

Engaging your Customer Re the Lease Accounting Changes

Staying ahead of the curve: part 2

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There is a great deal of anxiety out there in the lessor community regarding how the proposed lease accounting changes will impact our customers, their propensity to lease and our own lessor accounting (lessor accounting will be dealt with in a subsequent article).

The fact is the news is mostly good – not all good but probably 95% good. We are in a great position where although operating leases will be put on balance sheet (we could not stop that as it was dictated by the SEC) the lessee balance sheet presentation reflects the substance of the executory nature of the lease and the reported straight line lease cost is the same as current GAAP. Although operating leases will be capitalized the amounts put on the balance sheet as an asset are still lower than if the lessee borrows to buy – in many cases the amounts capitalized are significantly lower. Also the liability for capitalized operating leases will not be classified as debt so debt limit covenants will not be broken. The eight reasons why customers lease remain strong – see the table below. I have reported the table before but have made a few changes. I think it is a good one page tool to show your customer the benefits of leasing under the proposed rules.

I think most lessees do not know and understand what the impact of the proposed rules will be. They have not been following the project closely. There has been a great deal of misinformation published and posted. The project has dragged on for years with twists and turns. The project is in fact much different in good ways from what was originally presented in the project's Preliminary Views document and in both the first and second Exposure Drafts.

I recommend you learn the details of the current project decisions, their impacts and engage your customers to educate them as to the benefits in the FASB's approach. Deal with their objectives and demonstrate that the lease product is still better than borrowing to buy assets that they need to run their business.

The following are the major customer objections and the points to make to overcome the objections:

Objection #1 – “I am paid a bonus based on ROA and now that the lease will be an on balance sheet asset and my ROA will be worse. I might as well just borrow to buy.”

Talking points:

The asset in an operating lease will be on balance sheet BUT only to the extent of the present value of the rents (usually much less than cost of the asset) and the P&L lease cost is straight lined. What is your alternative? Is it borrow to buy? In that case the full asset cost is on balance sheet AND the interest cost to fund the asset plus depreciation of the asset result in a front loaded cost pattern.

As an example assume you are leasing some construction equipment under a three year fair market value purchase option lease. The present value of rents that goes on the balance sheet as an asset and liability is around 52% of the asset cost (48% better than borrowing to buy) and the first year's cost under the operating lease alternative lease is about 7% less than the first year's cost of a capital lease/loan. The ROA savings on that leased asset versus buying the asset including the cost to fund it in year one is about 55% better (48% off balance sheet benefit + 7% lower lease cost benefit). The following tables show the amount capitalized for several sample leases and the approximate increased cost broken down by lease term comparing a financed purchase of the asset versus an operating lease of the same asset:

Lease Type	Terms	Est. Capitalized Value @ 6% disc rate
PC lease	36 mos, 2.73% pmt, FMV with 15 day interim rent	91% of cost
Auto fleet lease	12 mos, 2.5% pmt, 76% RVG (split TRAC)	29% of cost
Construction equip lease	36 mos, 1.6% pmt, FMV, 50% residual	52% of cost
Cat Scanner lease	60 mos, 1.5% pmt, FMV, 20% residual	77% of cost
Corp jet lease	120 mos, 0.65% pmt, FMV	59% of cost
Corp jet lease	120 mos, 0.65% pmt, 56% RVG	59% of cost
RE synthetic lease	60 mos, 0.5% pmt, 85% RVG	26% of cost

Lease Term	First Year Increase in Lease Cost – loan/capital lease vs. operating lease
3 Years	7%
5 Years	11%
7 Years	16%
10 Years	21%
20 Years	28%

Objection #2

“The debt limit covenants in my borrowing agreements will be broken if the new operating lease liability is on balance sheet.”

Talking Points:

The FASB listened to feedback that pointed out that executory contract (operating lease) liabilities are not debt per the UCC definition of debt. The FASB specifically said the capitalized operating lease obligation is to be reported on the balance sheet as a “non-debt” “other” liability. As a result the capitalized liability will not result in a technical default under your debt limit covenants. In other words it will not be added to your reported amount of debt.

Objection #3

“Capitalizing operating leases on balance sheet will ruin my credit rating.”

Talking Points:

Your credit rating should not change just because the FASB changes the rules for accounting and reporting of operating leases. Bank lenders and credit analysts already deal with operating lease obligations reported in your footnotes. They estimate the value of the implied asset and liability created by operating leases to adjust their measures and ratios used to make credit assessments. The proposed formula to capitalize operating leases under the new rules is substantially the same as the methodology used by the major rating agencies to determine an estimated implied lease asset and liability. In some cases the estimates they use will be higher than what the proposed rules require. The capitalized value of an operating lease is less than the asset and liability that result from borrowing to buy. When you borrow to buy, the loan is reported as debt and will impact your ability to borrow as it eats into your credit capacity that lenders allocate to your company.

Objection #4

“I lease lots of PCs and the new accounting is too complex and too much work for my staff – I may as well just buy the PCs.”

Talking Points:

The FASB has accepted an accounting method for capitalizing operating leases that is actually very simple. Right now you probably use an Excel spreadsheet to capture all the future rents in your operating leases and sum up the rents to report the amounts in your footnotes. To account for operating lease costs under current GAAP you accrue the average rent and pay the actual rent. Under the proposed rules you will use the exact same method to account for the operating lease cost. To record the present value of remaining rents as an asset and liability under the proposed rules all you need to do is add a discount rate and a present value calculation formula to the top of the column for each lease in your Excel rent spread sheet. Each month you put the new sum of the present values of all your leases on your balance sheet as an asset and other liability. It can be done as one entry by your accounting staff each month reversing the previous month's entry and booking the new present value. Very simple.

Don't forget that the other benefits of leasing a PC such as:

- The capitalized amount in the PC lease is less than the cost of the asset so there is still a partial off balance sheet benefit.
- The straight line P&L cost pattern in an operating lease is better than the front ended cost pattern of a financed purchase.
- The lessor is assuming residual risk so you can return the PC and lease a newer, better model every 3 years or so as technology improves.
- The lessor has to deal with the environmental regulatory compliance concerns with disposing of computers than you return at lease expiry.

Conclusion:

Don't be afraid to engage the customer regarding the proposed lease accounting rules. The rules are certain to be enacted but there is good news to focus on. The alternative that the customer faces is borrowing to buy and it is not a good one. Emphasize to your customers that the eight reasons for leasing remain despite the proposed accounting changes:

Reason for Leasing	Details	Status After Proposed New Rules
Raise Capital	Additional capital source, 100% financing, fixed rate, level payments, longer terms	Still a major benefit versus a bank loan especially for SME & non-investment grade lessees with limited sources of capital
Low cost capital	Low payments/rate due to tax benefits, residual & lessor low cost of funds	Still a benefit versus a bank loan
Tax benefits	Lessee can't use tax benefits & lease vs. buy shows lease option has lowest after tax PV cost	Still a benefit
Manage assets/ residual risk transfer	Lessee has flexibility to return asset	Still a benefit
Service	Outsource servicing of the leased assets.	Still a benefit
Convenience	Quick & easy financing process often available at point-of-sale	Still a benefit
Regulatory	Capital issues	Regulators should continue to treat ROU operating lease assets as "capital free" as they are an accounting contrivance and do not represent an asset in a bankruptcy liquidation
Accounting	Off balance sheet	Partial benefit if the PV < cost of the asset, S/B true for all op leases especially high residual assets w tax benefits. Liability is <u>not</u> debt – no impact to debt covenants

About the Author:

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