Proposed Lease Accounting Rules Will Change our Business
Focus on Large Ticket Transactions
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This is the forth 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 large ticket transactions. Municipal, IT/office equipment and vehicles 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. Future segments will cover construction/material handling and medical.

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.* ***It should be noted that the FASB did not receive much feedback from the large ticket community so they are proceeding without good information which is dangerous for the industry. They do not understand the issues particularly with leveraged leases.***

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. Estimated residual guarantee payments (the difference between the estimated residual value and the "strike price" in a TRAC, split TRAC or synthetic lease) are considered a lease payment and are included in the capitalization calculation. 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 cost will ***no***t be the straight line average rent as we have in current GAAP. 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 using a method which is 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 is to be eliminated. Existing leveraged leases will not be grandfathered. The rent and debt will be grossed up on the balance sheet. Equity will be reduced by the amount of earnings reversed. Future earnings will be taken on a pretax implicit rate basis. There is some outside hope that they will allow netting of debt under a separate project called "Balance Sheet—Offsetting", but as it stands they will not include leveraged leases in the scope. The Boards will not allow the "MISF" yield or a tax affected yield to be used for revenue recognition. This of course is a topic that readers in the large ticket segment should comment on to the Boards.

Timing:

They will issue a new exposure draft around 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 Large Ticket Business

There is not much good news here for the large ticket segment.

Impact to Lessees:

- All but short term leases will be capitalized. The amount capitalized should be less than the equipment cost in the case of true leases based on the tax benefits transferred in the form of tax affected rents. The bigger the PV benefit, the lower the amount capitalized. Synthetic leases fare very well as only the contractual rents and the amount the residual guarantee is in the money are included in the capitalization calculation.
- 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. It is a timing difference that will turn around in the later years of the lease term. The front ending effect will be greater the longer 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%
10 Years	21%
20 Years	28%

- Strange as it may seem EBITDA for lessees will improve as rent will not be considered a negative operating cash outflow.

Impact to Lessors:

- Leveraged leases will be grossed up requiring more capital to be allocated unless we get relief under the "Balance Sheet – Offsetting" project. The revenue recognized will be based on the pretax yield in the lease, not the tax affected yield. Alternatives like partnership structures will still allow reporting of only the net investment in the partnership although those structures are less efficient than leveraged leases. Partnership structure revenue recognition also does not allow for an MISF-like revenue pattern.
- The synthetic leases should be classified as R&R leases. A PV lease receivable and residual will be booked. The residual guarantee is not considered a minimum lease payment as per current GAAP. There will be no need to buy residual insurance as they should not be treated as operating leases.
- For manufacturers/captives it is likely that only partial sales-type lease profit will be recognized up-front. Gains on sale will be recognized based on the portion of the value of the right of use transferred in the lease. The value of the right of use is the PV of the rents so if the rents PV to 85% of fair value of the leased asset, then 85% 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.

Where Might We Be In The End?

Lessee P&L pattern is a major issue with lessees in this segment due to the long lease terms. It will be a major battle to change the Boards' minds and I guess the chances are 50/50. We need lots of comment letters from lessees to change their view. The loss of leveraged lease treatment will be a big blow to the industry as balance sheets will be inflated and earnings recognition patterns will flatten and the cost of leasing for lessees will increase. I have to say it loud and clear that only a concerted effort via comment letters and private meetings with the FASB will save some form of leveraged lease accounting. It is all up to you.

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