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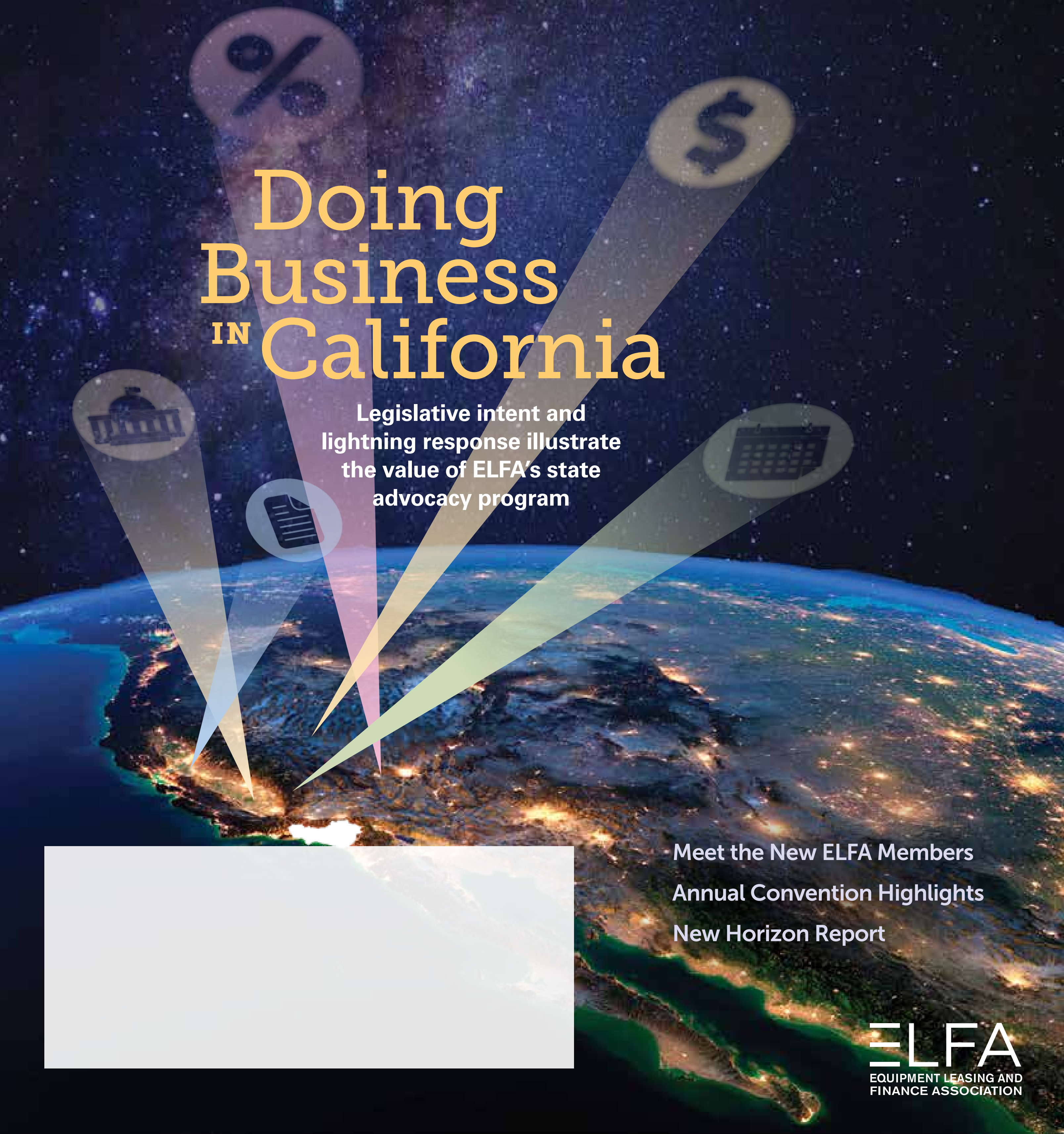
Leasing&Finance
THE MAGAZINE FOR INDUSTRY EXECUTIVES

NOVEMBER | DECEMBER 2019



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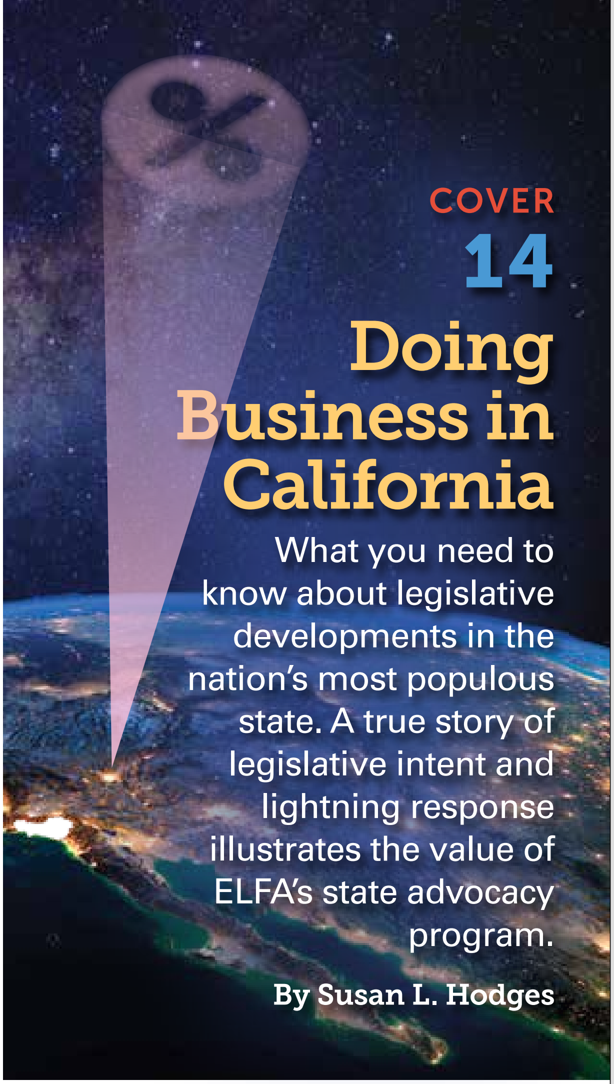

FEATURE

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FEATURES

PORTFOLIO IMPAIRMENT REVIEW

What Are Best Practices?

By R David Conover, Rob Herb and Christopher Nugent

A NEW SURVEY OF ASSET MANAGERS reveals that when it comes to impairment testing, there have been some changes over the past decade.

Both new and experienced asset managers frequently ask the same questions regarding impairment testing: How often should I test residual values in my portfolio? How can I accomplish the impairment testing required FAS 144? Are there risks if I test too frequently or, more important, not frequently enough? Is there a standard methodology for testing? Do I test all or sample? How do I balance the important aspect of risk management with time and resources? Should I use third-party appraisers to perform my testing?

The ELFA Equipment Management Committee recently conducted a survey of equipment managers to gauge where practices stand today and how they have changed since 2009, when the committee last conducted a survey on this topic. The committee's goal is to assist asset managers in developing best practices in portfolio management to comply with accounting standards. Aside from complying with the technical accounting rules and regulations, the asset manager needs to practice sound portfolio management to manage equipment risk.

A NOTE ABOUT FAS 144

FAS 144 applies to long-lived assets that are to be held or used and defines an impairment as a condition that exists when the book value of a long-lived asset or asset group exceeds its fair value. It further requires that an impairment loss shall be recognized only if the book value of the long-lived asset or asset group is not recoverable and exceeds its fair value. Additional information is available from the FASB website at *www.fasb.org/summary/stsum144.shtml*, which is an important resource for equipment managers.

SURVEY RESULTS

A total of 48 asset or portfolio managers responded to the 14-question survey, which focused on both practices and actual impairment experience. Key findings were as follows:

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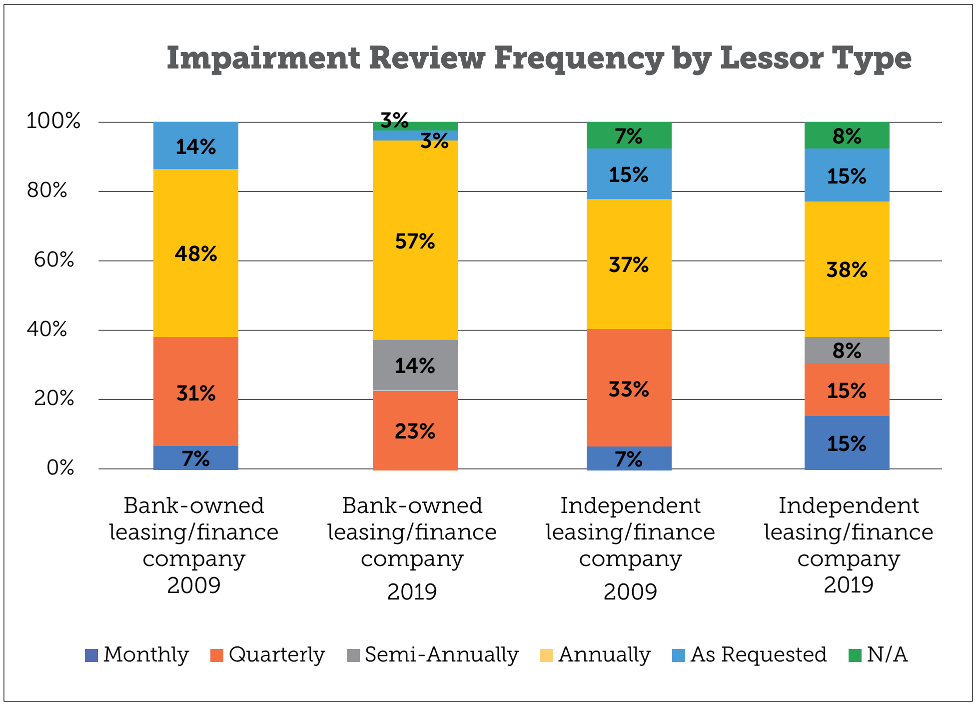
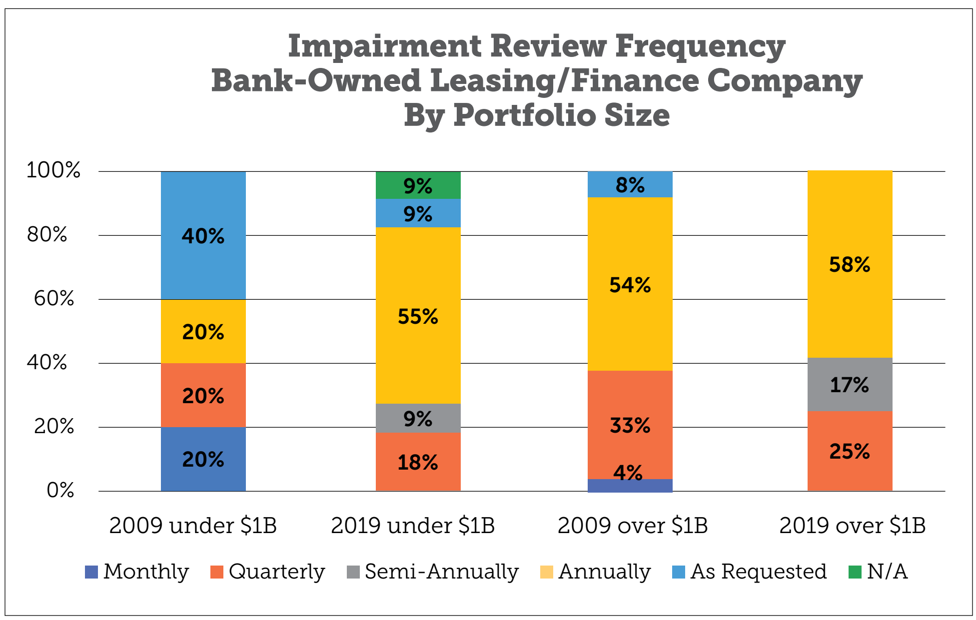


Impairment Processes – At a high level, we found larger equipment finance companies with net book value >$1B (dominated by bank-owned versus independents) have more formal impairment processes and review cycles, but don't take impairments more/less frequently. This difference perhaps speaks more to regulatory requirements and internal audit processes. Simply put, if you're under bank regulations, you need to formally document your practices in a process document and adherence to that policy will be audited. Senior managers and auditors of a company with net book value <$1B can get comfortable with an asset manager's practices without needing a formal policy.

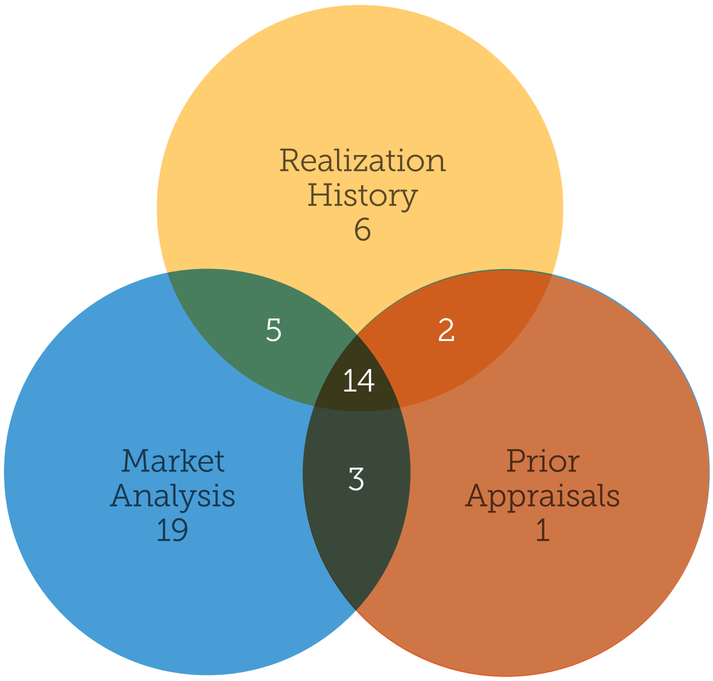


Impairment Review Schedule – A total of 94% of banks now have a regular impairment review schedule, which is up from 86% 10 years ago. Just under a quarter of independents reported they don't have a regular impairment review, which is consistent with 2009 results. It is interesting to note that in both groups, there has been a move from quarterly to semi-annual reviews, which could speak to the stability of the economy.

Looking at bank-owned equipment finance companies, we see that, not surprisingly, larger organizations are more likely to have a scheduled impairment review. Independents did not show a trend based upon size.

Methodology – When asked what type of methodology they employ—residual realization history, market analysis of comparable sales and listings, or review of prior appraisals—the results were mixed. From a methodology standpoint, market analysis (external data) was the most common source of data, with 77% of respondents using it and roughly half of those combining it with internal realization history or prior appraisal reports. Banks >1$B were more likely to employ third-party appraisers to perform this work in conjunction with internal staff, perhaps to address industry specializations or to ensure impartiality. These banks are also the most interested in exploring artificial intelligence/predictive analytics to improve/automate the impairment process. Also, the method to stratify the portfolio (by industry, asset type, contracts with large RV exposures) varies by respondent but larger organizations tend to engage in multiple stratifications versus just one cut.

IMPAIRMENT TESTING METHODOLOGY



BEST PRACTICES

The prudent asset manager needs to comply with GAAP, FAS 144, the internal policies and procedures of the company and with the strictures and mandates of internal and external auditors. This requires review and analysis of the relevant portfolio to identify and manage equipment book value risks and to identify areas of the portfolio that may be at risk.

A portfolio impairment review policy and procedure that accomplishes this would have the following elements:

- A representative sample of the portfolio is typically defined as 20% of the contracts for each major segment/vertical. In addition, the sample would typically include all assets with residual over $100,000.
- When sampling, it is appropriate to exclude recently booked transactions (usually those booked within past 12–16 months as review can be considered current).
- When reviewing with portfolio approach realization, history is a good metric.
- A frequency of semi-annually or annually is appropriate.
- Impairment review process: Compare FMV at lease termination with expected FMV of asset.
- Review responsible party: internal asset management staff or external appraisal, depending on expertise and time availability.
- Deliverables: summary document listing all assets reviewed by residual at maturity versus FMV, recommendations for impairments.

See the ELFA website at *www.elfaonline.org/industry-topics/equipment-management* for additional information and the complete best practices document as recommended by the ELFA Equipment Management Committee.

Your documented procedure needs to ensure rigor while at the same time incorporating a degree of flexibility to allow an asset manager to investigate areas of the portfolio where there are questions, while being regimented enough to ensure integrity, consistency and reliability of process. The procedure needs to start with extracting the data and the populations to be reviewed. This can be customized by the lessor based upon business model, verticals served and external risks identified. For a less mature financing organization, 100% of the transactions may be reviewed if this is not too much of a burden.

Bottom line: Define a policy, have procedures, perform at least annually, customize to business and document! ☰

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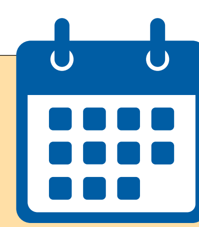

SAVE THE DATE!

Learn more on this topic at the 2020 Equipment Management Conference, Feb. 23–25 at the Omni Resort at Championsgate in Orlando, Florida.

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