

Bill Bosco Speaks on the Impact of the Proposed Lease Accounting Rules
The Project is in its Final Stages

I spoke on the Commercial Real Estate show, a national syndicated business radio program. I co-presented with Alan Bushell, president of ProLease, a lease accounting and administration software system. The show focused on the impact to the commercial real estate lessee issues but covered general information on the FASB Lease Accounting Project and its status as well as the business and operational impact and how to begin to prepare for the new rules. The link to the radio program is as follows: <http://commercialrealestateshow.com/listen/fasb-lease-accounting-standards-a-whole-new-world/>

Status of the Project and Operational Issues

The FASB and International Accounting Standards Board (IASB) will issue separate rules as they can't agree on lessee accounting. The FASB version is much more favorable to lessees than the IASB version. The FASB retains the current two lease capitalization model and separately accounts for and reports operating leases on the balance sheet and P&L. The net is the FASB version will capitalize operating leases but leave the P&L cost as the straight line average rent and most importantly NOT classify the operating lease liability as debt. This means that most financial analysis ratios and measures will be unchanged for US lessees and debt covenants that limit debt will not be impacted. This is not so for IASB lessees as the IASB version considers the lease liability as debt and they "front end" lease costs as they treat operating leases just like capital leases.

The project is in its final stages and is likely to be signed around year end 2015. The likely transition year is 2018 (January 1, 2018 for those companies with a calendar year end). Lessees should not be lulled into thinking you have until 2018 to work on the transition. SEC registrants have to present comparative financial statements – two years of balance sheets and three years of income statements. That means you have to revise your 2016 income statement when presented in 2018. Although, if you have only a few leases, the FASB version can be handled as simply as using an excel spread sheet to calculate and record the capitalized lease asset and liability amounts each period, leaving expense accounting unchanged, there likely is a systems decision. Large companies will want to have a lease accounting software system to handle large volumes of leases and capture, calculate and store information to support the new lease accounting on audit. If you want to run parallel you better start now with the planning and execution of the new process and transition (booking all your operating leases). Thankfully the process will be simpler for lessors as the current lessor modes will be retained with some changes that, in my opinion are not major.

A new lessee process for administrating and accounting for lease must be put in place and documented. Since operating leases are currently only reported in the footnotes, the level of importance from an audit and financial reporting perspective is not as high. The game has changed. Internal controls must be documented demonstrating that the rules are being followed. The new rules also involve more disciplines in the organization to work together to do the operating lease accounting. Because there is a need to assess things like renewal and purchase options and the expected payment under residual guarantees, the business people managing the leased assets will have to give estimates to the accounting department. When a lease is modified it will require communication with the accounting department and re-booking.

Draft of the Final Rule

The FASB and the IASB has asked me (among others) to review the final draft to see if there are any “fatal” flaws. The fatal flaws draft is very much the same as the project outline I have been reporting on of late. There will be no surprises, but I cannot divulge the entire content of the confidential draft or the FASB will be forced to kill me (accounting rules setting can be serious business).

I can reveal *some* things as the ELFA Accounting Conference included an interactive session with Tom Linsmeier and Gary Kabureck board members of the FASB and IASB respectively where they talked publicly about what is new in the final draft. I will focus on the FASB version of the final draft.

What is new is generally good news that will make the new rules easier to apply. The good news first – the FASB decided to call leases finance leases or operating leases (dropping the Type A & B meaningless labels). The FASB “reinstated” the 75% of useful life and 90% of fair value “bright lines” in the lease classification guidance to help make classification judgements easier and avoid inconsistent application. “Reasonably certain” replaced “significant economic incentive” as the new terminology regarding assessing whether options are to be included in lease payments (the intent is not to change current GAAP).

On the bad news or potentially bad news side (they are getting feedback that may change their minds and they are responding with requests for more information), they dropped the lease classification exception for assets in the last 25% of their useful lives. Gross billed property taxes are no longer considered an executory cost but rather will be a lease payment and capitalized (this should lead to lessees demanding net lease structures). There is confusion over the calculation if the implicit rate for lessor classification and lessor revenue recognition as they dropped ITC from the definition of the implicit rate and classification test yet added IDC. In my opinion there should be two implicit rates. The lease classification implicit rate should ignore IDC but include ITC as a reduction in the asset cost/fair value. For purposes of lease income amortization that implicit rate should be the internal rate of return considering ITC and as a deduction and IDC as an addition to the asset cost (the present value in the calculation. The FASB staff recognizes the issue so I am hoping for a good outcome. There still is uncertainty in my mind over the important issue of sale leasebacks of equipment containing a purchase option (the presence of a purchase option negates sale treatment under the new revenue recognition rules) done at or near delivery of the asset where the lessee has no profit element. These are very common in the industry and we need examples and clarification/guidance in several areas to avoid loss of sale treatment. When is does the lessee control the physical asset, e. g. in a corporate aircraft scenario, do commitments to buy and progress payments mean the lessee owns/controls the plane? There would be no sale leaseback if the plane is not controlled by the lessee. When is a lessee an agent vs. a principal? I contend that in most sale leasebacks done at or near delivery the lessee is ordering the asset and seeking competitive bids from lessors but may actual fund the asset before the lease is finally arranged. If the lessee is merely an agent and has no profit element there is no sale leaseback. The new rules say “momentary” holding of title does not necessary mean the lessee effectively controls the asset. They have to define “momentary” - I suggested 90 days.

There is hope that the FASB will deal with the issues identified as Tom Linsmeier invited the audience members at the ELFA conference to send him detailed emails on the issues raised. Also the FASB staff has been doing a great job in outreach to me and others to try to understand and adjust issues raised where they agree.

The Financial Impact

This rules change will impact all lessees who must produce audited financial statements. The industry segments that will see the biggest impact will be retailers and banks because of their real estate leases. Also large ticket long lived equipment lessees including airlines, package delivery companies, trucking companies and users of rail cars and locomotives will see a big impact. In preparing for my radio show talk I tested four companies with large amounts of footnoted future operating lease rents and found in three major retailers and one major airline the increase in assets ranged from 23% to a whopping 57%! I estimated the amount of assets that would be added to their balance sheets when the new rules hit using a lease capitalization model available on my website. The results are as follows:

| | <u>Total assets</u> | <u>Op Leases Capitalized</u> | <u>Details</u> |
|------------|---------------------|------------------------------|----------------|
| Walgreens | \$37bn | \$21bn/ 57% increase | 8,000 stores |
| CVS | \$74bn | \$17bn/ 23% increase | 7,000 stores |
| United AL | \$36bn | \$13bn/ 36% increase | 510 aircraft |
| McDonald's | \$34bn | \$9bn/ 26% increase | details NA |

You can see that peers may have different impacts depending on how much they lease and the length of their leases. Walgreens currently does leases with longer terms than CVS as an example. Companies will surely react to change strategies and structures to minimize the amounts capitalized without impacting their operational needs for use of the leased assets.

Some financial ratios & measures will change for the worse and the results for US companies vs IASB companies will be different are as follows:

| <u>Key Ratios/Measures</u> | <u>FASB Version</u> | <u>IASB Version</u> |
|----------------------------|---------------------|--|
| EBITDA | no change | better – rent replace by amort & int |
| Gross Margin | no change | no change |
| Operating Exp Ratio | no change | better – rent replaced by amortization |
| Current Ratio | no change | no change |
| Quick Ratio | worse – add'l liab | worse – additional liability |
| Net Worth | no change | no change |
| Debt/Equity Ratio | no change | worse – additional debt + eroded equity |
| Return on Assets | worse – add'l asset | worse – additional asset + front ended costs |
| Return on Equity | no change | ?? Less equity but front ended lease costs |

As per above there will be changes to key financial ratios and measures when the rules are applied. The market will adjust as it always has when accounting rules change. What will likely change is lessees will react to the impact and adjust lease strategies and terms where they can. An accounting change does not change the credit rating or equity valuation of a lessee company BUT in a peer comparison analysis there may be variations depending on the level of leasing and the differences in lease terms.

Bill Bosco is the Principal of Leasing 101, a lease consulting company. Bill has over 40 years' experience in the leasing industry. His areas of expertise are accounting, tax, financial analysis, structuring, pricing and training. He has been on the EFLA accounting committee since 1988 and was chairman for 10 years. He is a frequent author and speaker on leasing topics. He has been selected to the FASB/IASB Lease Project working group, as the ELFA representative. He can be reached at wbleasing101@aol.com, www.leasing-101.com or 914-522-3233.