Proposed Lease Accounting Rules Will Change our Business
Focus on Construction/Material Handling/Agriculture Equipment
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as of September 2011

This is the fifth of a six part series on how the proposed lease accounting rules will impact six major market segments in the leasing industry. This segment will focus on ***construction/material handling/agriculture equipment***. The municipal, IT/office equipment, vehicles and large ticket market segments were covered previously although readers from those segments should read on as I include new information regarding recent FASB/IASB decisions in the lessee and lessor summaries below. The last article in this series will cover the medical equipment segment and will appear in the next issue of The Monitor.

Summary of the proposed changes to the Exposure Draft (ED) issued 8/17/11:
Note: Most of what was proposed in the Exposure Draft (ED) issued by the FASB/IASB boards has changed as they addressed most of the negative aspects that the industry and the ELFA pointed out in comment letters. ***It should be noted that the FASB/IASB have decided to re-expose the proposed rules shortly.*** *This is great news as it gives us and our customers another chance to comment. We know what the new exposure draft will include (see summary below for lessee and lessor accounting and timing). There are 2 major issues remaining that I see that the FASB/IASB need to change and they are – retain straight line P&L rent expense as per current GAAP for operating leases as currently defined and retain some form of leveraged lease accounting. I hope readers will send in comment letters to the new exposure draft when issued as there is power in the number of comment letters. If you don't comment don't complain about the results.*

Lessee:

Where we are now is that all operating leases will be capitalized as an asset (the right of use (ROU) of the leased asset) and a liability (capitalized lease obligation) measured by the present value of the ***estimated*** lease payments based on the definition of the term of lease (virtually unchanged versus current GAAP). Minimum lease payments to be capitalized will include interim rent payments, contractual payments, bargain or compelling renewal payments, estimated payments under residual guarantees (the amount by which the residual guarantee is in the money) and estimated contingent rent payments, as explained below, occurring during the estimated lease term. Variable payments based on usage like cost per use or excess mileage charges will only be considered a minimum lease payment if they are considered to be "disguised' minimum lease payments (where the contractual rents are below market and the contingent rents are sure to occur and make up the difference). Variable payments based on interest rates (floating rate leases) or an index like CPI are to be included as a minimum lease payment using the spot rate to estimate future payments. As the spot rate changes for floating rate leases or when the rent changes based on changes in CPI, the new spot rate is used to recalculate and book the adjustment of future rents. If the lease payment includes service/executory cost elements as in a bundled full service lease, the lessee and lessor must separate the executory (service) costs from the lease payment, but if the lessee has no observable market information to estimate the breakdown it would have to capitalize the whole bundled payment. The lessee will consider the lease term to be the contractual lease term plus renewals where the lessee has a "significant economic incentive" to exercise the options (in other words, the definition is very much the same as current GAAP). Purchase options will be ignored unless they are bargains (in which case the lease is considered a loan/capital lease). Lessees will use their incremental borrowing rate or the implicit rate in the lease, if known, to calculate the PV of the payments to determine the amount to capitalize. Lessees have to review and adjust estimated variable payments, estimated residual guarantee payments and the lease term estimate (as in if the lessee decides to renew the lease or decides that a bargain renewal will not be exercised) whenever they report financial results and use the original incremental borrowing rate to calculate any adjustment. However, if the estimated lease term changes the incremental borrowing rate will also have to be changed to reflect the revised term. Leases of 12 month terms or less and have no renewal options can be accounted for under the current operating lease method if so elected. The P&L lease cost will be comprised of straight line amortization of the ROU asset and imputed interest on the liability. This front ends lease costs for lessees. Lessees will be required to provide more extensive disclosures compared to current GAAP.

Lessor:

Lessor accounting has been decided with 2 proposed methods for equipment lessors. Short term leases, where the term including possible renewals is 12 months or less can still use the current GAAP operating lease method. All other leases will be accounted for much like current GAAP direct finance leases. This is good news compared to what was proposed under the ED and, thankfully, compared to current GAAP where many leases in this segment were operating leases for the lessor. They call the new lessor accounting method the "receivable and residual" (R&R) method. Under this method a PV receivable and a "plugged' residual would be recorded and the leased asset is removed from the lessor's balance sheet. The residual asset is accreted over the term so that the sum of the finance income on the lease rents as collected and the residual accretion will be the same as the amortization of unearned income under current direct finance lease accounting. The rate used to discount the rents and accrete the residual would be the implicit rate in the lease. Lessors are also required to estimate lease payments in the same manner as lessees.

Sales-type lease accounting for gross profits of manufacturers/dealers will be allowed for all but short term leases, but the portion of the gross profit related to the residual must be deferred until the asset is sold or released. This generally is good news as more leases will be subject to sales-type gross profit recognition. The only downside is the deferral of the residual portion of the gross profit.

The above gross profit recognition under the R&R method is available only if the profit in the lease is "reasonably assured". This should not be an issue for equipment leases as the considerations to decide if profits are reasonably assured are uncertainty about the residual value, uncertainty re the split between executory costs in a lease with services and uncertainty about the fair value of the leased asset at inception.   All of the equipment leases I have seen over my career would be considered to have reasonably assured profits.

Leveraged lease accounting is a US-only issue and will be eliminated with no grandfathering of existing deals. The Boards will not allow the "MISF" yield or a tax affected yield to be used for revenue recognition for tax leases.

Timing:

They will issue a new exposure draft before year end with a 120 day comment period. They will read the comment letters and make adjustments if they see fit. This means it will not be until mid 2012 that they will issue the new lease accounting rules. The transition date is still 2015 when lessees and lessors have to convert all existing leases and begin accounting under the new rules. I urge all readers to submit a comment letter.

Focus on the construction/material handling/agriculture equipment business segments

In my opinion the overall impact to lessees will not be too damaging and the lessor decisions are actually good for this industry segment.

Impact to Lessees:

- The traditional reasons for leasing (raising capital, low financing cost, fixed rates, level payments, transfer of tax benefits, managing equipment needs, convenience and service) will continue to exist. The off-balance sheet accounting reason for leasing will be reduced but not eliminated as long as the amount capitalized is less than the cost of the equipment. Accounting is not the driving reason for leasing in this industry segment as the lessees generally are non-public small and medium sized companies that have limited sources of capital. Leasing is a popular source of capital to acquire the use of equipment.
- All but short term leases will be capitalized. The amount capitalized for current GAAP operating leases ***should be*** significantly less than the equipment cost in the case of true leases based on the tax benefits transferred in the form of tax affected rents and the strong residual values in this industry segment. This is especially true as long as bonus MACRS remains in effect.   As a result FMV tax leases should remain as a viable product. The bigger the PV benefit, the lower the amount capitalized. Dollar out leases to commercial credits will be treated the same as under current GAAP capital lease accounting – the lease will be capitalized at 100% of the asset's price. Synthetic leases will remain a popular product for lessees that can use the tax benefits as the capitalized amount will be low compared to the equipment cost. The municipal tax exempt lease market will remain popular (as it will be unchanged) as the Government Accounting Standards Board (GASB) has not taken up a lease accounting change project as of this writing. Examples of the probable impact by product are as follows:

Lease Type	Terms	Lessee	Commentary

		Capitalized Amount	
FMV "true" leases	Cost = $100,000 Term = 60 months Rent = $1,205 in advance Residual assumed = 40% Pretax implicit rate = 3.5% Cost = $100,000 Term = 36 months Rent = $1,606 in advance Residual assumed = 50% Pretax implicit rate = 3.5%	$61,193 (61% of cost) assuming a lessee incremental borrowing rate of 7% $52,324 (52% of cost) assuming a lessee incremental borrowing rate of 7%	• Pricing assumes 100% bonus • Low PV/amount capitalized makes the product attractive
Dollar out	Cost = $100,000 Term = 60 months Rent = $1.969 in advance Purchase Option = $1 Implicit rate 7%	$100,000 = cost	• Same result as current capital lease accounting
Synthetic lease	Cost = $100,000 Term = 60 months Rent = $1,274 in advance Month 60 PO/RVG = 50% Implicit rate = 7%	$64,730 (64% of cost)	• Purchase option and residual guarantee ignored except to the extent that the residual guarantee is "in the money" • Low PV capitalized makes the product attractive
Dollar out to a state or local municipality	Cost = $100,000 Term = 60 months Rent = $1.814 in advance Purchase Option = $1 Implicit rate 3.5%	$0	• Municipalities use government accounting (GASB) which still recognizes operating lease treatment for dollar out leases with non-appropriation clauses

- The impact of front ending of lessee P&L lease costs ***will not be severe*** given that lease terms are not long in this industry segment. Typical lease terms range from 3 to 5 years with some lease terms as long as 7 years. The P&L cost pattern will be front ended and will not be called rent expense. Rent expense will be replaced by straight line amortization of the ROU asset and imputed interest on the lease obligation. The front ended pattern will cause lessees to book deferred tax assets as book expenses reported will exceed the tax deductions for rent in the early years of the lease. The front ended pattern is a timing difference that will turn around in the later years of the lease term. The front ending effect will be lower the shorter the lease term as illustrated in the table below.

The Effect of Front Ending Lease Costs	
Lease Term	**First Year Increase in Lease Cost – proposed rules vs. current GAAP**
3 Years	7%
5 Years	11%
7 Years	16%

- Lessees with cost plus contracts will still only get cost reimbursement for rent paid. With the front ending of lease costs as proposed it will mean that reported lease costs in the early years of the lease term will be more than costs reimbursed, although this is a temporary difference as the costs reimbursed in the last half of the lease will be higher than reported lease costs. Cost reimbursement rules do not allow for reimbursement of the ROU asset amortization and the imputed interest on the lease obligation.

Impact to Lessors:

- There will be no more operating lease accounting except for short term leases. This is great news as the earnings pattern under the R&R method is more representative of the economics of the lease. The earnings pattern under an R&R lease without a sales-type gross profit creates a constant yield versus the declining lease investment.
- Synthetic leases will be classified as R&R method leases. A PV lease receivable and plugged residual will be booked. The residual guarantee is not considered a minimum lease payment as per current GAAP (not the best outcome as you can't "securitize" a residual and get off balance sheet treatment as a residual is not considered a financial asset). There will be no need to buy residual insurance for accounting purposes as synthetic leases will not be treated as operating leases.
- For manufacturers/captives sales-type lease profit will be recognized up-front for ***all*** but short term leases. Gains on sale will be recognized based on the portion of the value of the right of use transferred in the lease, with the balance (the residual portion) deferred. The value of the right of use is the PV of the rents so if the rents PV to 79% of fair value of the leased asset, then 79% of the gross profit will be recognized. The gross profit attributed to the residual will be deferred and recognized when the asset is sold or re-leased. I think that this is good news for this segment as many leases are operating leases and current GAAP does not allow sales-type gross profit recognition for operating leases. The residuals in this segment are so high that buying residual insurance to get sales-type lease treatment under current GAAP is too costly, but now residual insure will not be needed.

Conclusion – things don't look bad!

This market segment seems to be faring pretty well as the amounts capitalized by lessees will generally be low compared to the equipment cost due to the high residual values of the equipment. Lessors should be generally be happy as the only real negative news for lessors is the loss of leveraged lease accounting which is not a structure suited for this segment. On the positive side all leases will be sales type leases but with the portion of the gross profit related to the residual deferred. This should be great news for this segment as most many leases had residuals too high to qualify as sales type leases. It would be nice to get the FASB/IASB to retain straight line rent expense for lessees for what are now operating leases. This can only be achieved if enough comment letters are sent in with well thought out reasoning.

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