Preparing for the New Lease Accounting Rules
Dealing with Customers and Your Business Planning
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The project to change lease accounting has been a painfully long project. Rest assured though, the project will be completed by mid 2015. The project objective to capitalize all operating leases on the balance sheet of lessees has been a scary thought for both the leasing community and its lessee customers. Despite being in the news I believe many customers do not understand the impact of the project on them. The project has evolved to where it is not as bad as it once appeared, in fact some lease structures fare very well. Customers should be educated on the fact that the FASB's recent decisions will result in little change to the reasons why they lease. You should be knowledgeable on the nuances of the proposed rules so that you can explain the impact to customers and you should be reacting to the proposed changes in advance.

Evolution of the Project: The Outset

At the outset of the project the proposed lessee accounting model was to treat all operating leases as though they were capital leases and to estimate likely renewals and variable rents to dramatically increase the amount capitalized. The impact on the balance sheet would have been a new asset and debt measured at amounts that could approach or, in some cases, possibly exceed the cost of the asset. On the income statement the lease cost would have been higher, in total, compared to current GAAP due to the inclusion of estimated payments in the initial accounting for the capitalized leases. The pattern of lease cost would have been front loaded as in capital lease accounting as the expense elements would have been the sum of straight line depreciation and imputed interest on the lease liability. In the first half of the lease term the pattern of lease cost would have been higher than the straight line average of rents as under the current GAAP model, . The proposed model would not have portrayed the true economic effects of leases on lessees' financial statements. Rather it would have overstated the balance sheet amounts and mismatched the lease cost versus the use benefit in the lease.

The added debt form the capitalized leases would have caused debt limit covenants to be breached. This in and of itself would have caused lessees to delay equipment acquisitions and possibly not lease at all. The front ended cost pattern would have been a drag on earnings and capital. The cost pattern combined with the increased assts and debt could have also impacted other debt covenants based on financial measures and ratios. The proposed model imposed tremendous complexity on lessee customers. Specifically they would have to deal with estimating rents, booking the asset and liability, imputing depreciation and interest expense and then continually adjusting the amounts when the estimates varied from actual results. That was not a pretty picture for new business prospects for the industry. The Equipment Leasing and Finance Foundation sponsored an economic study that predicted the changes would negatively impact the economy and employment in the same manner as would an increase in interest rates on US businesses.

Evolution of the Project: Where We Are

Both the FASB and IASB agreed to simplify the project by eliminating the need to estimate likely renewals and variable rents. Further, the FASB listened to feedback and broke from the above single lease (capital lease accounting for all lease) model and reverted to a two lease model where operating leases would be capitalized but treated differently than capital leases. The former operating would be accounted for virtually the same as under current GAAP for P&L cost purposes, that is, the cost pattern would remain as the straight line average rent. Additionally the FASB decided that the capitalized operating lease liability is not to be classified as debt– rather it will be an "other" liability. The resulting impact is minimal impact on debt covenants and in fact no impact on debt limit covenants. These changes made by the FASB present the financial impact of operating leases more closely to the true economics of the transaction. They changes also eliminate most of the negative aspects of the proposed changes. The amount capitalized will be less that the equipment cost so there will still be an accounting benefit to leasing over borrowing to buy. The greater the residual assumed and the higher the tax benefits, the lower the capitalized amount. The question is – do customers understand all of this?

What should you do?

First your sales staff should understand the details of the project. The project is close to completion (completion expected in mid 2015, with transition expected to 2018) so we know all the major proposed provisions now. Do some sales staff training on the details of the project and its impact on customers.

You should be proactive with your customers to show, in an upbeat way, that the impact of the project is minimal. You should develop sales staff talking points on the current state of the project with details as to what the impact will be on customers. This will help the sales staff in dealing with customer objections. You should develop educational marketing materials and deliver them to customers. This will allay customers' fears and may differentiate you from the competition as being a knowledgeable and trusted advisor. You should stress that the traditional reasons why customers lease will remain strong and viable despite the rules changes. The following grid illustrates my points:

Reason for Leasing	**Details**	**Status After Proposed New Rules**
Raise Capital	Additional capital source, 100% financing, fixed rate, level payments, longer payment terms, avoid impacting debt limit covenants, lease cost in operating budget	Still a major benefit versus buying financed by a bank loan/debt especially for small and medium sized entities and non-investment grade lessees with limited sources of capital
Low cost capital	Low payments/rate due to tax benefits, residual and lessor low cost of funds; implied equity vs. the capitalized lease amount is less than actual equity required when borrowing to buy	Still a benefit versus a bank loan and owning the asset
Tax benefits	Lessee can't use tax benefits and the lease vs. buy analysis shows lease option has lowest after tax present valued 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 and easy financing process often available at point-of-sale	Still a benefit
Regulatory	Capital issues	Still a benefit as regulators should still treat ROU assets as "capital free" as they are an accounting contrivance and do not represent an asset in a bankruptcy liquidation
Accounting	Off balance sheet	Still a partial benefit if the present valued capitalized amount is less than the cost of the asset, should be true for high residual assets and the impact of tax benefits

You should also review your lease structures against the proposed rules to see which products work best and where changes are should be made. You should also look at the impact on asset types and markets so that you focus on the areas where the prospects are best given the details of the proposed rules. There are positive and negative nuances in the proposed rules that need to be understood.

Conclusion:

In my opinion the prospects for the industry are good despite the proposed changes. We should see little impact on new business volumes from the changes. In fact there could be some opportunities. Stay ahead of the curve on the project.

About the Author:

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