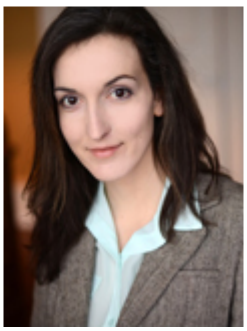
ELFA Financial Accounting Committee: Transitioning to the New Lease Accounting Standards

by Rita Garwood 2015

In part one of a three part series, Monitor editor, Rita E. Garwood, sits down with members of the ELFA's Financial Accounting Committee — Bill Bosco, John Bober and Rod Hurd — as well as ELFA president and CEO-elect Ralph Petta at the ELFA's 2015 Lease and Finance Accountants Conference to discuss the most important steps that lessors and lessees can take to ensure a smooth transition to the new accounting standards.



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The lease accounting project has been a hot topic since it was first proposed by the FASB and IASB in 2006 to improve transparency by including operating leases on a lessee's balance sheet. After many board meetings, comment letters, drafts and redrafts, the project is finally coming to an end. With a transition date of 2019 (a year later for private companies), *Monitor* asked members of the ELFA's Financial Accounting Committee what would be at the top of their to-do lists if they were ultimately accountable for a company's smooth transition to the new accounting standards.

Creating a Framework in Large Organizations

Rod Hurd, CFO of Bridgeway Capital, advises that all companies should establish a framework to implement a successful transition. However, this framework will look different in a large organization versus a smaller privately held company. It will also look different for lessees and lessors. Hurd says each department of a larger organization is bound to have both misinformation and valuable insights regarding the impending changes. "In my experience involving managing change, you have to put together a team that allows these different disciplines to meet at a common place," Hurd says.

The panel suggests large organizations establish an interdisciplinary team — comprised of representatives from the legal, credit, marketing, operations, equipment management and tax departments — to ensure that a company is fully prepared for all aspects of the coming changes. “It’s essential for good communication,” Hurd says. “You need sub-committees to actually get the work done efficiently. It’s not only the accounting department that should be driving this. The change is going to have credit taking and monitoring implications. The marketing people will also need to know how to talk to the customer.”

John Bober, global technical controller at GE Capital and chair of the Equipment Leasing and Finance Association (ELFA)’s Financial Accounting Committee, agrees. “You need to be very careful on the communications plan, because it’s not just communication with your customers,” Bober explains. “You also need to communicate with your employees to make sure they have a good line of sight on how the changes will or will not impact the business.

“Whenever you have a change you can never over resource the project,” Bober says. “You do need to think of it as a multi-disciplinary task. And in addition to that, while we are an equipment lessor organization, every company is also a lessee somewhere as well, leasing for its own office equipment or real estate.” Because of this, Bober says myriad of implications will exist across a leasing company, including the customer facing side, the administration, and the budgeting and reporting processes. How returns on investments are measured may also be impacted.

Utilizing Outside Resources at Small Companies

Hurd says the transition will be more challenging for smaller companies. Outside resources, like those provided by the ELFA, will be critical to the transitional process, and will provide small businesses with a greater understanding of changes as well as an ability to respond accordingly.

While the ELFA has been involved in the lease accounting project since its inception, ELFA president and CEO-elect Ralph Petta says the association is shifting gears from influencing and analyzing the project through its work with the FASB and the IASB, to providing necessary information and communication strategies to ELFA members.

“When the proposal is published and when there is a new standard, the association is going to transition,” Petta explains. “We’re scheduling a free webinar, a one-day workshop, customized in-house training and sessions on the new standard at all of our 2016 events. We’ll also be providing educational resources and tools for ELFA members and their customers on the ELFA website and our Equipment Finance Advantage end-user website. In addition, our financial accounting committee is putting in place a three-part series to talk about the impact of the new rules and how to communicate that to our membership, their customers and others. There is a lot more that we can do and will do.”

Petta says the ELFA is also developing a working group as a sounding board for any implementation issues. “It will be mostly our financial accounting committee, who are the technical experts and who have been a tremendous resource to the association,” Petta says. By sharing information and ideas, this group will ensure that the ELFA continues to be a valuable resource to the FASB after issuance of the standard.

Top Priorities for Lessors

Group Photo: (L-R) Bill Bosco, principal, Leasing 101; Ralph Petta, president & CEO-elect, Equipment Leasing and Finance Association; John Bober, global technical controller at GE Capital and chair of the ELFA Accounting Committee; Rod Hurd, CFO, Bridgeway Capital Advisors

When committees are formed and education begins, regular *Monitor* contributor, Bill Bosco, principal of Leasing 101, says lessors and lessees will need to prepare for the changes in different ways. From a lessor perspective, Bosco says there are fewer accounting changes from current GAAP, so there will be some — but not many — systems implications.

"In our opinion, it's working out actually very well in the U.S. because the FASB has basically decided to keep the current framework in place, but just capitalize operating leases for lessee customers," Bosco says. "There was a concern that customers might stop leasing because the liability on their books would break their debt covenants, the asset would be on books and the accounting would be complicated."

Bosco says it will be essential for lessors to understand the rules, make any necessary product adjustments, decide on new initiatives and focus on education. He believes a great deal of misinformation about the standard has been circulating, which makes education vital. "Lessors have to educate customers, and they have to educate their own staff, both sales and accounting/operations," he says.

"Changes may affect income recognition on sales-type leases if they have to use third party residual value insurance to achieve sales-type lease accounting," Bosco explains. According to a recent ELFA whitepaper, the new rules preclude lessors from recognizing sales-type profit at the commencement of the lease for any direct financing lease that employs third-party insurance or residual guarantees. For those impacted, this will cause income recognition changes on sales-type leases, which will be important for lessors to understand and plan for as their forecasted revenue will flatten out temporarily.

Sale leaseback rules are also important for lessors to comprehend. "Due to changes to sale leaseback rules where the leaseback contains a purchase option, it will be more difficult to achieve sale and operating leaseback treatment without careful structuring," Bosco explains. This will impact how they execute sale leasebacks with customers. Some lessors use sale leasebacks to fund their portfolios and will have the same concerns — to ensure the transactions are structured to be accounted for as sales and operating leasebacks.

Top Priorities for Lessees

Bosco says the lessee side is more complicated. "Companies have thousands of leases and they've never had to do anything more than accumulate information to be reported in the footnotes about future rent obligations," Bosco explains. "Now they've got to capitalize every one of those leases;; so large companies definitely need a system and a new process with internal controls. Any leases with services like full service leases or real estate gross billed leases will have to be bifurcated so that only the lease payment (not the service portion) gets capitalized."

The interdisciplinary team Hurd suggested would also be essential for lessees, according to Bosco, as more inter-department involvement will take place when a lease must be capitalized. "You have to look at renewals, for instance," Bosco says. "Estimates have to be made as to whether those renewal options are reasonably certain to be exercised, and the accounting department can't make those estimates." Bosco says other operating departments of the business will have to decide whether or not a renewal is compelling or a bargain to include that in the lease term.

Bosco says the value of the asset must also be assessed if a company is guaranteeing a residual as in a TRAC lease or synthetic lease. "Some operating department in the business has to be making those judgements to give them to the accounting department in order to book the transaction," he explains. "But it's going to be a huge task extracting information from every lease including contractual rents, variable rents, breakdown of lease portions of bundled/gross billed leases, and inputting the information into a system and developing a lease management process and a set of internal controls that could be audited."

While in the footnotes, leases did not attract a high level of attention from auditors, but Bosco says that will inevitably change once leases are on the balance sheet. "Lessees are going to have to document their lease management process and show that they have internal controls," Bosco says.

Overall, the panel agrees the equipment leasing business will remain strong despite the accounting changes. "Lessees will continue to lease because there are many reasons why lessees lease. From an accounting perspective the operating lease is only partially on the balance sheet, in that just the present value (PV) of the rents goes on the balance sheet — it's still got some accounting benefits, so we don't see a change businesswise for lessees, but we do see a big impact on lessees in terms of their need for an accounting system," Bosco says.

"If you only have a few leases, you can do the calculations easily," Bosco explains. "I did a little study. Walgreens has 8,300 leased stores so it's going to be a huge undertaking. Looking at their footnotes, an estimated calculation shows the capitalization of leases adds 57% more assets to their balance sheet. United Airlines has 510 leased aircraft. Their balance sheet assets are only going to go up about 25%. I say 'only,' but that's still big numbers. It has an operational impact, and it has a financial impact as well."

Bosco says this may cause some companies to adopt new strategies, such as negotiating shorter lease terms without compromising business needs. "Retailers may not continue to use 25-year real estate lease terms because the amount that gets capitalized is a lot more than if you do a 10-year lease term," Bosco explains, "But you first have to consider your business needs."

Capital-Raising Concerns

Hurd says that the change in accounting may also cause capital raising issues for lessees. Hurd explains that, although some of the bigger companies' lenders and credit rating agencies already consider the impact of capitalizing leases, some covenants t may be adversely impacted by capitalization. Hurd says this potential will lead treasurers to examine current and project future financials to discover areas that need renegotiation and to determine what changes will be necessary to keep the business model aligned with existing covenants. Debt limit covenants and debt to equity ratios should not be impacted as the FASB has specifically decided to classify the operating lease liability as a non-debt operating liability. However, other financial ratios and limits will have to be reviewed for impact..

"It's going to be an issue for small business because they generally don't negotiate their covenants," Hurd says. "They often get a standard form that says in consideration for the money, sign here." Hurd explains that small businesses will need to examine existing covenants and capital raising agreements to determine if the company will be in compliance as of the effective date. "Unless they successfully report capitalized operating lease obligations as 'non-debt' they may end up with a covenant violation,." Hurd says.

As a result, Hurd says that, despite existing relationships with a bank or its loan platform, many small business agreements will be sent to the lenders' loan committee because the accounting changes will likely require amendments to certain of the ratios. "And now you're competing anew with others in a loan approval process that usually involves looking at the relationship in terms of whether or not you're desirable," Hurd explains. "This process gives lenders a second look at the relationship."

"Most of the important financial ratios and measures aren't going to change in the FASB model," Bosco says. "The FASB says that the liability isn't debt, but small banks might just look at the balance sheets and say, '"Do a debt to equity ratio including the operating lease liability or they may inadvertently include the lease liability in the covenant debt limit calculation.'" Lenders will need to be educated on the true nature of the new capitalized lease asset and liability and lessees need to know how to present it in their financials."

For successful adaptation to the change, Hurd says small businesses will need extra time. "What hasn't taken off in the U.S. is a special, stable framework for small- and mid-size enterprises that the Europeans have. Accordingly, more, more time is going to be critical," Hurd says.

In the next installment of this series, our panel will discuss the new revenue recognition standard, including its implications on the ultimate performance of equipment finance companies.