FAS 13 Becomes Topic 842:
Differences Are Minimal

BY BILL BOSCO

With the FASB leases project nearing its finale, Bill Bosco outlines key changes to lessor accounting, including the definition of lease payments and how the new rules will affect bundled leases. He also discusses changes to the definition of a lease, updated lease classifications and the end of the leveraged lease.

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The leases project will soon be signed by the FASB and will be called ASC Topic 842. Although the FASB originally set out to change lessor GAAP, the board decided to retain current lessor GAAP, for the most part, as financial statement users did not cite any major issues with lessor accounting. There will be some changes, however, which this article will cover. At the date of this writing the final version of ASC Topic 842 was not available, but the content is known, so the conclusions in this article should hold true.

Definition of a Lease

Topic 842 will define a lease as a contract that conveys the right to use an underlying asset for a period of time in exchange for consideration. At inception of a contract, an entity should determine whether the contract is or contains a lease, which occurs only if the contract depends on the use of an identified asset and conveys the right to control the use of the identified asset. When controlling the asset's use, the customer has both the right to obtain substantially all the economic benefits from using the asset and the right to direct the use of the asset.

The most significant difference between the old and new definitions of a lease is the elimination of the condition in ASC 840-10-15-6(c) relating to control by a purchaser over the economic output of an asset. Under Topic 842, taking all, or substantially all, of an asset's output will not be sufficient to define the arrangement as a lease. While this definition change could result in a significant reduction in the number of leases identified, it should not significantly affect lessor accounting since the majority of those arrangements would have qualified as operating leases.

Leveraged leases will be dropped as a lease classification beginning on the transition date, but existing leveraged leases will be grandfathered. You can still do leveraged leases until the date the new rules become effective. Consistent with the past rule, lease classification will not change if the lease is transferred to a new lessor, so there will still be an active market for trading leveraged leases.

Lease Classification

Lease classification will not change substantively as the FASB retained the 75% lease term compared to useful life lease and 90% present value of payments versus fair value/cost as guidance. Lessors will have operating leases, finance leases or sales-type leases as they do today. However, there is a change in the definition of a sales-type lease.

Under Topic 842, only leases that qualify for classification as a finance lease without the use of third-party involvement are sales-type leases for which the lessor can recognize the gross selling profit up front. Leases that qualify as a finance lease through the use of third-party residual insurance will still be classified as finance leases, but the "selling profit" will be recognized as part of finance lease interest revenue over the lease term. This is still a better outcome than if the lease is an operating lease where the gross profit is straight lined over the lease term. Lessors who regularly use third-party residual insurance to qualify for sales-type lease accounting should review the impact on sales and revenue projections. One way to accelerate the selling profit under Topic 842 is to use a third-party vendor lessor — that is, sell the leases. The tradeoffs of selling may result in relinquishing control of the customer relationship and losing finance and residual upside revenues, but those arrangements may be structured to overcome the tradeoffs.

The need for residual insurance (RVI) to convert operating leases to finance leases will remain a useful tool for financial institution lessors as the income pattern matches the investment versus straight line rent. More importantly, finance lease accounting avoids depreciation of operating lease assets that negatively affect operating efficiency ratios which investors focus on when measuring profitability of financial institutions.

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Lessor Accounting

The basic models for operating leases, finance leases and sales-type leases will remain the same.

The definition of lease payments will change. Guaranteed residuals will not be a lease payment for purposes of recognizing a finance lease; rather, it will be classified as a residual. The guarantee will still count in lease classification as always, so synthetic lease and split-TRAC structuring will remain the same.

Variable lease payments based on a rate or an index are lease payments in finance and sales-type leases that must be recorded as a lease receivable at commencement using the spot rate. A lessor will only adjust the carrying amount of a lease when the variable rents are based on a rate or index if the lease is modified. As it is under Topic 840, all other variable payments will be accounted for as they become receivable for finance leases. For operating leases, all variable rents will continue to be accounted for as they become receivable.

Bundled leases, such as full service leases, have lease and non-lease components. A lessor must separate the rent and services components. If the lease is a finance lease, which not typical in full-service leases, rent is recorded as a lease receivable. If the lease is an operating lease, as most full-service leases are, rent is recorded as rent income. The service portion is service fee income recorded on a cash basis as it becomes receivable for all leases.

As a related issue, lessees will be asking lessors for the breakdown of bundled billed leases so they may separate the gross payment and reduce the amount they must capitalize for the lease. They will have the same rule as the lessor for separating the components. Lessors may be reluctant to divulge pricing of the individual components, which could make lessees' estimating amounts for each component difficult. Lessees must use available market pricing of components, and most often there is no source for market pricing of similar transactions. Lessees may estimate the breakdown but it remains to be seen how auditors will react in practice if a lessee cannot support its estimates because of the lack of observable pricing.

The definition of initial direct costs (IDC) for lessors will change, which will be particularly important for entities that make both loans and leases. The new definition of IDC for lease accounting will include only third-party costs that would not have been incurred but for the lease. For many small- or mid-sized ticket leases, this will be *zero*. The old model, where many internal costs and direct external costs qualify for deferral, will still apply to loans. There could be systems issues associated with the difference, so if a company has both loans and finance leases in a single system, they should consider whether changes might be required. The financial implications and forecasts could be significant and should be reviewed as costs that were formerly deferred as a reduction in lease revenue will hit *current* P&L on the *expense* line. Finally, because Topic 842 also changes the definition of the interest rate implicit in the lease to require the inclusion of IDC as part of the cost of the leased asset, lessors should consider the potential effect on RVI purchased to ensure classification as a finance lease.

Sale leasebacks

Many lessors use sale leasebacks to fund their portfolio of leased assets — they are a seller/lessee and lease the assets back from a third-party lessor. The rules for sale leasebacks will change dramatically for any leaseback that contains a fixed-price purchase option, even if it is a non-bargain option. Generally, denying sale and operating leaseback accounting as the definition of a sale will conform to the new revenue recognition standard. The new definition of a sale includes giving up control. A purchase option allows the seller/lessee, or lessor using the structure as a funding mechanism, to control the asset even if the purchase option is not a bargain.

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If the transaction is a failed sale, both the seller/lessee and lessor account for it as a financing, which is not logical as the lease will be presented on the seller/lessee's balance sheet as debt and as a loan receivable for the lessor. Instead, the seller/lessee should report the lease obligation as a non-debt operating liability, which is the substance of the deal and beneficial to financial ratios and measures. Seller/lessees will have to work with their lessors to insure they structure and manage sale leasebacks to avoid failed sale leaseback accounting. One option is to sign an agency agreement with lessors; if the lessee is merely acting an agent in the transaction, it is not a sale leaseback.

Taking this issue to the business side with end-user customers, lessors will also have to work with customers to avoid failed sale leaseback accounting, but that is a subject for another article. One lessee issue pertains to large ticket assets — like aircraft — that have a long purchasing process with the need for committed orders and down payments or progress payments. These are likely to be considered sale leasebacks unless the lessee's rights are not ownership indices, or if lessee is not acting as a principal in an agent agreement agreed upon by the lessee and lessor.

A second lessee issue concerns master leases where, as a cost-saving and logistics easing mechanism, the lessor agrees that the lessee will buy and warehouse a number of assets that the lessor will fund on a period basis and include in the master lease arrangement. These issues concern both the lessor and the buyer-lessor's accounting for a failed sale-leaseback. Lessors will want to avoid that as it misstates and mispresents the asset which is a leased asset.

The lease accounting project has been more than 10 years in the making. At first, it looked like it would be a wild ride for the industry, but it settled down to a logical conclusion not far from the old FAS 13 risks and rewards model. The big changes are with lessee accounting, and I recommend reading *monitordaily* articles like "Customer Education is Key During FASB Implementations" for more details. Lessors should become experts in their customers' needs to add value in making sales.

Thanks to Jeffrey Ellis, senior managing director of FT Consulting, for reviewing and providing commentary on this article. m

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