

White Paper – Navigating in the New Lease Accounting World

The Lease Accounting Standard will have Significant Impacts to lessees

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Background

The Lease Accounting Project has finally concluded as the IASB issued their version in January 2016 and the FASB issued their version in February 2016. This paper outlines the important elements of the new standard dealing with the FASB version except where noted, but IASB version issues are covered since many of our customers are IASB companies. It highlights what is new and what the implications are. It outlines what lessees and lessors need to be doing to prepare for transition. For public companies the transition will occur in 2019 in financial statements for periods beginning after December 15, 2018. It should be noted that the SEC requires 3 years of comparative income statements and two years comparative balance sheets. This means that for public companies 2017 is the start for capturing data for reporting in 2019. For private companies the transition year is one year later or 2020.

We have been following it closely from the first paper introducing the idea of changing lease accounting in 1995. The initial proposal was to completely change both lessor and lessee accounting in ways that did not reflect the substance of leases for lessees or lessors. The project gained importance from the 2005 SEC study of off balance sheet transactions which cited lessee operating lease obligations as the largest off balance sheet obligation. The SEC recommended that lease accounting be reconsidered and operating lease obligations recognized on balance sheet. As a result of the SEC report the Financial Accounting Standards Boards (FASB) and the International Accounting Standards Board (IASB) put the project to overhaul lease accounting on their agendas as a joint project in 2006.

The preliminary views document issued for comment in 2009 and initial exposure draft in 2010 proposed to account of all lessee leases as capital leases and lessors would use two new methods to account for operating and finance leases. In the 2011 exposure draft they continued to propose that equipment leases all be accounted for as capital leases by lessees. The ELFA commented negatively along with the vast majority of other commenters (there were over 1500 comment letters received commenting on the project's three exposure documents). The ELFA's positions were that the FAS 13 risks and rewards framework works best to reflect the substance of leases for both lessees and lessors. Lessor accounting was not "broken" and worked very well for users of financial statements. The US commercial law and tax systems follow a risks and rewards methodology as well to determine if a lease is a financed purchase or a rental contract. Aligning accounting, tax and legal regimes simplifies the compliance and accounting for preparers and gives financial statement users the most decision useful information on leases – or any financial item for that matter. Lessees in operating leases are party to an executory contract and do not own the physical asset and the lease obligation is not debt. In a bankruptcy liquidation the asset is returned to the lessor and the future lease obligations are extinguished. Segregating a lessee's lease assets that are owned vs rented and lease liabilities that are debt vs executory is important information for lenders. For taxation (income, sales and property), the lessee is the owner in a finance lease and the interest expense is deductible. In an operating lease the lessor owns the asset and the rent is deductible by the lessee.

The ELFA understood that the goal of the project was to put an asset and “debt-like” liability on the balance sheet for lenders, analysts and investors as they make similar adjustments for operating leases for their particular analytical objectives. We argued that the basic risks and rewards framework should be retained and operating lease obligations should be put on the balance sheet as non-debt operating liabilities with no change to straight line rent expense accounting.

The FASB retained the basic FAS 13 (FAS 13 will be called ASC 842 under the FASB’s new accounting rules codification regime) framework for classification (the tests are virtually the same), P&L lease expense (they kept the straight line expense) and, although they put an operating lease liability on the balance sheet it is NOT classified as debt. This is great news for US companies who report their financial statements using US GAAP.

The IASB will adopt a one lease model for lessees where all operating leases will be treated as finance leases resulting in front ended lease costs and the lease liability classified as debt. This is not so good news, so be aware of this for your customers who have parent companies located in an IFRS country as they report their financials using IASB GAAP.

The FASB listened to the feedback and did retain the basic framework of FAS 13. The scope is the same, covering only leases of property, plant and equipment. The definition of a lease is virtually the same for most equipment and real estate leases. They retained the current classification tests. Lessee accounting retains the two lease model – the finance lease vs. operating lease distinction. With two different accounting and reporting methods in line with FAS 13’s concepts. There were some important changes to the definition of lease payments, Initial Direct Costs (IDC) and sale leasebacks for both lessees and lessors.

Some also think that lessor accounting will not change, as they heard that both Boards decided to keep the current rules in place. Although that is generally true, they have changed a few things, most notably, changing the definition of IDC, dropping leveraged lease accounting for new leases, changing sale leaseback accounting rules where a non-bargain fixed purchase option is present and not allowing sales type lease accounting when using third party residual insurance.

Both lessees and those lessors who lease in their assets (they are lessees too) should be looking at acquiring a lessee lease accounting system, installing it and testing the data well in advance of the change in the new accounting rules. New internal processes and controls have to be established and documented for audit purposes. The capitalization of operating lease payments will place more scrutiny on operating leases and items that were not focused on before like interim rents and re-stocking fees with be capitalized.

Some lessors think lessee customers will buy rather than lease because operating leases will be shown on the balance sheet and leasing may attract greater scrutiny by the customer’s CFO. That should not be the case as although there may be some negative aspects to the new rules, the reasons why customers lease remain strong, in fact there still will be partial accounting benefits as only the present value of operating lease payments goes on the balance sheet and the cost patterns remains as straight line. It is important for lessors to understand the rules, train sales staff to be proactive in educating customers and to adjust products to take advantage of opportunities and avoid negative impacts.

The Details: Lessee Issues

There are 2 key issues for the lessee for both FASB and IASB customers. The first is capitalization of the lease and the resulting financial impact (balance sheet, profit and loss statement, debt covenants, credit rating and financial ratios/measures) – the FASB and IASB do not agree on the accounting and reporting in very important ways, thus the lessee impacts are different as explained below. Second is what payments are capitalized, and the FASB and IASB do agree on this.

Both Boards agree that in all leases the lessee acquires a right of use (an asset) and incurs a liability (the obligation to make lease payments). Where they do not agree is that in some leases the lessee also acquires an ownership interest. The FASB recognizes there are two types of leases – finance leases (formerly known as capital leases) and operating leases. Finance leases are accounted for as a debt financed purchase of the leased asset. Operating leases are accounting for as the acquisition of a right of use and the incurrence of a non-debt other operating liability. The IASB requires the lessee to account for all leases as though they are debt financed purchases of the leased asset – not a good outcome as more financial ratios and measures deteriorate and debt covenants will be violated (see chart below).

The capitalization methodology is to present value the lease payments using the implicit rate in the lease (this is only known in leases where the lessee is guaranteeing the residual or a portion of the residual) or the lessee's incremental borrowing rate (this is the rate that will be used most often). Often the lessee will not know that rate either as it generally does not borrow fixed rate (most leases have fixed payments) medium term funds with a duration equivalent to the lease's duration (the lessor's assumed residual acts like a balloon). An acceptable equivalent to the incremental borrowing rate may be the lessee's revolver borrowing rate swapped to fixed matching the swap term to the lease term. The present value amount is recorded as leased asset and liability. Under the FASB model the finance lease ROU asset and operating lease ROU asset are separately reported (this allows lenders, bank regulators and tax authorities to best understand which assets are owned versus rented). The FASB model also classifies finance lease obligations as debt while operating lease obligations are reported as non-debt operating liabilities (an important distinction for lenders, credit analysts and debt covenant compliance). Under the IASB model all leases are accounted for as finance leases meaning all lease assets are comingled and all lease liabilities are all considered debt.

Subsequent accounting for finance leases is to amortize the ROU asset straight line over the lease term or, if there is an automatic transfer of title or bargain purchase option, over the useful life of the asset. The finance lease obligation is accounted for as a loan with interest imputed using the rate used to discount the lease payments. The combination of imputed interest and asset amortization creates a front ended lease cost pattern (not desirable). The subsequent accounting for FASB operating leases is to record the lease expense as the straight line average of the lease payments. The lease liability is amortized by the difference between cash rent payments and the imputed interest. The ROU operating lease asset is amortized by the difference between the straight line rent expense and the interest

Lessors should note that lessees will benefit from the lowest present value capitalized as it minimizes the impact on Return on Assets (ROA) that is a common measure used by investors and is also commonly a factor in customers' personal compensation. Lessees will also benefit from operating lease classification as the lease cost is straight lined and the liability is not classified as debt. All of these issues are important to their impact on financial ratios and measures.

amount imputed to the liability amortization. Any initial direct costs, landlord allowances and impairment are amortized straight line over the lease term as a component of rent expense. The net expense reported is a straight line expense labeled as rent expense.

Lease payments include contractual rents, any other fixed payments the lessor can force the lessee to pay, any bargain renewal or purchase options, variable payments based on a rate or index (set at the spot rate at commencement) and the probable amount payable under any lessee residual guarantee. Other variable payments will be accounted for on a cash basis unless they are disguised minimum payments meaning the fixed lease payment is below market and the variable payment is virtually assured of being incurred. In that case an estimate of the disguised minimum payment must be capitalized. The FASB decided that variable payments based on a rate (LIBOR) or an index (CPI) do not have to be rebooked when the payments change unless there has been another event that causes the lease to be rebooked – this eases the compliance burden on lessees. The IASB requires rebooking whenever the variable payments change.

Lessor's should note that the fact that operating leases are capitalized, lease payments will receive greater scrutiny. Items like interim rents, variable rents that are virtually assured of occurring (disguised minimum payments) and restocking fees that were overlooked in the past will be capitalized as they are lease payments.

Any services included in a gross billed or bundled billed full service lease should be separated with the non-lease portion accounted for on a cash basis and the lease portion capitalized. If the lessor does not disclose the breakdown, lessee's can estimate the breakdown but the estimate has to be supported with maximum use of observable market pricing for the lease or non-lease components. The breakdown will be audited. The lessee can elect to capitalize the full amount of the bundled billed payment but that is not desirable as it will overstate the amount capitalized – less assets = better ROA.

Separating as much service and non-leases costs as possible is more important to IASB lessees for two reasons – the lower the amount of payments in the capitalization calculation, the less assets and debt reported on the balance sheet and the lower the amount of lease costs that are front ended (the bifurcated service/non-lease costs are a straight line expense.)

Lessee's should note that separating non-lease components is a transition work issue and it will be a big job to transition all operating leases given the need to provide comparative statements. This is not just a 2019 issue. For existing leases ask your lessor for the breakdown of lease and non-lease elements now so that you are prepared to capitalize the correct lease payment in the earliest period you have to report under the new standard – for public companies that will be in 2017.

Sale leasebacks with purchase options

The rules for sale leasebacks will change dramatically for any leaseback that contains a purchase option, generally denying sale and operating leaseback accounting as the definition of a sale conforms to the new revenue recognition standard. The new definition of a sale includes giving up control. A purchase option allows the seller lessee to control the asset even if the purchase option is not a bargain (we disagree, fought and lost our arguments against control ignoring risks and rewards). If the transaction is a failed sale, both the lessee and lessor account for it as a financing – not logical as the lease will be

presented on balance sheet as debt for the lessee and a loan receivable for the lessor. Many equipment leases are sale leasebacks merely due to the logistics in the lease origination process and no one cared as current sale and operating lease GAAP is based on risks and rewards (not control) and allows non-bargain purchase options. 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 as if the lessee is merely an agent in the transaction it is not a sale leaseback. Another option for assets that are constructed (like corporate jets) and require committed orders and down payments is for lessees to do some pre clearance work with your auditors to understand if a right to an aircraft gives the lessee control of the aircraft. If having a right does not mean having control of the physical asset it is not a sale leaseback.

Other Lessee issues

The definition of initial direct costs (IDC) will change to eliminate inclusion of any internal overhead costs. The implications are that internal direct costs will hit P&L when incurred, deteriorating performance.

Lessees should do a pro-forma estimate of the financial results under the new rules and look at how the changes will impact debt covenants. There should be little or no impact as the FASB made an effort to keep all of current operating lease GAAP in place except for the capitalization. They also made sure the new operating lease liability would not be considered debt. If there are any expected impacts lessees should discuss the issues with their banks to resolve them before transition.

The transition process for leases that commenced before the transition date will be a large undertaking and lessees should put together a project team now. There may be a need to purchase lease accounting software. Existing capital leases are grandfathered. Operating leases are capitalized by recognizing the present value of the remaining rents as though they were newly entered leases. This means extracting data on existing leases to determine the lease payments remaining – this included bifurcating non-lease components and calculating capitalizable variable rents and residual value guarantee payments. The FASB has allowed some transition practical expedient reliefs but if elected a lessee has to adopt all the reliefs. It appears to be wise to accept the reliefs as they are designed to lessen the transition workload and complexity. The transition reliefs include: not having to reassess items like lease classification, whether there was a sale in sale leasebacks and whether a contract contains a lease, and not having to revise IDC.

Lessees will have to develop a lease accounting process with internal controls to insure that they account for new leases at commencement and capture changes over the lease life. The accounting department will have to extract lease payment information from the lease document. The new rules will require the accounting department to interface with other departments within the lessee organization to get necessary information to account for the capitalized leases. The lease term, renewal options and purchase options need to be evaluated by an operations department managing the leased asset to determine if the options are reasonably certain to be exercised or not. The probability of payment under residual guarantees must be assessed by an operations department at commencement and at least annually thereafter. The treasury department needs to provide the booking discount rate and rates for variable payments based on a rate or index. Any gross or bundled billed payments must be bifurcated by an operations department managing the leased asset.

Lessee impacts and strategies:

Unfortunately IASB customers, will have to account for operating leases as finance leases meaning the lease liability is debt and the lease cost is front ended. As a result the impact to financial ratios and debt limit covenants is more severe. The structuring objective of both FASB and IASB lessees will be to minimize the capitalized amount of leases. There are product options and structures that a lessor can employ to help meet the lessees' objective.

Some lessee financial ratios and 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 Ratio	no change	better – rent replaced by amortization
Current Ratio*	worse – ROU asset not current	worse – ROU asset not current
Quick Ratio*	worse – added liability	worse – additional liability
Net Worth	no change	worse – asset amortizes faster than the liab
Liabilities to Net Worth*	worse – added liability	worse – additional liability
Debt/Equity Ratio	no change	worse – additional debt + eroded equity
Return on Assets	worse – added ROU asset	worse – additional asset + front ended costs
Return on Equity	no change	worse - less equity but front ended cost

*Could be argued that the added liability is an executory liability that disappears in a liquidation so it is misplaced

Lessees should do proforma calculations of their financials assuming all operating leases are capitalized and run the calculations required by their debt covenants. This should be done as soon as possible to identify if there are issues that they need to address with their lenders before they must transition to the new rules.

Lessee lease accounting issues with structuring ideas/commentary are as follows:

Issue	FASB	IASB
Balance sheet classification	Best if lease is an operating lease = liability <u>NOT</u> debt	Doesn't matter as all leases are treated as finance leases = liability <u>IS</u> debt
P&L	Operating lease expense is the straight line average rent	All leases have front ended costs = imputed interest + straight line asset amortization
Separation of elements in a bundled billed lease	The more services and non-lease costs bifurcated in bundled billed/gross billed operating leases, the lower the rent to be capitalized.	The more services and non-lease costs bifurcated, the lower the rent to be capitalized and the lower the amount of costs front ended (non-lease elements are straight line expenses if bifurcated).
Structuring	Best option is an operating lease with the lowest PV of rents. Residual guarantees can lower rents. Product choice and bifurcating non-lease elements can lower rents. Adding a CPI clause while reducing rent is a lessor option but it comes with risk. Shortening the lease term is an option that comes with risk.	Best option is a lease with the lowest PV of rents. Residual guarantees can lower rents. Lessors can lower rents thru product choice and bifurcating non-lease elements. Shortening the lease term is an option that comes with risk.

The Lease vs. Buy Decision

The new rules should not change lessee behavior. There are many business, meaning non-accounting, reasons why customers lease. The alternative to a lease is to borrow to buy the asset.

The business reasons why customers won't borrow to buy are:

- no money down and get immediate use of the leased asset versus a loan typically requiring a down payment,
- avoid using capital on a non-core business asset,
- level fixed rate payments over a term that closely match the asset useful life,
- outsourcing service in a full service lease is more cost effective and easier to manage,
- the customer must dispose of the used asset if owned, and
- convenience – a lease is often point of sale “financing” and with a simple quick process for approval.

The financial reasons against a customer's borrowing to buy are:

- can the customer even get a loan from a bank,
- the rate will be floating and may be high,
- a down payment may be required,
- the term and loan payments may not fit the customer's cash management budget,
- full asset cost is on balance sheet, reducing ROA which is often the basis for compensation and investment evaluation,
- the loan **IS** debt which may violate debt covenants,
- the costs are front ended (imputed interest and straight line depreciation),
- leasing provides a hedge against obsolescence.

A summary of the general reason why customers lease and how those reasons fare under the proposed new rules:

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, less than 100% of the asset cost on balance sheet	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

Lessors Product and Structuring Opportunities

Lease product options include conditional sales, fair market value (FMV) leases, synthetic leases, and for vehicles - TRAC and split TRAC leases. The “best” financial products for lowering the amount capitalized, allowing straight line expense and avoiding the lease liability classified as debt are operating leases structured as FMV leases, synthetic leases or Split-TRACs. The worst products (assuming a US customer) are conditional sales and TRACs as they are finance leases and capitalized generally at 100% of cost. For IFRS customers all products will result in the lease liability labeled as debt and front ended lease costs. The IFRS customer is still motivated to lower the PV of the rents to lower the amount of assets and liabilities capitalized to minimize the negative impacts to financial ratios and measures.

Residual guarantee products and variations may be attractive (remember a residual guarantee may eliminate tax benefits to the lessor) given that only the probable payment (not the full amount of the guarantee) under the residual guarantee is capitalized. At commencement the probable payment under the guarantee should be zero as the residual guarantee is generally structured with the strike price set at the expected future value – it is not “in the money”. A residual guarantee allows the lessor to offer a lower rent by assuming a higher residual without the asset risk, as the lessee guarantees the residual (there is credit risk, that is, can the lessee pay the guarantee if needed?).

The following table of capitalized values for different lease structures shows that the split TRAC and synthetic leases offer the lowest capitalized values. The high residual assets offer lower capitalized values than low residual assets. Note that the PC lease with an interim rent would not be classified as an operating lease as the interim rent will be capitalized causing the present value to exceed 90% of the asset cost. These values are not purported to represent current market pricing.

Lease Type	Sample Terms	Estimated 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/Ag 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
Truck lease	84 mos, 1.24% pmt, FMV 23% resid	85% of cost
Corp jet lease	120 mos, 0.65% pmt, FMV	59% of cost
RE synthetic lease	60 mos, 0.5% pmt, 85% RVG	26% of cost

The Details: Lessor Issues

Lessor/customer interface

Lessors should understand the new rules as they impact customers and product offerings. There is a great deal of misinformation being communicated about the new rules in articles and hearsay. The rules will not be detrimental as first thought. There are actually some opportunities too.

The lessor sales staff has to be trained. They have to understand the new rules and the implications. They have to prepare for dealing with customer questions and objections. Their marketing plans have to be adjusted for product changes. Marketing materials have to be updated.

Your customers should be told that 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 single lease (capital lease accounting for all lease) model and reverted to our current GAAP two lease model where operating leases would be capitalized but treated differently than finance leases. Operating leases are 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” operating 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 and also eliminate most of the negative aspects of the new rules. The amount capitalized will be less that the equipment cost and the cost is straight lined 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?

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 details of the project focusing on 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 the 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.

Lessor internal accounting issues

The good news re lessor accounting is the FASB decided that there were no major deficiencies in lessor accounting so they left most of it in place. The classification of leases as either operating or finance leases remains the same. The revenue accounting models for both also remain the same so there will be no major systems changes required.

The need for residual insurance (RVI) to convert operating leases to finance leases will remain a useful tool for financial institutions as the income pattern is better but more importantly finance lease accounting avoids depreciation of operating lease assets that negatively impact operating efficiency ratios that investors key on.

Sales type changes

The definition of a sales type lease will change only where third party residual insurance was needed to convert the lease from an operating lease. The reason for this change is to conform to the new revenue recognition rules that define a sale as being based on a transaction between two parties (third party involvement cannot create the sale).

If the operating lease is not converted to a finance lease, the gross profit is straight lined over the lease term. If residual insurance is purchased to convert the lease to a finance lease the gross profit is

included in the revenue amortization and implicit rate calculations such that the gross profit is recognized at a constant rate versus the declining lessor investment - just like any other finance lease. The impact here is for those manufacturers and dealers who do need to use RVI, their revenue pattern will suffer in the short run although it is only a timing difference and once they reach a level state where old leases are replacing new leases the negative impact will disappear.

An alternative strategy to accelerate gross profit recognition is to use a third party vendor lessor to buy the leases which will give the seller sale treatment although there is a tradeoff of loss of control of the customer and loss of finance revenue.

Lessor portfolio funding options

If a lessor acquires its portfolio leased assets by borrowing and buying, there is no change from current GAAP, that is, the lessor records the asset at cost (100%) and the loan that finances the purchase as debt. The lessor accounts for the asset it leases out as a finance lease or operating lease, and records interest expense on the loan. .

If the lessor decides to execute a sale leaseback of those purchased assets and includes a purchase option in the leaseback as often occurs, the new rules would **not** consider that a sale, so the sales proceeds and leaseback are recorded as debt (a confusing and bad outcome). The end user leases would be recorded as either operating or finance leases. Under current GAAP many lessors use sale leasebacks with EBOs or purchase options to remove their portfolio of operating lease assets off their books – that will not be the case in the future without careful structuring. It would still be advantageous to do a sale leaseback with a fixed price purchase option if structured so that it qualifies as a sale (you need to be considered an agent arranging the sale leaseback). The benefits are the liability is not debt and the value of the asset is likely to be lower as it would be the ROU asset resulting from capitalizing the operating leaseback.

IDC changes

The definition of IDC will change to include only those costs directly attributable to negotiating and arranging a lease that would not have been incurred if the lease had not been obtained. It can include sales commissions but not internal overhead costs. Many lessors allocate internal initial direct costs to be included in IDC as allowed under the current definition. The financial impact to this change is an acceleration of operating costs (it is a timing difference so it will level off when the new leases are replacing old leases at an even pace). The operational impact is that the definition of loan IDC will remain unchanged so lessors who are also lenders will have two different IDC processes.

Full service lessors

Full service lessors will have to bifurcate their payments into lease and non-lease components in the P&L. This should not be too great an issue as it just puts the service revenue on a different line. The more problematic issue is that lessees will ask for a breakdown of payment components for both new leases and all existing leases that will be in effect on the transition date. Lessors may view this as proprietary pricing information. If they refuse to provide the information it may be difficult for lessees to find observable market pricing for the lease and service components. Lessees can use reasonable estimates but it remains to be seen as to how the auditors will deal with the issue if market information is not available.

The issue of divulging the breakdown of lease and non-lease components may turn out to be a competitive issue. If some lessors provide the breakdown it may force other lessors to do so as lessees will likely demand it.

Leveraged leases dropped but existing leases grandfathered

The leveraged lease rules for new leases will be dropped from the rules. They did allow existing leveraged leases at the transition date to be grandfathered. This is an opportunity to continue to do leveraged leases as the rules will allow them to continue to be accounted for as leveraged leases even after they are traded.

Summary and conclusions

The rules are complex and lessors who best understand the rules and implications will be in a better competitive position, able to show value added consultative selling skills to their customers and stand out from the competition.

U.S. lessees will look to continue to get operating lease treatment, to minimize lease payments and to separate non-lease elements – all contribute to more advantageous financial presentation and results. Structures with lessee residual guarantees can produce the lowest capitalized amounts. IASB lessees will also be motivated to minimize lease payments and bifurcate non-lease payments from rents and residual guarantee structures can help lower rents to be capitalized.

Business should remain strong and there are new structuring opportunities to consider.