VISUAL LEASE

MDU CONSTRUCTION SERVICES GROUP

Lease Optimization for Manufacturing Businesses:

Unlocking the Benefits of Your Equipment Leases

Manufacturing businesses often have a large volume of equipment leases spread throughout their organization. This creates challenges around visibility, and as a result, increases the risk of missing lease options and making potential overpayments.

Due to the new lease accounting standards (ASC 842, IFRS 16), companies are paying closer attention to their lease portfolios more than ever before. As they gain greater visibility into their leases, companies are learning more about the benefits beyond compliance.

In this whitepaper, we will share the benefits of lease optimization, including:

- How to identify significant cost-saving opportunities
- How to use lease data to improve business decisions

The following is transcribed from a live webinar presentation, featuring a question-and-answer format from the following speakers:

Joe Fitzgerald

Senior Vice President,
Lease Market Strategy, Visual Lease

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Jon Hunke

Vice President, Accounting and EIT,
MDU Construction Services Group

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Businesses in the manufacturing industry, like MDU Group, have had to take a closer look at their leases to comply with the new lease accounting standards. As a result, this has created an opportunity to reduce significant risks and overpayments.

The Risk of Overpaying for Your Leases

Leases are expensive, but undermanaged

Joe Fitzgerald, Visual Lease:

Besides payroll, what are some other significant business costs? A lot of companies don't necessarily realize that leases are typically one of the most significant business expenses.

However, more are starting to recognize it now as they consolidate and centralize their leases to deal with the new lease accounting standards that have hit us in the last few years.

Jon Hunke, MDU Group:

The lease portfolio must be managed, as this can be a high cost for an organization. I believe companies have started to realize – or are realizing – this.

Joe Fitzgerald, Visual Lease:

Leases are inherently important to your business. For many organizations, they are essential to carry out your operations. Business location can greatly impact your revenue, your productivity and your costs. Further, equipment leases are typically smaller in average dollar size, but usually, there's a much higher volume of them and they are decentralized across an organization.

However, all leases are costly and complex. We've seen over the years how lease agreements are often misunderstood and overlooked. We've also seen what happens when companies don't keep track of their leases, including:

- Missing options to get out of a lease early
- Overpaying for operating costs and tax charges
- Failing to ask the landlord for contributions to construction costs (typically referred to as tenant improvement credits)
- Continuing to pay rent after terminated leases
- Having errors in lease arrangements

These oversights can amount to millions of dollars in overstated expenses. While companies can try to mitigate these risks, many of these issues are unfixable once they pass and have to be addressed on a prospective basis.

Today, leases are getting new attention, as the new lease accounting standards require that you place all leases on your balance sheet, thus a much higher level of scrutiny.

How businesses handle their lease portfolios

Joe Fitzgerald, Visual Lease:

Traditionally, organizations have a more centralized approach to their real estate leases than their equipment leases.

Jon Hunke, MDU Group:

I would agree – real estate leases are a little easier to track. Depending on the industry, some companies also have fewer real estate leases and more equipment leases.

In addition, when preparing for the new lease accounting standards, it's important to look for complete right of-use-assets and identify embedded leases, which sometimes get overlooked.

Joe Fitzgerald, Visual Lease:

Although ASC 842 and IFRS 16 diverge in a few ways, they're very similar. The bottom line is leases that were traditionally off the balance sheet are now going on the balance sheet. Because of this, there's a much higher degree of scrutiny around your lease portfolio.

It's also very important to note that leases are dynamic. They will change over time, and any changes or adjustments going forward must be looked at to see if there's a change in accounting that needs to be recorded.

Jon, you mentioned embedded leases. Can you provide an example of an embedded lease?

Jon Hunke, MDU Group:

When looking for embedded leases, you're looking to identify if you fully control the right of use of an asset.

For example, if you're on the construction side, you have a subcontractor for a crane on a job site. Looking at this in the old way, it was a subcontract cost to the job and you'd move on.

But now, looking into that even further, do you control 100% of that? Meaning, you provide the operator, you're using the unit and evaluating whether it meets the standards. So, that would be an example of an embedded lease that you would need to consider in your organization.

ASC 842

(publicly-traded and private companies)

Effective date for public companies:

Fiscal years beginning after **December 15, 2018**

Effective date for private companies:

Fiscal years beginning after **December 15, 2021**

IFRS 16

(non-US companies)

Effective date for companies:

Fiscal years beginning on or after **January 1, 2019**

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Managing leases before and after ASC 842

Jon Hunke, MDU Group:

As a public company, MDU was one of the first to adopt ASC 842. We strengthened and updated business controls to provide a consolidated lease database, which gave us visibility into every lease. This took an extreme amount of effort to organize with various stakeholders and create updated processes for reporting.

> "Visual Lease assisted us with not only tracking leases, but with reporting compliance required for lease disclosures in financial statements."

The cloud-based platform is supported by SOC reports to ensure accurate calculations and reporting disclosures required for compliance. With SOC controls in place, we can control who has access to the platform and easily identify who makes updates to lease data. Then, by looking at the SOC control reports that Visual Lease provides, we also add company controls, and apply them to make sure that we have a good, comfortable fit with the accuracy that we're reporting.

Joe Fitzgerald, Visual Lease:

SOC reporting comes up often for our company. It's key in how our customers do their own testing and validation, and for working with auditors.

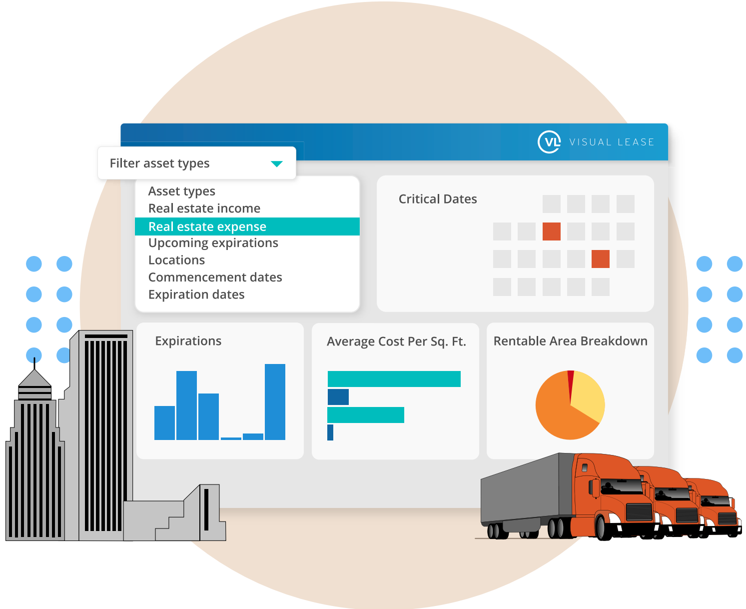
How does MDU handle end-of-term lease management?

Jon Hunke, MDU Group:

In the past, it was through trying to remember. Now, with Visual Lease software, we have dashboards right on the main screen of our lease portfolio and can look at what's coming up and start to plan for termination. On top of that, there are various reports that we can provide and distribute to stakeholders who are responsible for those renewals.

We also review vendor statements to make sure that we can utilize them because sometimes we have to extend those leases to make the right business decision. Using automated reports within Visual Lease, we have the individuals that are responsible review, approve and give us the updates.

Whether it's new lease agreements or existing lease terms, we look for the abstracted data within the platform, so we can find if there's common area maintenance on our real estate that we need to consider and apply.



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Lease Accounting Process

Cross-departmental responsibilities in lease accounting

Joe Fitzgerald, Visual Lease:

To perform lease accounting, I tell customers to get a big boat and go down the hall – and get people from other departments into the boat - because there's any number of folks involved in the lease process, including folks from finance, real estate, legal procurement, IT, etc.

Each department plays a part in getting set up and staying compliant. They're not only going to be necessary to get to Day 1 (the initial transition from ASC 840 to ASC 842), but also, Day 2 (maintaining compliance as you go forward).

Jon Hunke, MDU Group:

We must be in the same marina because that same boat applies for our organization.

At MDU, we have various project managers responsible for securing their own project equipment. We have procurement managers, fleet managers, the back of house, etc. On the accounting side, they are all involved whether it's copiers, leases or phone systems. And then, of course, you have legal. So, it's a combination of all those individuals assisting with compiling our lease portfolio.

Currently, we've got a few thousand leases in our organization that we're tracking using Visual Lease to simplify the process of reporting and compliance. Visual Lease provides a segregation of duties within the software to allow users to perform various functions. By doing this, it eliminates and reduces the amount of business control conflicts, and helps with the segregation of duties. The software is flexible in allowing various staff to perform their lease portfolio and management duties required for our organization.

Joe Fitzgerald, Visual Lease:

The reality is lease accounting is highly administrative, not just accounting-centric. Getting all the data – and maintaining it – to perform lease accounting is a significantly administrative, analytical lift.

It requires resources from various departments. That's my point about getting everybody in the boat. It really takes a whole new approach to lease administration and accounting. It's a lot more work, but there's a lot of good that can come out of that.

Lease accounting is an ongoing administrative lift

Joe Fitzgerald, Visual Lease:

One of the reasons why lease accounting is such a large administrative lift is because leases are large legal contracts that are often 100-200 pages long. They can involve a lot of clauses, amendments, and sometimes require trained professionals to negotiate and interpret them. There's a lot of critical dates to keep track of, too, whether it be the end-of-term dates or notification dates.

As mentioned earlier, leases are also dynamic; terms change all the time. Surprisingly, more equipment leases tend to go to term than real estate leases.

To be compliant and stay compliant, you must account for every change. Although not every change or modification is going to result in a change, you need to evaluate them to see if it does.

The ongoing administrative effort required to maintain compliance is much greater than what you've had prior to ASC 842. And companies must account for this to avoid inaccurate lease data.

In a recent survey from the Visual Lease Data Institute, 99% of surveyed senior finance and accounting professionals acknowledged real fears in potentially misreporting company lease information, including impacts such as:

51%
Increased audit fees and fines

49%
Damage to a company's reputation

48%
Risk of legal action

44%
Damage to their own professional reputation

This points to a critical need for automation through lease accounting technology. Software can solve for this through automated calculations, and therefore reduce the risk of manual error. It also provides an audit trail functionality that ensures every change is recorded, fully transparent and accurate for the audit.

Jon Hunke, MDU Group:

We've seen this from auditors reviewing our financial statements. When there's new footnote disclosures, they look to see how we generated those transactions, how those transactions are reporting into our footnote compliance and how we can prove the accuracy. Before using technology, we had a manual process using Excel that created more risk.

Now that we use Visual Lease, it gives us a lease list and we can provide SOC ownership, and the control owners related to that, which strengthens our audit opinions.

When we look at who is responsible and how we can segregate, we give the lease list out to the managers, so they can treat leases as a living component of our organization, because it needs to be managed.

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The Impact of Lease Optimization

Accurate lease accounting can lead to real business benefits

Joe Fitzgerald, Visual Lease:

In the same Visual Lease Data Institute survey mentioned earlier, 100% of everyone who responded acknowledged that lease accounting compliance comes with real business benefits.

Understanding just how complex and expensive leases are, particularly now under ASC 842, is reason enough to invest time and resources into achieving and maintaining compliance. But when you consider all the side benefits associated with lease accounting, it becomes glaringly evident that lease portfolios can streamline processes, create efficiencies and help companies get more out of their leases. You can even find ways to make your business operations more profitable. This concept is called lease optimization.

It's going to enable you to sustain lease accounting compliance, while at the same time unlock hard and soft savings, which really addresses two major business concerns with one effort.

Jon Hunke, MDU Group:

Leases must be managed to maximize the business value they provide.

By viewing historical reports and trends, you can see the cost of ownership of those leases, like a real estate footprint calculation on square footage to the dollar values for the markets you are in.

Day 1
Transition to lease accounting standards

Day 2
Maintaining lease data

Day 3
Lease optimization

Joe Fitzgerald, Visual Lease:

What is lease optimization and how does it relate to lease accounting? Let's take a step back to look at Day 1, Day 2 and Day 3.

Day 1 is the initial transition from ASC 840 to ASC 842, where you get the right of-use-asset and related lease liability up on your balance sheet.

Day 2 is everything that happens after Day 1, including all of the changes that have implications to your lease accounting. Whether it be the modification to terms, new leases coming on, old leases going off, you need to have a process to sustain compliance into Day 2.

Then, there are a lot of things that start to occur with Day 3, which is lease optimization. Once you have a centralized view of your leases and you've got the compliance under control, you can start to think about ways to reduce costs and save money in your lease portfolio.

New opportunities to grow and scale

Joe Fitzgerald, Visual Lease:

Typically, businesses have much better visibility into their leases after adopting ASC 842, and they realize that their previous process was not as great as they thought.

This new visibility due to lease accounting helps reduce expenses, which can come in different forms, including tangible, hard-cost savings. Some of this can be from ancillary costs around your leases, or better negotiations on lease rates once you can see what your lease portfolio looks like.

But just how impactful is lease optimization?

In a recent VLDI report, businesses shared the following benefits of lease optimization:

54%
More transparent valuation of the organization

54%
Cost savings

53%
Easier preparation for audits

50%
Ability to make strategic leasing decisions

There's a cost to get and maintain compliance, but as a result, you can end up saving money on your leases.

Once you've got a lens on your lease portfolio, you'll be able to make better leasing decisions. With new savings come new opportunities to grow and scale your business.

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Steps your business can take to optimize your lease portfolio

Joe Fitzgerald, Visual Lease:

Let's review some key ways to help you get a tighter control of your leases.

1 Have a controlled inventory of all your lease documents and update it as deals change

This goes back to the concept of leaning on other folks within your organization. While lease accounting typically sits within the accounting and finance area; as leases change, it will most likely require involvement from real estate or procurement.

Others may need to get involved to handle all the changes and make sure your lease data stays up-to-date as these changes take place.

If you do this, it makes the overall lease management process much easier – and reduces the drain on people resources. Additionally, the process should be repeatable and easy to use.

2 Capture, monitor and act on all critical lease dates

This includes critical lease terms that have a financial impact, such as end-of-term options.

To ensure you're prepared, get ahead of important milestones by identifying all critical lease dates. That way, you can manage leases – and the end of term – properly. As previously stated, lease management is one of the main benefits of using lease accounting and administration technology like Visual Lease.

3 Ensure that you stay on top of all changes you make to your leases

A strong line of communication between accounting and operations teams is critical to ensure both parties are aware of any noteworthy updates.

Real estate leases are far more dynamic than equipment leases, but regardless, you need to make sure that you have a reliable process to report all lease updates in a timely manner.

Jon Hunke, MDU Group:

What really stands out to me about lease optimization is the ability to reduce surprises for your organization. What I mean by that is lease optimization creates an ability to make conscious proactive decisions, as opposed to being in a state of reactiveness.

A company can review its lease portfolio, manage the critical dates to get leases to where they need to be and provide reporting compliance assurance for accurate reporting. This all starts with organization, planning and getting your lease list consolidated.

To be successful, you also must train employees on roles and responsibilities. This can be as simple as educating your staff about the key components of your lease agreements and what to pay the utmost attention to.

Joe Fitzgerald, Visual Lease:

Having a cross-functional technology solution, like Visual Lease, that handles both lease management and lease administration, allows you to see the entirety of a lease and make decisions that are best for your organization.

Real-world examples

Joe Fitzgerald, Visual Lease:

Let's transition to examine real examples of company losses due to a lack of having proper lease management processes in place.

-$105K

A large manufacturing company lost $105K because they did not realize that their lessor was continuing to bill expenses for surrendered property.

Operating expenses
(end of term)

-$185K

The third largest insurance company in the US lost $185K because they didn't realize their landlord needed to offset operating expense increases against tax decreases.

Operating expenses

-$210K

A large tech company lost $210K because the tenant was not aware that tax abatement was not being added back to the base tax amount.

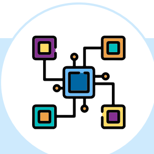
Operating expenses

-$500K

A national bank lost $500K because the tenant forgot to request reimbursement for tenant improvements from the landlord.

Landlord incentives
(tenant allowances)

On the flip side, how has lease management improved business operations?



A large global business was able to minimize the number of vendors needed for fleet management, from 13 vendors to 3, through Day 2 lease accounting compliance.

Created efficiencies and realized hard dollar savings

A US-based Visual Lease customer with equipment leases realized a disparity in their rates after achieving lease accounting compliance. As a result, they were able to work with the vendor to improve their rates for leases across the country.

Improved vendor and end of term management

I've spoken with many lessors regarding lease rate negotiations, and they typically factor in that customers may not return equipment for a number of months. It may seem odd, but it's something they need to account for when negotiating lease rates.

On a related note, we've seen the impact of inflation in the recent months. What are the implications of inflation, its impact on equipment costs and how that affects the incremental borrowing rate (IBR)?

Jon Hunke, MDU Group:

With respect to IBR, in years past, we've had some low interest rates, but we're seeing those pressures now with inflation and the cost of borrowing starting to increase.

At MDU, we currently review IBR on a quarterly basis for leases that need to imply an IBR for that calculation. In addition, when you look at the supply chain that we have, it's important for us to have a consolidated list to monitor lease expirations, and know the terms and expiration dates.

The clauses within your lease contracts, if given proper notice, should also allow you to extend the expiration date. That's another way to maximize your lease portfolio, as supply chains are impacting the availability to products, facilities or even equipment that all companies are facing.

Joe Fitzgerald, Visual Lease:

That's interesting; with business costs increasing, there's never been a better time to unlock savings.

I keep coming back to the fact that this is a compliance exercise. Particularly now, companies have just been through COVID-19, business costs are increasing, inflation rates are going up – it's really an opportunity to manage and optimize your lease portfolio, and not just achieve accounting compliance. Lease management and optimization will unlock both hard and soft dollar savings. With just one effort, you'll address two major business concerns, and really position your organization for success.

To close this out, let's review some of the most common problems for manufacturing companies in meeting the new lease accounting requirements.

Jon Hunke, MDU Group:

I think one of the first issues manufacturing organizations will run into is identifying embedded leases – understanding which pieces of equipment might be under a lease, and looking for what those lease terms are.

It's important to start by identifying the lease agreements. Then, do a good read through them, so you can properly calculate those beginning right-of-use assets and right-of-use liability journal entries required for the financial statements.

After that, make sure the remaining terms and obligations that are required to properly document amortization schedules for your footnote disclosures (which include the weighted average interest rate and the number of term years remaining) are clearly identified.

Joe Fitzgerald, Visual Lease:

I'll add that lease accounting contains similarities, but can be dependent on your industry. The manufacturing industry may find you have some unique embedded lease arrangements that you'll need to think about a little differently than a company in another sector. That's one thing that I've seen where I would say the lease accounting standard diverges from sector to sector.

About Visual Lease

Visual Lease is the #1 lease optimization software for managing, analyzing, streamlining and reporting on lease portfolios. Developed by industry-leading lease professionals and CPAs, it combines GAAP, IFRS and GASB-compliant lease accounting controls with easy, flexible and automated lease management processes. More than 1000 of the world's largest publicly traded and privately-owned corporations rely on Visual Lease to control their lease portfolios, integrate with their existing business systems and maintain regulatory compliance. Committed to ongoing innovation and unparalleled customer service, Visual Lease helps organizations transform their lease compliance requirements into financial opportunities.