debt is loaded onto the balance sheet.

The impacts are not expected to be felt uniformly across all metrics. Seventy percent of respondents expect the change to have little or no effect on cash flow, while approximately 60% expect neither negative nor positive impacts on their companies' market capitalization or credit ratings. More respondents (21% and 24% of respondents, respectively) think that working capital and return on equity will worsen, but primarily these effects will be temporary.

Not surprisingly, the greatest concerns are over the impact on financial ratios such as debt-to-equity (D/E ratio) and return on assets (ROA) as more debt is loaded onto the balance sheet. Half of respondents expect their D/E ratio to worsen, and a little more than half think ROA will be impacted negatively. The pessimistic outlooks for D/E ratio and ROA is one of the more noticeable correlations to a negative perception of the proposed standard overall. In the survey, even a temporary decline in either of these two metrics correlates more to a negative view overall than do temporary declines in any of the other metrics.

Nearly a quarter (23%) of respondents expect the impacts on D/E ratio and ROA to permanently alter the capital structure of their companies. These are the only two metrics on which executives believe the new standard will have permanent negative effects. Respondents appear to be most concerned about the impact on financial ratios resulting from increasing the amount of debt on the balance sheet while equity is correspondingly squeezed out. Similarly, the asset side of the ledger would be inflated, affecting ROA.

Asset efficiency and debt management will rise to the top of the agenda for many companies.

In particular, the new standard may make it more difficult for management to achieve targeted rates of return. A senior vice president from a U.S. bank writes, "Capital will have to be provided for additional assets, and ROA will worsen as return will be temporarily worse and assets will permanently increase." Even for companies outside of the banking industry that do not have mandated capitalization requirements, the potential effects of a revision of lease accounting rules can have serious consequences. For example, companies must be careful about violating bank covenants when they are forced to increase their debt levels. An executive in manufacturing says his company must "understand the effect on capital spending and the effect on bank covenants."

Asset efficiency and debt management will rise to the top of the agenda for many companies as they consider the new lease accounting standard. Measurement of assets may shift from reducing operating costs in the short term to increasing return on assets over the long term. This change could result in an increased focus on capital planning and long-term financing, including the company's ability to obtain that type of financing or to generate necessary cash flow. Consequently, the focus may shift somewhat from operations and short-term financial management.

As one vice president at an Indian financial services firm writes, "Capital will have to be increased and debt consolidation will be key in giving satisfactory numbers at the quarter end." Treasurers, CFOs, and others responsible for financial decision making will carefully consider their alternatives for capitalization (e.g., "leverage ratios and ability to raise money in the market by way of bonds or other instruments," "allot more funds and increase the liquidity of the firm").

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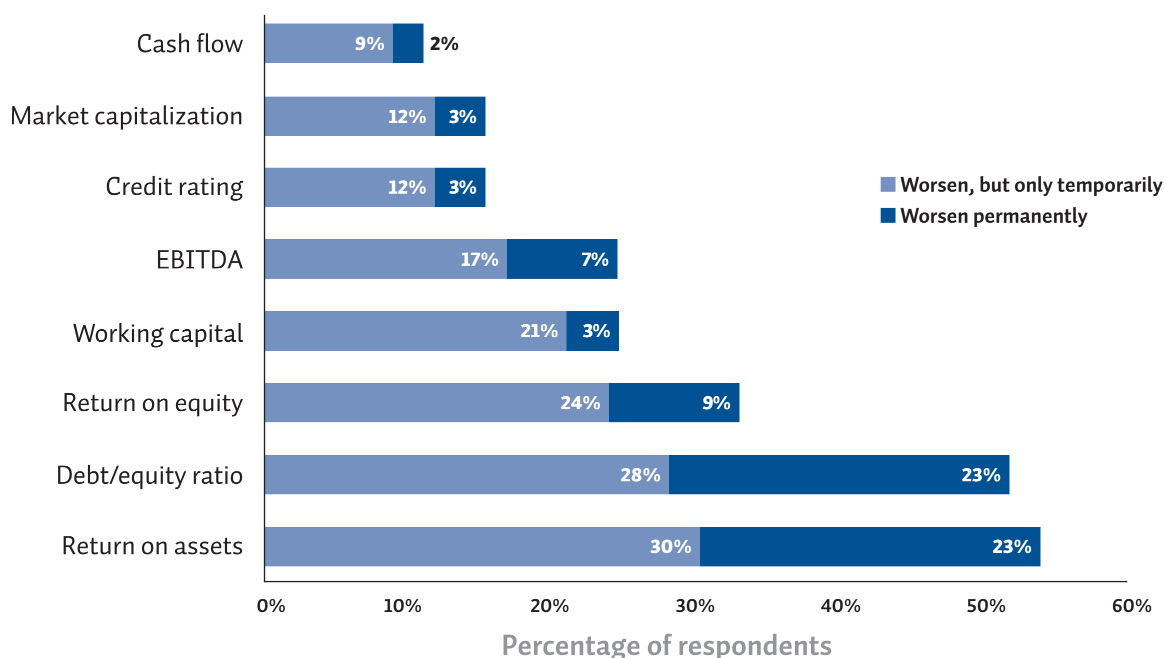
FIGURE 3: **Executives exhibit the most concern over permanent worsening in debt/equity ratios and return on assets.**

In your judgment, what effect do you expect that the changes in lease accounting rules will have on the following financial metrics for your company?



Far-reaching changes in lease processes

Overall, senior executives anticipate that their companies will need to make far-reaching changes in order to accommodate the new lease accounting standard. The task of training staff is of particular concern: three-quarters of respondents say that accounting and finance staff will require additional training to ensure that affected departments come up to speed on the requirements for the new standard, and to change company processes for evaluating lease transactions. (See Figure 4.)

Companies must prepare for the increased level of work required to adapt to the new standard. A senior vice president from a U.S. financial services firm notes that his company will have to "more closely review lease/buy transactions to ensure that the best economic outcome is achieved, since both will end up on the balance sheet." This will "require significant investment in new accounting tools and processes."

One executive in the U.S. aerospace and defense industry says that implementing the standard will involve "a costly assessment of existing leases and how they need to be re-booked, and then massive training for internal lease and accounting staff." In the United Kingdom, a director of finance writes about the need to drive change down through multiple levels of his organization: "It's definitely going to involve further training for staff. These changes often have more of an effect at the grassroots level than they do higher up."

At the same time, most companies expect to manage the change process without ramping up on personnel, with fewer than half of the respondents saying they will add staff. Many finance functions will be directed to make do with what they have, which could stress thinly-spread organizations even more.

Opportunities for better asset management

Beyond noting the cost of implementation, executives in our survey are still working to determine what the proposed changes in the lease accounting standard will mean for their company's financial performance. As seen in Figure 4, a

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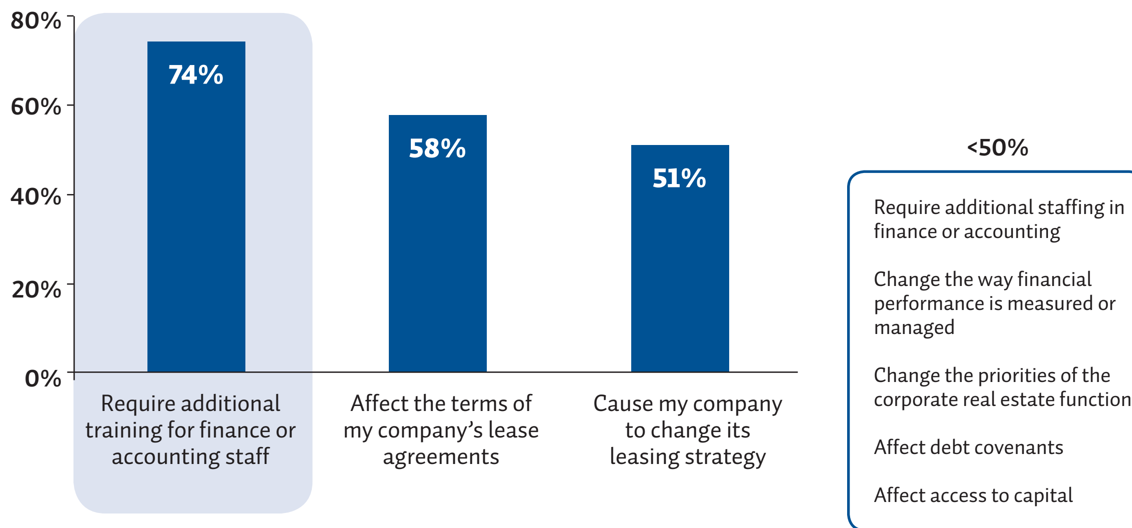
FIGURE 4: Most executives in our survey agree that their companies will need to conduct additional training to adapt to the new lease accounting standard.

Converting operating leases to capital leases will…



Percentage of respondents saying that the impact is "likely" to occur

majority (58%) of respondents believe the new standard will affect the terms of their companies' lease agreements, and about half (51%) expect that they will be changing their leasing strategy. For example, one financial services executive in our survey anticipates that the new standard will mean that his company will "shorten terms on leases—renegotiating existing leases and implementing shorter terms for all new leases."

In addition, anywhere from 70% to 80% of respondents expect their companies will have to make either moderate or substantial changes in accounting and compliance processes, and between 50% and 65% see moderate or substantial changes in real estate management, asset management, IT systems and applications, tax policies and practices, and even business and operating processes.

The effects of the new standard have the potential to ripple throughout an organization. "One of the more complicating components of this pronouncement is that it impacts a number of non-accounting functions," points out John Merino, Chief Accounting Officer at FedEx. Mr. Merino estimates that the company has around 14,000 leases globally, "ranging from aircraft leases to facilities to copiers in our office locations." (FedEx also has an extensive truck fleet, but Mr. Merino notes that the company already owns most of this fleet instead of leasing it.)

In many cases within FedEx, lease renewal decisions are made by local operations managers. Once the new standard goes into effect, says Mr. Merino, it will be critical to "make sure that local managers understand and are educated in how to make those judgments and have a mechanism to provide that information to the accountants."

The treasurer at a Danish manufacturing company makes a similar point in our survey. He writes, "We will consider long-term leasing of equipment with the same carefulness as capex that is purchased and financed through bank loans—this has not happened before."

The process of making lease-vs.-buy decisions is likely to become more involved, particularly for real estate leases. The economics of large or long-term leases will change, and each lease will need to be re-examined and re-valued in order to determine the best

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More pessimism in the U.S. than outside of it

Concern over the changes appears to be more widespread among U.S. companies than outside the U.S. More than half of U.S. respondents (54%) think the change in lease accounting will have a negative impact.

The greater transparency and comparability anticipated from the new standard may be seen as benefits more frequently outside of the U.S., where a great many more local reporting standards can be in play. About a third (32%) of respondents from non-U.S. companies have a positive opinion of the lease accounting change. Non-U.S. companies are also more likely to say that nearly all stakeholders will have a more accurate understanding of company performance as a result of the change.

U.S. respondents, by and large, think the accounting change will have no effect on stakeholder understanding of company performance. However, U.S. respondents are more likely than non-U.S. respondents to believe that the change will result in a less accurate understanding on the part of investors or shareholders—possibly because of the deterioration finance executives expect to see in their companies' debt/equity ratios and return on assets as a result of the new standard.

Indeed, among U.S. respondents, one-third (33%) expect a permanent decline in D/E ratios, and 35% expect a permanent decline in ROA. These are much higher rates than seen outside the U.S., where only 10% and 9%, respectively, expect permanent declines in D/E ratios and ROA.

In addition, in our survey, lower values of assets affected correlate with higher concern with a permanent decline in D/E ratios, suggesting that companies where leasing is less important may not be as well prepared to cope with the financial consequences of the proposed change. The U.S. companies in the survey more frequently tend to fall into the lower-value categories for equipment assets, in particular, than do non-U.S. companies.

In our survey, 70% to 80% of respondents expect their companies will have to make either moderate or substantial changes in accounting and compliance processes.

financial strategy. A controller at a large Japanese manufacturer writes that reconfiguring operating expenses as capital expenses or investment will mean that "more validation and risk analysis" will be required for those expenses than previously.

The process of making lease-vs.-buy decisions is likely to become more involved, particularly for real estate leases.

The significance of introducing more analytical rigor into leasing decisions is summed up by Mr. Merino: "Once the rules are finalized, putting in place the systemic and internal control functions that allow us to revisit and challenge the lease term consideration will be critical. When you have as many leases as we have, as dispersed throughout the world as we have, owned by as many individual operating departments as we have, you've got to have some mechanism in place to be able to assert to yourselves and to your auditors, frankly, that you've updated your best estimate of the lease terms, the renewals, etc."

In fact, in Mr. Merino's eyes, the greater transparency and comparability that results from putting all types of leases in the same basket can be one of the benefits of the change, allowing companies to make better-informed decisions. The bottom line, in his view: "Now we can really talk. What are the renewal terms? What's the best transaction structure?"

Information systems to support change

Respondents also indicate that their companies will require adjustments to every type of information system they employ, ranging from reprogramming systems to upgrading or installing entirely new systems or applications. (See Figure 5.) For example, to determine the term of each lease, companies will need, first, to capture and analyze detailed information from within leases such as renewal and termination options, and then combine this with market conditions and economic indices. Add to this new controls for review, approval, and auditing, and organizations will require substantial system upgrades in order to manage very large quantities of information.

The most immediate need will be in accounting systems, and in associated asset management and real estate management systems, to ensure compliance. For some, the update may be substantial: a director of finance in the technology industry writes that his company's "entire accounting system has to be changed." Another respondent—the treasurer at a manufacturing firm—writes of his concerns in the near term: "The initial cost of adoption of this new accounting standard will be a large negative impact on earnings and capital in the year of adoption due to the

projected cost and new system requirements." And a third executive says, simply and directly, that his company will "need better systems [as well as] people (this will be a very costly change!)."

Approximately two-thirds of respondents (67%) say that they will need to make some level of change in financial transaction processing systems. Beyond these transactional systems, 60 percent of respondents expect to make changes in planning, budgeting, and forecasting systems, while about half of the respondents see the need for changes in tax planning and compliance systems (52%), as well as in business intelligence or performance reporting systems (49%).

Sixty percent of respondents also anticipate the need for changes to enterprise asset management systems, while 56% expect to address real estate and facilities management systems. A vice president of finance in the chemicals industry writes that one of his biggest challenges will be to "make our lease tracking systems more auditable, with better controls."

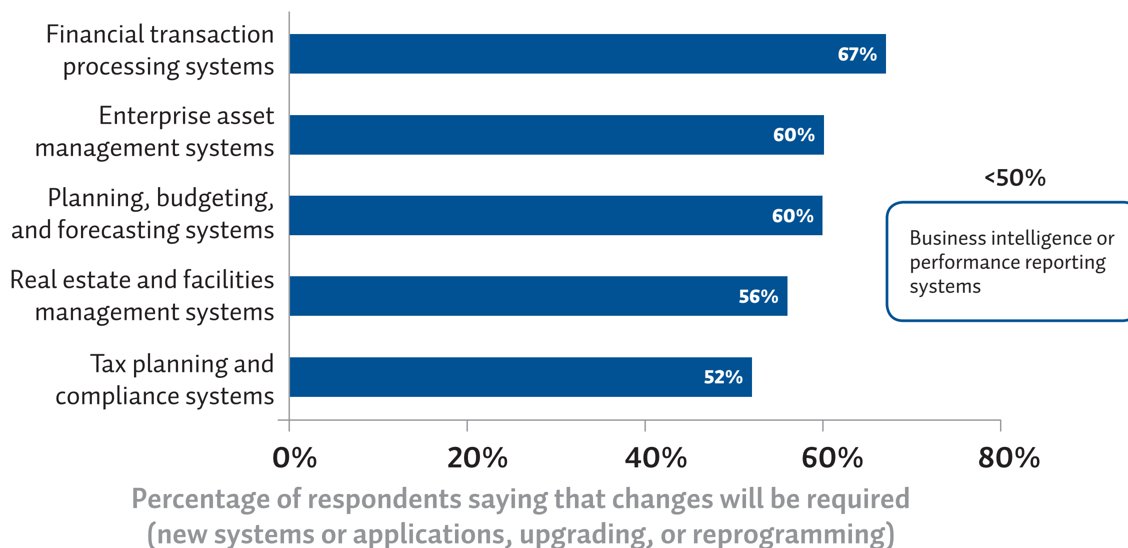
Mr. Merino at FedEx talks about the advantages of having already started down the path toward better lease tracking: "We were already in the process of developing and deploying a global contract management system. That initiative represents the fundamental, critical first step for us, which is to have one consistent way to capture the underlying information about contracts globally, including leases and the attendant details. Having that in place, with the information available on a transactional level, will then allow us to apply the proper accounting to calculate our lease liability."

With this kind of enterprise-wide resource, Mr. Merino continues, FedEx will be able to provide the data management and analytical support operations managers need to make local decisions. "At the end of the day, I can't tell you if we're going to renew the lease on some operating terminal; that's a decision based on the operators' needs and their assessments," Mr. Merino says. "But what you need to centralize is the tool and the internal control functions that enable you to be confident that those judgments are being made accurately and updated in the field." He adds, "And that's a significant change, because I don't think any company really has as robust and complete a system as they need to capture all these things."

Sixty percent of respondents anticipate the need for changes to enterprise asset management systems, while 56% expect to address real estate and facilities management systems.

FIGURE 5: Senior executives identify multiple systems and applications that will need to be modified in response to the proposed change in the lease accounting standard.

What kinds of changes do you expect your company will have to make to the following information systems or applications in order to handle the changes in lease accounting rules?



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Some companies may explore outsourcing to gain information management capabilities they currently lack. As a senior vice president in a Singapore-based financial services firm writes, one alternative his company is considering is "to outsource to some external firm that can help us to manage the leases that we never had to track so rigorously, e.g., the plant and equipment."

The bottom line is that management will need to understand the capabilities they have on hand that will allow them to manage the change. Mr. Merino cautions, "Probably the most important challenge is developing the transaction-level systems and protocols on a global basis to keep track of this [change in accounting]. I think companies probably will significantly underestimate the requirements. Anyone who is foolish enough to think they can do this on a spreadsheet is only a few quarters away from having a big problem. So, developing transactional systems and contract management systems, and leveraging lease accounting software to do so on a global basis, is first and foremost the most important challenge."

Defining an optimal role for real estate management

As the average value of real estate leases is much higher than that of equipment leases, the role of the corporate real estate function also must be factored into management decision making. One respondent writes, with some degree of understatement, "I think the treasury function will be a lot more interested in and will influence real estate leasing decisions." Leases for storefronts, warehouses, distribution facilities, production facilities, and office space can no longer be treated as operating expenses that are the sole responsibility of business unit or departmental management. Instead, they will automatically be scrutinized as capital investments, affecting the capital structure and financial metrics that historically have been the concern of treasury functions.

"I think companies probably will significantly underestimate the requirements. Anyone who is foolish enough to think they can do this on a spreadsheet is only a few quarters away from having a big problem," warns the chief accounting officer of a large transportation and logistics firm.

The impacts on the corporate real estate function are likely to vary from company to company. In companies where corporate real estate has already been integrated into management decision making, the need to change could be minimal. As one director of finance from the telecommunications industry tells us, "Corporate real estate supports strategic initiatives and therefore would not be affected much: those needs will still exist, we just will have to recast their operating metrics."

"Probably the most important challenge is developing the transaction-level systems and protocols to keep track," according to a chief accounting officer we interviewed.

Other companies will have a much different experience. Another executive writes, "The real estate function will feel effects not only on the operating level, but also on the financial level. If we purchase and finance the real estate assets, the valuation of the assets will [in turn] make changes in our financial ratios." Corporate and finance management must be able to gauge the extent of these impacts both to make the most effective decisions on financing strategies and to manage the perceptions of external parties with a stake in company performance.

Getting a jump on the game

Our survey results suggest that many companies are still in the beginning stages of preparing for the change, and fewer than 10% of respondents feel that they are adequately prepared for the change now.

Mr. Merino firmly believes that the time to start preparing for the new standard is now. "While 2015 sounds like a ways out," he notes, "keep in mind we also have to have three years of comparable periods going backward with this retrospective application. So, you're going to have to be calculating and keeping your books on a dual basis for those prior three years." He warns, "In order to capture the information, to be able to do it correctly, the lead time is substantial. … I think taking the time to really appreciate how much of an implication the standard will have for your organization is time very well spent."

Companies can take steps to be prepared even before the final standard is issued, and, in fact, they may find in the necessity to change a motivation to improve their own asset management practices. Several respondents lay out specific plans or processes

Fewer than 10% of respondents feel that they are adequately prepared for the change now.

for preparing for and implementing the new lease accounting standard. A director of finance at a large U.S. firm in the wholesale/retail industry writes a brief, soup-to-nuts overview of the effort the changeover will require: "Understand impacts, gather historical information for comparative statements, educate stakeholders, develop system requirements, plan for system conversion."

A VP of finance from the U.S. healthcare industry offers a similar plan:

"1. Build pro-forma results and prepare board and rating agencies for the change.
2. Redesign the capital planning process. Develop policies for corresponding accounting and asset management.
3. Train staff and constituency on the new standard.
4. Redesign accounting systems to accommodate the changes."

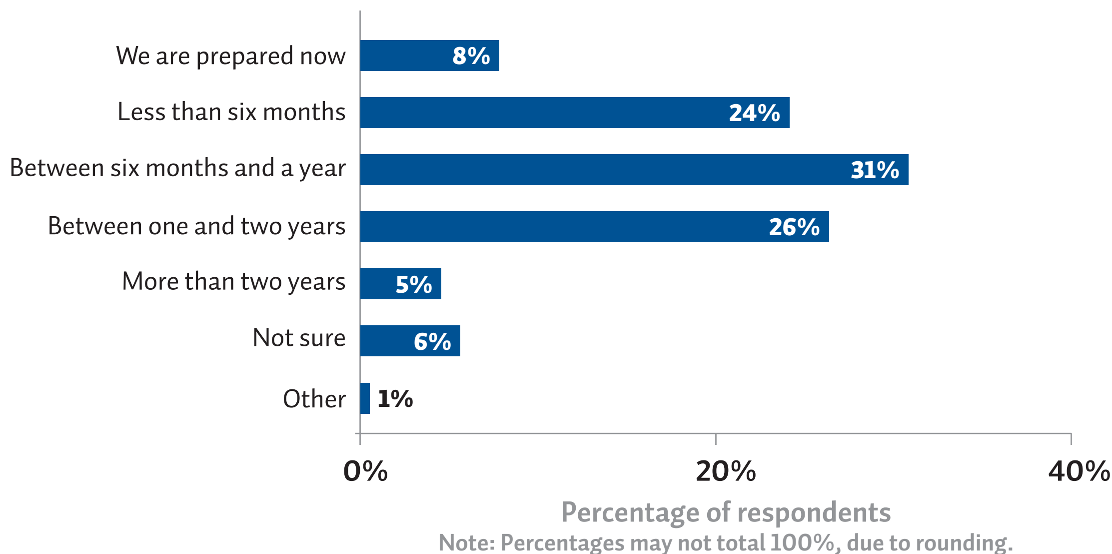
However, only one in five companies in the survey (21%) have already prepared pro-forma financial statements to gauge the impact of the new lease accounting standard. Two-thirds of the companies either plan on preparing pro formas or are still considering it, but haven't yet done so. (See Figure 7.)

Several respondents note that the first order of business is to understand the size and scope of the proposed change, starting with creating a consolidated inventory of all leasing arrangements and then determining the optimal treatment for each lease under the new standard. A vice president in the U.S. consumer goods industry summarizes the sentiments of a number of his fellow respondents when he says that his most immediate need is to "complete an inventory of leases and categorize by type and materiality to assist with implementation of the new standard." Another respondent, who is a director of finance in the chemical industry, writes that his company will start by laying the groundwork for managing the change: "Look now at the leasing arrangements for upcoming renewals in anticipation of the change. Identify all equipment leases, work with the fixed asset system to program any changes, and work with external auditors to be sure to implement the revisions correctly."

In any case, it will be important to do the work up front to make sure all parties—shareholders, financing institutions, auditors, and management alike—have a good understanding of the impacts on performance metrics they can expect to see. These include any changes that will show up on the financial statements they rely upon, as well as changes needed in systems and processes to manage the types of assets that will be affected.

FIGURE 6: Only a handful of companies in our survey believe that they are fully prepared to make the change to the new accounting standard.

Assuming the effective date for the new lease accounting rules is January 1, 2015, how much time do you estimate your company will need in order to be prepared to implement the rules?



Note: Percentages may not total 100%, due to rounding.

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Meeting the challenges, reaping the benefits

Of course, final decisions can't be made until the new accounting standard is actually issued, which is always an uncertain process. But there are initial steps any company can take now to ready itself, and these are also basic tenets of any effective asset management strategy.

The first step is getting your arms around the problem: know what you know, and, importantly, know what you don't know. Make sure you understand how many leases you are dealing with, what kind, who's responsible, what terms are affected, etc.—gather all the data you'll need to take a broad look at the impact on the company. For some, this may mean significant changes to internal reporting processes and lease management systems.

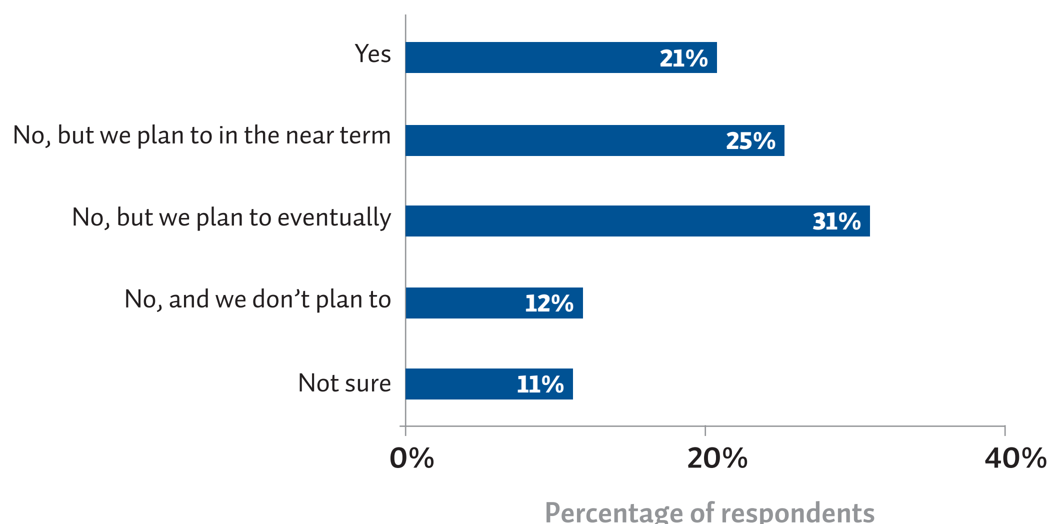
Once you have the basic data in hand, do a formal and structured estimate of the size of the changes involved. How different will your balance sheet look? How about your income statement? Running pro formas or even keeping parallel books during the interim may be the most prudent course for determining the ultimate impacts of the accounting change and preparing your company accordingly.

Finally, when you understand the nature and size of the changes in financials, then you can plan on how to manage those metrics. Some companies are already looking ahead to revise their leasing strategies: a CFO from the wholesale/retail industry writes his company will "begin thinking about entering into any leases today which continue on beyond 2015 and ensure they are structured as efficiently as possible, considering changes down the road." And in understanding the impacts on leasing and financing strategies early, companies will also be better equipped to develop targeted communication strategies for both external and internal stakeholders to reduce the chance of surprises.

By starting now to understand and manage the change—in processes, people, and systems—companies can mitigate the cost and time involved while also preparing themselves to take full advantage of the benefits offered by increased standardization and comparability in leasing strategies.

FIGURE 7: **Finance executives are still making plans to quantify the magnitude of the change.**

Has your company prepared pro-forma financial statements to assess the impact of the changes in lease accounting rules?



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Sponsor's perspective

So, what are the realities that your company needs to consider?

Real estate and asset leasing will remain an important source of finance for many companies. Leasing can provide flexible payment options for companies to preserve cash versus paying up front; help companies upgrade to newer solutions by lowering total cost of acquisition; and maximize liquidity by freeing up cash and preserving credit lines for core business needs. And leasing can reduce the risk of technological obsolescence with mid-lease upgrades and end-of-lease options.

The addition of operating leases to the balance sheet accounting of public companies will add billions in new assets and create a significant increase in the complexity and operational workload of finance, real estate, and asset management functions within mid- to large-sized companies.

Yet, 92% percent of respondents consider their companies *not prepared* to capture, organize, and report the balance sheet impact on their company today, let alone implement necessary management processes to manage or reduce this impact in a sustainable, ongoing manner. Furthermore, new information, new processes, and new reporting requirements (such as management of lease term assumptions related to renewal options that create significant economic incentive to extend or terminate leases) will require most companies to implement major system upgrades or new lease accounting systems to comply with the proposed standard.

We know this because we sat down with senior finance and real estate executives from many of the world's largest and most impacted companies—those that are IBM customers and those that are not—to gain a broad understanding of the system requirements needed for these changes. We established a customer advisory board and focus groups, interviewed analysts, and underwrote this important survey with CFO Research Services; and they shared the financial and operational impact on companies around the world.

As a result, we at IBM have a strong understanding of the challenges, opportunities, and system requirements that companies face as a result of the new lease accounting standard:

First, companies require automated business processes to reduce the time required to load necessary lease information, alert to necessary actions, simplify management of complex financial assumptions, and streamline delivery of auditable financial reports on a quarterly or annual basis. These requirements create a need for a single, consolidated system with robust pre-built lease accounting capabilities for all classes of leased assets—real property, fleet, equipment, and other leased infrastructure—built on a single technology platform.

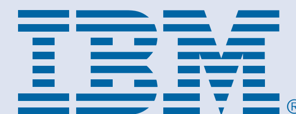
Secondly, companies require an enterprise-class system that scales beyond the tracking of information for thousands of leases to track hundreds of thousands of financial and operational assumptions, decisions, and data changes related to these leases with detailed auditing of approvals—one that provides consistent global management of approvals and that audits data changes.

Finally, beyond compliance, the new standard will highlight differences in the capital allocation strategies of companies as never before. This new standard creates the opportunity for companies to gain increased investor confidence and competitive advantage through increased asset efficiency. As companies undertake the detailed work to size their lease portfolios, many will look to eliminate under-utilized assets from the balance sheet before they impede financial ratios or trigger debt covenants. To achieve this reduction, they require simple-to-use strategic real estate and asset planning solutions that deliver rigorous scenario analysis based on contract terms and market conditions to forecast impacts on balance sheet, profit and loss statements, and income statements for new leases and lease renewals.

In conclusion, the results of this survey serve to underscore the profound operational and financial impacts that the new lease accounting standard will create for publicly traded companies in the U.S., Europe, and many countries. Many will struggle with the vast amounts of information required, the increased complexity necessary to manage this information, and the detailed reporting requirements. The results also highlight the need for new capital planning analysis, processes, and reports to support the change from short-term operational management—characterized by expense management—to a longer-term financial management focus—characterized by increased return on assets.

For more information about IBM's lease accounting solutions, please contact your IBM sales representative or IBM Business Partner, or visit the IBM website: **ibm.com**/software/tivoli/lease-accounting

IBM can help customers accelerate preparedness with the proposed lease accounting standard, streamline real estate and asset management processes, and help increase return on leased assets.



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