Risk Watch

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AUDITING LOW-HANGING FRUIT

By reviewing leases, internal auditors can help their organizations manage their complexity and risks.

Low-hanging fruit orchards are often planted somewhere between the hills of complexity, sea of silos, and forest of forgetfulness. Internal auditors who can harvest such fruit can bring quick value to their organizations.

One area that is ripe for auditing is leasing of portable assets such as IT, medical, or material-handling equipment. These audits can help an organization:

- Ensure it only pays for the equipment received.
- Lower effective interest rates.
- Ensure the benefits of the lease are achieved.
- Avoid contractual penalties and defaults to lessors and other lenders.
- Maximize tax benefits.
- Avoid issuing financial restatements.

There are opportunities to provide value at various stages in the leasing process, from contracting through the duration of the lease term to the end of a lease. For example, many leases are complex, yet finance, IT, and legal functions aren't always coordinated to ensure the economics make sense and legal exposures are protected. Also, because leases often are bundled in larger IT agreements for software and services, lease terms and conditions may receive less focus. In decentralized organizations, the lack of local expertise may result in violations of corporate finance policies or missed covenants on other loans.

During the lease term, organizations frequently have problems tracking the assets under lease, which can create challenges at the end of the term. Also, most leases have strict notification requirements when unexpected events such as loss or damage occur. The people who negotiated the lease may have moved on to other responsibilities and the knowledge of how to handle such instances may be lost. As a result, at end of the lease term, problems often arise related to refreshing the lease or avoiding painful contractual triggers.

Analyzing for "Uglies"

James Burns, CEO of Blue Sky Capital Strategies and a former corporate treasurer, shed light on the cause of these challenges in a recent presentation to the Association for Financial Professionals. He indicated that, unlike conventional debt financing where lenders are all governed under a single agreement, such as a bank revolver or bond indenture, documentation for lease transactions, called master lease agreements (MLAs), may vary significantly from lessor to lessor. Burns advised internal auditors to look at the "ugliest" aspects of the legal document and the processes to which they apply:

- **Start with board resolutions of corporate authority.** There should be a policy for centralizing lending

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decisions in finance/treasury. Also, auditors should evaluate awareness of the risk if these policies are violated. An IT security manager approving a purchase may not be familiar with the risks associated with a contract containing an embedded lease.

- **Analyze all "mandatory interim rent" provisions** on the front end of leases that increase the effective interest rate paid. This is especially important if an accurate rate would lead to the rejection of the overall capital project.
- **Analyze all provisions where lessor notification is required,** including exact conditions and timing. Then, start the internal business dialogue early enough that the organization can make an informed decision and notify the lessor as agreed.
- **Ensure centralized tracking of leases for accurate U.S. Generally Accepted Accounting Principles reporting and tax compliance.** Individuals with the knowledge about how the leases of physical assets actually operate must be involved with the tracking.
- **Analyze all provisions for a missing asset "casualty event."** These provisions frequently trigger a termination event that leads to a stipulated loss payment at a value that is far higher than the fair market value of the asset.
- **Analyze all provisions for end-of-life notifications.** If these strictly enforced notifications are missed, then automatic payments may be triggered under compulsory extension provisions.

In addition to these economic benefits, auditors can help identify breaches of other loan covenants that could result in penalties or a difficult future negotiation with the lessor. Moreover, they can help ensure appropriate financial reporting of the leases. For example, new payments triggered under lease provisions might lead to under-reporting of contingent or real liabilities in financial statement footnotes.

Simplifying With Software

Although life cycle tracking and a thorough understanding of MLAs are necessary, MLAs often are difficult to understand for people who are not trained in legal concepts. The tax implications of leases can be complex and may involve determining whether a lease constitutes a "true" or "conditional" sale, calculating depreciation on capital leases, or ensuring tax rules are met. Moreover, organizations often track leases using spreadsheets or their physical asset management systems, which can create many exposures.

Specialized lease software can provide simplicity and consistency to lease management. For example, it can enable auditors to provide advice about using a lease management system that addresses lease complexities.

Uniform Legal

Burns' third recommendation is a customer-based MLA. This document provides benefits such as simplifying the contract, directly stating the effective interest rate, removing ugly terms and conditions, clarifying key provisions, and leveling the playing field for bidders. Auditors can assess older agreements against the MLA to ensure appropriate protections and clarity of terms are in place. If the organization doesn't have an MLA, auditors can recommend that the chief financial officer establish one.

> Auditors can identify breaches of loan covenants that could result in penalties.

Harvesting the Fruit

Lease audits provide benefits to the organization as a whole, but also make it easier for individuals in the organization. For example, the results of these audits can assist:

- Corporate tax and treasury leaders trying to coordinate decentralized divisions and negotiate better leases by leveraging repository information.
- Corporate finance and planning leaders who want accurate rates for capital budgeting decisions.
- Corporate accounts payable leaders who want assurance that payments relate to real assets.
- IT leaders seeking clarity on refresh cycles for planning software stack roll-outs, data center consolidation, and introduction of newer infrastructure.
- Physical security leaders seeking to quantify savings resulting from minimizing loss of leased assets.
- Legal and compliance executives who want to avoid contractual penalties, simplify contract management, and cut legal costs.
- Any profit and loss leader who was assigned these costs.

There are many areas in leases of property, material-handling machinery, and small equipment where auditors can identify ways to help the organization save money, comply with regulations, and improve future planning. These types of reviews should be in every internal audit function's audit plans. Ia

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