Proposed Lease Accounting Rules Will Change our Business
Focus on Municipal/Not-for-Profit Business
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This is the third 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 Municipal/Not-for-Profit business. IT/office equipment and vehicles were covered previously (see update to those articles below). Future segments will cover construction/material handling, large ticket, 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.*

Lessee:

Where we are now is that all operating leases for non government lessees 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). Government lessees follow GASB rules which will remain the same as FAS 13 – great news. 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 Municipal/Not-for-Profit Business

The good news here is the Muni business segment will not be seriously impacted by the proposed lease rules. The customer base in the Muni business segment are either state and local governmental entities that use the "dollar out" lease product or non-governmental entities such as not-for-profit (501c3) hospitals that use either loans or synthetic leases in complex structures where working through a state agency they get the benefit of tax exempt financing. Another big product used by not-for-profit hospitals is FMV leases of QTE equipment with pricing being particularly good now because of 100% bonus MACRS.

Impact to Lessees:

- Lessees that are state and local governments do not follow FASB GAAP but rather follow government accounting rules put out by the Government Accounting Standards Board ("GASB"). The GASB does not have lease accounting on its current agenda so, as far as I know, the current GASB GAAP will prevail. That is that the tax exempt Muni lease financing structure, a lease with a non-appropriations right to terminate clause, a nominal (typically $1) purchase option and a lease payment that has a principal and interest component are treated as operating leases by lessees. Since they will continue to be treated as operating leases there should be no change in lessee behavior.
- Lessees in tax exempt Muni deals that are not state and local governments will have to follow the new lease accounting rules. Where the tax exempt financing product is a loan there will be no change in the customers' accounting as loan accounting will not be impacted. Where the tax exempt Muni product is a synthetic lease, the lessee will have to capitalize the lease. The amount capitalized will be the present value of the contractual rents and the amount of the residual guarantee that is likely to be paid (in other words the amount that the residual guarantee exceeds the expected value of the asset at lease expiry). Since at inception the residual guarantee is set at the expected fair market value the amount of the residual guarantee considered to be a minimum lease payment will be zero. The lessee will have to monitor the residual guarantee throughout the lease term and if it does appear that a payment is likely then the lease obligation and right of use lease asset have to be adjusted and the future lease cost recognition will reflect the increased cost. As I understand, the volume of synthetic leases had declined so few are being done. It should be noted that the amount

capitalized under a synthetic lease will be lower than the asset cost as the purchase option is ignored as it is a non-bargain and the amount of the residual guarantee capitalized will generally be zero. As an example, a 60 month synthetic lease with a 25% purchase option/residual guarantee and a 3.5% implicit rate will capitalize at about 79% of equipment cost. The same lease with a 50% purchase option/residual guarantee will capitalize at about 58% of equipment cost. The lessee will likely have to use capital lease accounting, that is, recognize imputed interest on the lease obligation and amortize the leased asset straight line over the lease term. The Boards are likely to allow straight line P&L (possibly called rent expense) for leases that qualify as operating leases under IAS 17 like criteria. A synthetic lease would not be considered an IAS 17 operating lease because it has upside in that it has a purchase option and it has downside first loss residual risk in that it is providing a residual guarantee. The FMV QTE leases done with not-for-profit hospitals that are popular now will be capitalized as the hospital will have to follow the new GAAP. Because of the FMV structure and the low PV, the lease would be an operating lease under IAS 17 like classification criteria and should thus get straight line lease cost recognition.

Figure 1. Capitalized amounts by lease type

Lease Type	Terms	Lessee Capitalized Amount	Commentary
Dollar out to a state or local municipality	Cost = $100,000 Term = 60 months Rent = $1.819 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
Synthetic lease to a hospital qualifying for tax exempt financing	Cost = $100,000 Term = 60 months Rent = $1,437 Month 60 PO/RVG = 25% Implicit rate = 3.5%	$79,008 (79% of cost)	• PO/RVG ignored except to the extent that the RVG is “in the money” • Low PV capitalized makes the product attractive
FMV leases to no-for-profit hospitals	Cost = $100,000 Term = 60 months Rent = $1,514 Residual assumed = 20% Pretax implicit rate = 3.5%	$83,207 (83% of cost)	• Pricing assumes 100% bonus MACRS and QTE equipment • Low PV capitalized makes the product attractive

Impact to Lessors:

- The dollar out leases should be classified as loans. For manufacturers/captives it means no change in sales-type lease accounting for dollar out deals and profit recognition compared to current GAAP.
- The synthetic leases should be classified as R&R leases. A PV lease receivable and PV 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 means partial sales-type lease profit recognition in a synthetic lease. Gains on sales 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 79% of fair value of the leased asset, then 79% of the gross profit will be recognized. The gross profit in the residual will be deferred and recognized when the asset is sold or re-leased.
- The FMV leases should also be R&R leases but it will be a judgment call and the higher the residual the greater the risk that they will continue to be operating leases. Where the lessor is a manufacturer the proposed rule will allow partial sales type lease profit recognition for all leases.

Where Might We Be In The End?

What I reported above is still subject to change but it seems that the Muni segment will see little impact. As long as the GASB does not adopt the new rules, dollar out lease accounting will be the same as today. Synthetic leases and FMV QTE leases are capitalized but at much lower amounts than the leased asset cost. All but short term leases will likley be R&R leases so lessors will see an improvement. Sales-type lease accounting will be the same for dollar outs and partial gains will be allowed for synthetic leases FMV which is not a terrible outcome. We still have to watch the GASB agenda and watch progress of the FASB/IASB project as other segments of the industry still have issues that need to be fixed.

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