

## Recently Asked Questions

### *Default covenants, lessor accounting for synthetic leases and the FASB Leases Project*

By: Bill Bosco, Leasing 101

I get lots of questions asked and will devote this article to answer a few recently asked questions that may have broad interest.

**Question:** We've had several customers recently asking for changes to our standard default covenant wording in our lease documents because their auditors are telling them they will not otherwise obtain operating lease treatment.

Their auditors reference section 840-10-25-14 of the Accounting Standards Codification ("ASC"): "Default covenants related to nonperformance do not affect lease classification if all of the following conditions exist:

- a. The default covenant provision is customary in financing arrangements.
- b. The occurrence of the event of default is objectively determinable (for example, subjective acceleration clauses would not satisfy this condition).
- c. Predefined criteria, related solely to the lessee and its operations, have been established for the determination of the event of default.
- d. It is reasonable to assume, based on the facts and circumstances that exist at lease inception that the event of default will not occur. In applying this condition, it is expected that entities would consider recent trends in the lessee's operations.

If any of those conditions do not exist, then the maximum amount that the lessee could be required to pay under the default covenant shall be included in minimum lease payments for purposes of applying paragraph 840-10-25-1(d)."

The lessee is requesting to limit their remedies on default covenants that are as they describe "unrelated to the use of the asset" including: cross defaults, failure to comply with covenants or obligations in other leases or related agreements, and lessee merger/change of control.

They want to limit default payments for these types of "unrelated covenants" to an amount that when included in the present value calculation of the minimum lease payments discounted at the lessee's incremental borrowing rate used to classify the lease results in an amount that is less than 90% of the leased asset's value or otherwise they cannot obtain operating lease treatment.

Have you seen similar situations where lessees are requesting changes to default language at their accountant's direction?

**Answer:** Yes I have run into this many of times. It is a real issue that sometimes is ignored by auditors except for those who have detailed experience in lease accounting. It is also often ignored in smaller ticket leases. The issue of a default covenant possibly creating a minimum lease payment arose from EITF 97-1 so it has been around since 1997.

The issue is that you can't get operating lease treatment if:

- a) There is a covenant in the lease document that is not customary, objectively determinable, based on predefined criteria related only to the lessee and its operations and it is reasonable to assume that it is not likely to occur and
- b) the default remedy allows the lessor to cause the lessee to have to pay the "full" termination value (TV) or stipulated loss value (SLV) and buy out the lease.

The four conditions listed above in ASC 840-10-25-1 would not be satisfied if the covenant's default language contains "mushy", subjective language like "material adverse change" that would allow the lessor to call a default. A material adverse change trigger means that, if in the judgment of the lessor, there has been a material adverse change in the lessee's financial position, the lessor can call a default. "Material adverse change" is subjective - as an example a lessor could merely say (based on their judgment) that a decline that just occurred in the lessee's net worth is material to the lessor and then be able to call a default that forces the lessee to buy out the lease. In effect the lessor has added a minimum lease payment (a default the lessor can call on a whim (so to speak) that means the lessee's minimum lease payments would present value to more than 90% of the cost/fair value of the leased asset if one included the default remedy as a minimum lease payment in the initial present value lease classification test).

You also can't have cross default language in the lease document that allows the lessor to cross default to another document (commonly a loan or revolving credit agreement) that has subjective default conditions. Cross default clauses are common in leases.

If you do have default language that does not meet the four criteria a solution is to limit the default remedy amount to an amount that when present valued with the rest of the minimum lease payments would present value to less than 90% of the asset's cost/fair value. This is a bit complicated but it satisfies the auditors and the requirements of the lease classification tests considering the restrictions imposed by ASC840-10-25-1.

In my opinion the better answer is to fix the language in the default covenants to comply with the four criteria.

**Question:** I am in the process of working up a proposal for a synthetic lease. I have no experience with this type of lease. All of the research I have found online is for lessee accounting. I would like to get more information about lessor accounting for synthetic leases.

**Answer:** All synthetic leases and "split" or "modified" TRAC leases are structured to allow the lease to be classified as an operating lease by the lessee customer. In order to be classified as an operating lease by the lessee the lease must fail the four lease classification tests in FAS 13 (now known as ASC 840 under the FASB codified accounting rules numerical system). The key test is the 90% present value test where the present value of the minimum lease payments must be less than 90% of the cost or fair value of the leased asset. The residual guarantee provided by the lessee in a synthetic/split TRAC lease is considered a minimum lease payment. To get the present value to be less than 90%, the residual guarantee must be split with the lessor assuming an amount of residual risk and the lessee's residual guarantee being reduced so the total present value of minimum lease payments is less than 90% of cost/fair value of the leased asset. The amount of the lessor's residual risk must be the future value of at

least 10.1% of the leased asset's cost/fair value, using the rate implicit in the lease, to insure the classification calculation works in favor of operating lease classification.

The discount rate used by both the lessee and the lessor is the implicit rate in the lease as it is known to the lessee. The reason why it is known is the lessee can easily calculate the amount of residual risk retained by the lessor by reading the language that calculates the residual guarantee. The amount of the remaining lessor residual risk is obvious. It is important to note that the lessor's lease classification will also be an operating lease. Most lessors, especially financial institutions, find this unfavorable, especially financial institutions. Not only is the pattern of earnings is back ended (level rent revenue less declining interest cost to carry the investment and level depreciation during the term and the residual revenue recognized only at the end of the term), but depreciation expense is classified as an operating cost. This combination of negative factors results in negative impacts to financial measures such as net spread, return on assets and operating efficiency that analysts apply to financial institutions.

To avoid this problem, most financial institutions buy residual insurance in an amount that will cause the present value of minimum lease payments (including the insured residual) to equal or exceed 90% of cost/fair value of the leased asset and thus get direct finance lease accounting which produces finance revenue amortized at a constant rate over the lease term.

**Question:** What is going on with the FASB/IASB Leases Project? Will the Boards finish the project this year?

**Answer:** The Boards have been slow to start re-deliberations but should begin decision making meetings beginning in February. They received significant negative feedback in comment letters and their outreach meetings. The major areas that the majority of the feedback says should be addressed are: keeping the existing lease classification tests, leaving lessor accounting virtually unchanged and simplifying lessee accounting. The FASB is willing to follow the feedback which would lead to quick resolution and one that I agree with. But, the IASB seems to want to keep on the path of the wholesale changes that do not present leases according to their substance. Both chair persons want a quick resolution and I predict they will complete the project in 2014 with an implementation date of 2017 or later when all lessees and lessors will have to convert to the new rules. I also think the weight of the feedback will force them to continue to use the concepts in FAS 13 as the basic framework for the new rules.

*About the Author:*

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