Lease Accounting Project Overview
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Agenda

- Overview
  - Lessee Accounting
  - Lessor Accounting
  - Sale Lease Backs
- Project Timing
- Implications

Key: red = bad, green = good, amber = caution

What aspect of leasing is set to change?

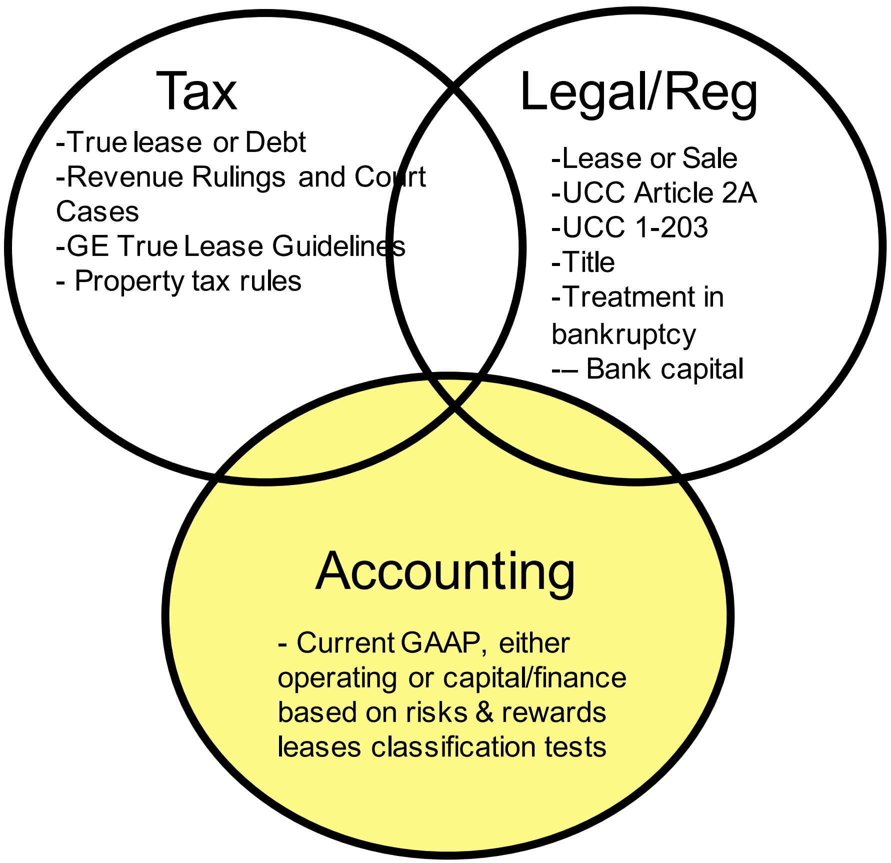
FASB proposals change US GAAP/IFRS ***accounting rules only***

- Bankruptcy law remains unchanged, **risks and rewards** of ownership model under Art. 2A UCC True lease vs. Art. 9 UCC secured loan

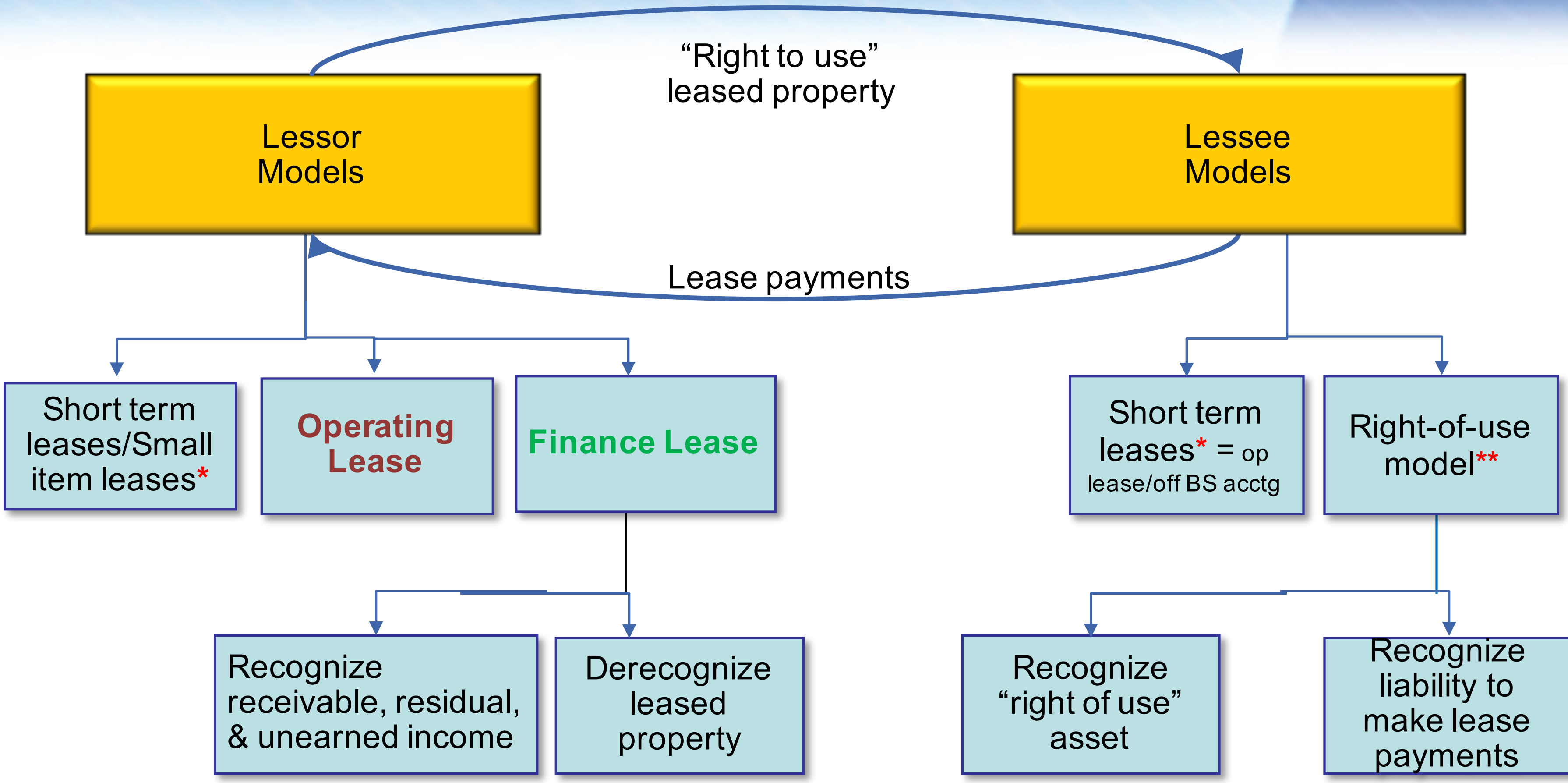
  Note: IASB will comingle finance and operating lease assets & liabilities. FASB will report separately according to legal substance, in line with: users' bankruptcy analysis, lenders' definition of debt & bank capital rules

- Tax rules remain unchanged, **risks & rewards assessment** of tax owner considering extent residual retained by lessor at end of lease

  Note: IASB = Bigger book-income tax differences; new complexity in sales/property tax. FASB in line with tax treatment.



Lease Models



*IASB allows a small item exemption ($5,000)

**FASB only = 2 lease types: *Operating lease & *Finance leases with different P&L cost patterns + separate BS presentation. IASB only = all leases are finance leases

Short Term Lease Exemption

- Short term leases can be exempt from capitalization
- Lessee may elect to use current operating lease (off balance sheet) accounting for short term leases
- Short term leases are leases with a term of 12 months or less considering only options where the lessee has significant economic incentive to exercise, aligning with the general definition of the lease term ***(a new change for the better – means more short term leases)***
- The *IASB only* allows an exemption for "low" value assets ($5,000)

Lessee Accounting

- The FASB & IASB will develop a new lease accounting standard by replacing FAS 13 **– the goal of a "fully" converged standard has been abandoned. The FASB has retained the 2 lease model for lessees while the IASB will treat all leases as finance leases.**
- Objective of the project is to **capitalize all material leases** on lessee's books.
- The lessee will account for the lease contract's rights & obligations as an asset & liability measured at the present value of the lease payments.
- The good news is that the reasons for leasing still remain valuable to lessees under the FASB model

Comparative Analysis

FASB Two-Lease Lessee Model

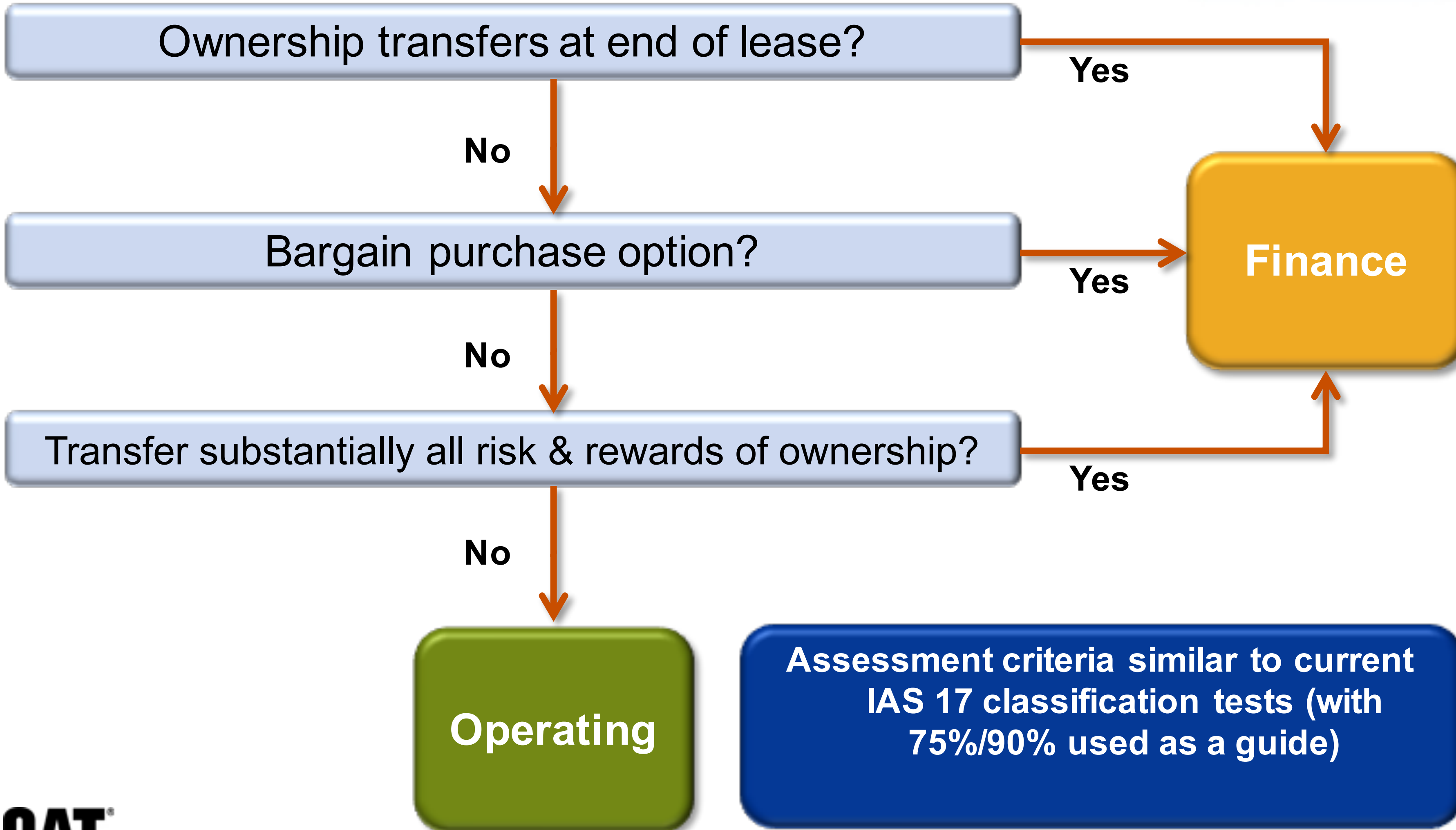
Lease Type	Current rules	Proposed New Rules
Capital Lease: Balance Sheet	On BS as an asset & debt	Finance Lease = On BS as an asset & debt
P&L	SL depreciation & imputed interest (front-ended cost)	Finance Lease = SL depreciation & imputed interest (front-ended cost)
Operating Lease: Balance Sheet	Off BS	Operating Lease = On BS as an "ROU" asset & "non- debt" liability. Capitalized value is the PV of the remaining rents.
P&L	Accrue the avg rent (SL cost)	Operating Lease = Accrue the avg rent (SL cost)

FASB Two-Lease Model

- Finance Lease: Similar to capital lease accounting under current GAAP
- Operating Leases: Similar to operating lease accounting under current GAAP <u>except that the lease is capitalized</u>
- The FASB is likely to dropped the Type A & B names and go back to calling them finance or operating leases.

*Determination of lease type is same for US lessees and **<u>all</u>** lessors and is based on IAS 17 like classification tests (for FASB, the 75% & 90% bright lines can be used as a guide). For IASB lessees **<u>all</u>** leases are finance leases.*

Lease Classification Test – Lessees (FASB only)



Financial

FASB Lessee Lease Classification Tests

Underlying principle: Is the lease a financed purchase or a rental based on IAS 17 like risks and rewards tests:

"A lessee would effectively obtain control of the underlying asset when any one of the following three criteria is met at lease commencement:
(a) The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
(b) The lessee has a significant economic incentive to exercise an option to purchase the underlying asset .
(c) The lessee otherwise has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease. Situations that individually or in combination would normally indicate that the lessee has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease include:
(i) The lease term is for a major part of the remaining economic life of the underlying asset.
(ii) The sum of the present value of the lease payments and any residual value guaranteed by the lessee amounts to substantially all of the fair value of the leased asset.
(iii) The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

Not significantly different from current FAS 13 tests – *GOOD NEWS!*
But, how will they be applied and interpreted?????

The FASB allows the "bright line" 75 % useful life & 90% of fair value per the current FAS 13 tests as a guide to help in judgement

Right-of-use model (ROU)

- Lessee will recognize
  - A right-of-use asset representing lessee's right to use the leased asset (finance lease asset is a ROU asset similar to PP&E, operating lease asset is a "ROU" asset and they are reported separately on the balance sheet)
  - A liability for its obligation to make lease payments (finance lease liability is debt, operating lease liability is a **non-debt "other" liability** and they are reported separately on the balance sheet)
- Initially measure and record the lessee's asset & liability at the PV of lease payments to be made over the term. The PV rate is either the implicit rate, if known, or the lessee's incremental borrowing rate
- The ROU asset may include a charge for initial direct costs and a credit for lessor incentives (common in real estate leases)

What is Finance Lease Lessee accounting?

Example

A company enters into a three-year lease for new $1,000 (list price) PC and agrees to pay the following: $339 per year in arrears. The present value of lease payments is $900 (**90%** of cost using a discount rate of 6.4%).

	Initial	Year 1	Year 2	Year 3	Total
Income statement:					
Interest expense		$ 57	$ 39	$ 21	
Amortization expense		$300	$300	$ 300	
Lease expense		$357	$339	$321	$1,017
Balance sheet					
Right-of-use asset	$900	$600	$300	$ 0	
Liability to make pmts	$(900)	$(618)	$(318)	$ 0	
Average rent paid		$339	$339	$339	$1,017
% Lease exp B/(W) avg rent		(6%)	0	6%	

What is Operating Lease Lessee accounting?

Example

A company enters into a three-year lease for new office space and agrees to pay the following: $10,000 in year 1, $12,000 in year 2 and $14,000 in year 3. The present value of lease payments is $32,500 (using a discount rate of 5%) at inception. Each period, the prior PV is reversed and the new PV of payments is recorded. The annual average rent expense is $12,000 with the difference between the actual cash paid and the accrued expense credited/charged to accrued rent payable.

	Initial	Year 1	Year 2	Year 3
Income statement		$12,000	$12,000	$12,000
Lease expense		$12,000	$12,000	$12,000
Balance sheet				
Right-of-use asset	$32,502	$24,127	$13,333	$ 0
Liability to make lease payments	$(32,500)	$(24,127)	$(13,333)	$ 0
Accrued rent payable	$ 0	$(2,000)	$(2,000)	$ 0

Lessee Presentation – FASB Only

Balance Sheet

- Present Finance and Operating right-of-use assets & liabilities separately on the B/S. **Operating Lease capitalized lease liability is *not* presented as debt.**

Income Statement

- Finance leases report interest and amortization of the ROU asset (All leases are finance leases under IASB)
- Operating leases report accrued average rent expense

Cash Flow Statement

- Operating lease payments = operating cash outflow
- Fiannce leases paymnets = principal & interest in financing activities

Disclosures – Table of maturities, table of components of lease expenses, amounts of ROU assets added, weighted average remaining term, weighted average discount rate and gains/losses from sale leasebacks

Lessee transition - FASB

- For Operating Leases that are currently operating leases (off balance sheet) each existing lease will be **booked as though it were a new lease at inception**
- For Finance Leases that are currently capital leases **are grandfathered** – no need to adjust carrying amounts for existing capital leases
- Sale leasebacks will be grandfathered in terms of not having to review them to see if they would have been sales under the proposed rules

Lease term

- Recognized lease term would include non-cancellable period, plus any optional periods where there it is reasonably certain the lessee will exercise the optionsignificant economic incentive to extend (or not terminate) the lease
- Purchase options – include on a basis consistent with renewal options
  - Assume exercise if significant economic incentive to exercise exists
- **Intended to be the same as current GAAP** but with new words to describe bargain options or options that would cause a penalty if not exercised (compulsion)

Lease payments

- Lease payments include:
  - Fixed payments
  - Variable payments based on index or rate (e.g., CPI or LIBOR) calculated using the spot rate
  - Termination penalties (if term is assumed not to be renewed)
  - Residual value guarantees, at the amount expected to be paid, if any (lessee only); lessor does NOT include all types of them
  - Exercise price of purchase option included in lease term
  - Variable payments that are disguised lease payments , that is, when it is remote that no payment will be due under the formula to calculate the variable payment
- Contingent rents based on performance (like percentage rents based on sales) or usage would be excluded
  - Recognized as incurred/accrued
  - Contingent rents ***must be*** truly variable to be excluded (aka ***not*** "disguised" minimum lease payments) is not an estimate must be booked

Leases + services

- Contracts that contain lease & non-lease (services, supplies, utilities, maintenance, etc.) components
  - Both lessors & lessees would be required to separately account for lease and non-lease components
  - Lessors would allocate payments in accordance with revenue recognition standard (separate criteria)
  - Lessees would generally use observable prices to allocate payments on a relative purchase price basis
    - Lessees can apply a residual method
    - Reasonable estimates can be used if observable prices not available **(GOOD NEWS!)**
    - Non-lease components that are not separated would be included with lease payments on balance sheet – **not a good outcome!**

Bifurcating Lease and Non-Lease Components

<table>
<tr><th></th><th>Lessee</th><th>Lessor</th></tr>
<tr><td>When there is an observable standalone price for each component</td><td rowspan="2">Separate and allocate based on relative standalone price of components – maximize the use of observable information <u>but reasonable estimates allowed!</u></td><td rowspan="2">Always separate and allocate using the revenue recognition standard’s guidance (i.e., on a relative selling price basis)</td></tr>
<tr><td>When there is not an observable standalone price for some or all components</td></tr>
<tr><td>Taxes and insurance on the property</td><td colspan="2">Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract <u>(separately bill to avoid capitalization)</u></td></tr>
<tr><td>Accounting policy election by class of underlying asset</td><td>Account for lease and non-lease components together as a single lease component – <u>Who would ever do that?</u></td><td></td></tr>
</table>

Lessor Accounting

Lessors retain basic models:

- DFL accounting - For leases considered "finance leases"
- Operating Lease
  - For lease not considered "financings"
  - Also short term/small item leases
- FASB only - Leveraged Lease accounting dropped with deals existing at transition date grandfathered.
- ITC/grant accounting as revenue ***TBD***
- Sales-type up-front gross profit allowed only for finance leases that do not have third party residual insurance or guarantees. Those with third party involvement will amortize gross profit as part of lease revenue.

Sale-leasebacks - proposed

- Still need to see details but as it stands:
  - For the IASB - Any Purchase Options at any price in the leaseback cause the transaction to be treated as a “failed SLB” or “financing”. Gains on sale will be amortized.
  - For the FASB – FMV purchase options will not negate sale treatment in a sale leaseback. Non bargain fixed price POs will negate sale treatment. Gains on sale will be taken up front.
- Will apply to equipment and real estate leases alike
- SLBs done before transition date are grandfathered
- Two ways to structure around the “failed” SLB with a PO rules:
  - If the lessee is acting as an agent between lessor & seller – no SLB
  - If lessee actions like down payments, progress payments do not give them “control” of the asset before lease commences = no SLB

Status

- The Boards are in final deliberations with only very minor issues to clear up
- The FASB and IASB will issue separate standards that are converged on most issues
- The major difference is on lessee accounting
  - The FASB voted for a two-lease lessee model (good news for US companies)
  - The IASB voted for lessees to account for all leases as though they were capital/finance leases (bad news for IFRS companies)
- They have made changes to the proposed rules that significantly reduce complexity

Timing

Discussion Paper	Exposure Draft	Second Exposure Draft	Final Standard*
March 2009	August 2010	May 16, 2013	Year end 2015

Effective date for implementation: TBD (not likely before 2018)

***The Boards have drafted the standard are in the final deliberations now with *separate* IASB and FASB standards to be issued. They should issue the standard by year end**

Effective Date	Years Presented in SEC Financial Statements under new rules
2018	Balance sheets: Year End 2018, 2017 Income Statements: Full Year 2018, 2017, 2016

Operational Impacts - Lessee

- **Capitalize leases that were formerly off balance sheet**
- **Transition to book existing leases (IASB more intense that FASB)**
  - A major project, IT systems support may be needed
  - Extraction of data from existing lease docs/files to book leases or use data that supports lease obligations footnote as a start or as the basis for calculating the balance sheet entry.
- **Implementation for existing and future leases**
  - New process for booking with more info needed ("economic incentives", & values vs. residual value guarantees ("RVGs"))
  - New ongoing process (info re variable payments: rate & index changes, values vs. RVGs)
  - Subleases – lessee ***and*** lessor accounting needed
  - More data for disclosures

Bottom Line Conclusions

- For US Lessors
  - Few changes – Great News ex for loss of LL acctg!
  - Lessees will have fewer issues with FASB approach – Little effect on lessee behavior ex for IFRS lessees with no Type B accounting
  - Possible loss of sale accounting re fixed POs in SLBs? (new structuring ideas will be developed to avoid SLB)
- For US Lessees:
  - New assets and liabilities on balance sheet
    - BUT only @ the PV of the payments
    - Type B asset not PPE/liability not debt – no debt covenant issue
  - Retain SL P&L cost
  - Reassessment/rebooking less frequent than expected
  - Loss of Type B accounting re fixed POs in SLBs?
  - Cost/Benefit
    - Transition: Lessees - all operating leases booked, new systems may be needed
- Traditional reasons for leasing continue!

CAT Financial

Engaging the Customer

Reason for Leasing	Details	Status After Proposed New Rules
Raise Capital	Additional capital source, 100% financing, fixed rate, level payments, longer terms	**Still a major benefit** versus a bank loan especially for SME & non-investment grade lessees with limited sources of capital
Low cost capital	Low payments/rate due to tax benefits, residual & lessor low cost of funds	**Still a benefit** versus a bank loan
Tax benefits	Lessee can't use tax benefits & lease vs. buy shows lease option has lowest after tax PV 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 & easy financing process often available at point-of-sale	**Still a benefit**
Regulatory	Capital issues	**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	**Partial benefit if the PV < cost of the asset**, S/B true for all op leases especially hi residual assets w tax benefits. Liability is **<u>not</u>** debt – no impact to debt covenants

Impact by Lessee Type

Lessee type	Potential impact
Investment grade/large companies	Some negative impact as leases often accounting focused, have more sources of capital, more analytical staff, loss of leveraged lease product increases lease costs
Non-investment grade/small & medium sized	Less impact as source of capital is prime reason for leasing, fewer sources of capital, level payments & 100% financing conserves cash, less concerned about balance sheet optics, less staff to analyze lease and less analytical
Municipal/tax exempt	GASB has its own lease project which is following the IASB one lease/capital lease model. This will not impact tax exempt muni leases as they are capitalized under current GGAP. FMV leases will be capitalized but they are rare in the equipment leasing market.. The real impact is in obscuring the muni costs and debt measures which may cause debt ratings to slip and increases the cost of reviewing a muni credit as the true leases will be characterized as debt.

Impact by Asset Type

Asset type	Potential impact
High residual – vehicles, aircraft, rail, construction, agriculture, medical, material handling	PV of rents (capitalized amount) significantly lower than cost of equipment = still some accounting benefit
Low residual – computers, copiers, faxes, office furniture and equipment	PV of rents (capitalized amount) closer to cost of equipment = little/less accounting benefit, interim rents (common in this segment) capitalized revealing a formerly ignored cost,, trade ups (on books) get higher scrutiny

Lessee Analysis
Lessor Product Offerings

Product	Impact to Lessee
Short Term Rental (1 yr or less)	Exempt from new rules – election to continue to use operating lease accounting ***(off balance sheet)***
Operating (Tax) Lease	Capitalized, **but** ***PV lower than equipment cost***
Synthetic Lease/TRAC	Capitalize only contractual rents, compelling renewal rents & estimated residual guarantee payments – ***capitalizes far less than expected***
Auto Fleet - Synthetic Lease/Split TRAC	May be viewed as a 12 month lease – no capitalization by lessee If lessee always renews may be judged as a longer than 12 month lease and capitalized For the lessor – will be an operating lease unless RV insurance is purchased
Capital lease	Capitalized as under current rules

Impact by Asset Type

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High residual – vehicles, aircraft, rail, construction, agriculture, medical, material handling	PV of rents (capitalized amount) significantly lower than cost of equipment = still some accounting benefit
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Capitalized Value by Lease Type

Lease Type	Terms	Est. 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 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
Corp jet lease	120 mos, 0.65% pmt, FMV	59% of cost
Corp jet lease	120 mos, 0.65% pmt, 56% RVG	59% of cost
RE synthetic lease	60 mos, 0.5% pmt, 85% RVG	26% of cost

Engaging the Customer

Lease Term	First Year Increase in Lease Cost – loan/capital lease vs. operating lease
3 Years	7%
5 Years	11%
7 Years	16%
10 Years	21%
20 Years	28%

Engaging the Customer

Objection #1 – "I am paid a bonus based on ROA and now that the lease will be an on balance sheet asset my ROA will be worse. I might as well just borrow to buy."

Talking points:

- The asset in an operating lease will be on balance sheet BUT only to the extent of the present value of the rents (much less than cost) and the P&L lease cost is straight lined.
- What is your alternative? Is it borrow to buy? In that case the full asset cost is on balance sheet AND the interest cost plus depreciation result in a front loaded cost pattern.
- As an example assume you are leasing some construction equipment under a three year FMV lease. The PV of rents that goes on the balance sheet is around 52% of the asset cost (48% better than borrowing to buy) and the first year's cost under the operating lease alternative lease is about 7% less than the first year's cost of a capital lease/loan. The **ROA savings on that leased asset versus buying the asset including the cost to fund it in year one is about 55%** (48% off balance sheet + 7% lower lease cost).

Engaging the Customer

Objection #2
“The debt limit covenants in my borrowing agreements will be broken if the operating lease liability is on balance sheet.”

Talking Points:

- The FASB listened to feedback that pointed out that executory contract (operating lease) liabilities are not debt per the UCC definition of debt.
- The FASB specifically said the capitalized operating lease obligation is to be reported on the balance sheet as a “non-debt” “other” liability.
- As a result **the capitalized liability will not result in a technical default under your debt limit covenants.**

Engaging the Customer

Objection #3
"Capitalizing operating leases on balance sheet will ruin my credit rating."

Talking Points:

- Your credit should not change just because the FASB changes the accounting and reporting of operating leases.
- Bank lenders and credit analysts already deal with operating lease obligations reported in your footnotes. They estimate the value of the asset and liability to adjust their measures and ratios used to make credit assessments.
- **The proposed formula to capitalize operating leases is substantially the same as what the major rating agencies use. In some cases the estimates they use will be higher than what the proposed rules require.**
- The capitalized value of an operating lease is less than the asset and liability that result from borrowing to buy. **When you borrow to buy, the loan is debt and will impact your ability to borrow as it eats into your credit capacity that lenders allocate to your company.**

Engaging the Customer

Objection #4

"I lease lots of PCs & the new accounting is too complex & too much work for my staff – I may as well just buy the PCs."

Talking Points:

The FASB has accepted simple accounting method for capitalizing op leases.

- To account for operating lease costs under current GAAP you accrue the average rent & pay the actual rent – **that will not change**.
- Now you probably use an Excel spreadsheet to capture the future op lease rents to report the amounts in your footnotes. To record the PV of remaining rents as an asset & liability all you need to do is add a discount rate & a PV calculation formula to the top of the column for each lease in your Excel file. Each month you record the new sum of the PVs of all your leases on B/S as an asset & other liability in **one new journal entry**.

Don't forget that the other benefits of leasing a PC such as:

- The capitalized amount in the PC lease is less than the cost of the asset so there is still a partial off balance sheet benefit.
- The straight line P&L cost pattern in an operating lease is better than the front ended cost pattern of a financed purchase.
- The lessor is assuming residual risk so you can return the PC & lease a newer, better model every 3 years or so as technology improves.
- The lessor has to deal with the environmental regs. re disposing of computers.

The Benefits of Leasing Will Remain

Reason for Leasing	Details	Status After Proposed New Rules
Raise Capital	Additional capital source, 100% financing, fixed rate, level payments, longer terms	**Still a major benefit** versus a bank loan especially for SME & non-investment grade lessees with limited sources of capital
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Lease Accounting Project Impact

Q&A

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