Proposed Lease Accounting Rules Will Change our Business
Focus on Vehicles
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This is the second 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 car fleet leases, truck leases and trailer leases. IT/office equipment was covered previously. Future segments will cover construction/material handling, large ticket transportation, medical and municipal leases. The articles will cover lessee and lessor impacts.

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. 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 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.

Impact to Lessees:

- Lessees will capitalize less than S&P does today, and significantly less than analysts who use the arbitrary 8X rent expense to capitalize leases like Moody's. The increased amounts capitalized will primarily come from interim rents, likely renewals and contingent rents.
- Lessees will be more aware of the true cost of leasing as they will know the present value of the estimated payments. The capitalized amounts of typical vehicle leases are shown in figure 1 below.
- The lease versus buy decision will be more than just an economic analysis as the lease will now be capitalized but at a much lower amount than the vehicle cost
- Reported lease cost will not be the straight line average rent but will be the front ended. The longer the lease term, the greater the acceleration. This acceleration is a timing difference as lease costs in the second half of the lease term will be equally lower than straight line. The percentage first year increase in lease costs due to the front end pattern is shown in figure 2 below.
- Lease expense will not be part of the operating budget. In fact there will be no rent expense, but rather there will be amortization and imputed interest as the component of lease cost. A higher level of internal approval will be needed on new business because leases are out of the operating budget and leases will eat into the lessee's capital budget.
- Lease accounting will be more complex and burdensome than ownership due to the need to review and adjust estimates.
- Lessees will ask lessors to bifurcate service costs/executory costs from full service vehicle leases with bundled payments.
- Although most reasons for leasing will survive, customers that have the option to pay cash or borrow from other sources may decide not to lease.

Figure 1. Capitalized amounts by lease type

Lease Type	Terms	Lessee Capitalized Amount	Commentary
Short Term Trailer Lease	Trailer Cost = $100,000 Term = 6 months Rent = $2,450	$0	• Use current operating lease method – off balance sheet
Auto Fleet Lease – Split TRAC or Synthetic Lease	Cost = $25,000 Term = 12 months Rent Floating @ LIBOR +2% Amortization= 2% per month Month 12 "TRAC" % = 76% Month to month option to renew or terminate	$6,422 @ 12 mo term (26% of cost)	• Still a significant accounting benefit • There is a concern that auditors may interpret rules re lease term and force a longer term based on lessee behavior
Truck Operating Lease	Cost = $89,000 Term = 84 months Rent =$1,100 Incremental borrowing rate = 7%	$72,288 or 82% of cost	Still an accounting benefit as only 82% of cost goes on balance sheet
Bundled Full Service Tractor Lease	Cost = $115,000 Term = 60 months Bundled payment = $2,355 Lease portion = $1,860 Incremental borrowing rate = 7%	$18,932 or 103% of cost if bundled payment is capitalized $93,933 or 82% if only the lease portion is capitalized	Lessee will pressure lessor for breakdown of service and "lease" portion of bundled payments
Trailer Finance Lease	Cost = $18,000 Term = 60 months Rent = $365 $1 purchase option Rate = 8%	$18,000	No change from current GAAP

Figure 2. Increase in First Year Lease Cost Vs Current GAAP

Term	Percentage Increase in Lease Cost Vs, Current GAAP
3 Years	7%
5 Years	11%
7 Years	16%
10 Years	21%
15 Years	26%

Impact to Lessors:

- Except for short term leases there will be no operating leases, so earnings patterns will improve for those lessors whose leases were classified as operating leases.
- The R&R method is virtually the same as the direct finance method
- There oil be no operating lease except for short term leases, so there will be no need to buy residual insurance to improve the lease classification
- Guaranteed residuals will not be classified as financial assets. This is a change from current GAAP and does negatively affect sales type profit recognition
- For manufacturers/dealers, the upfront sales type lease profits will be lower as partial profit will be recognized and the portion related to the residual will be deferred.

Where Might We Be In The End?

The major reasons why customers lease (100% low cost fixed rate financing, level payments, service, tax benefit transfer, residual risk transfer and convenience) will continue to exist. Off balance sheet benefits in FMV leases will be limited to how much real residual risk is taken by the lessor, that is, the lower the PV of lease payments, the more favorable the accounting treatment. Partial off balance sheet benefits in synthetic and split-TRAC leases will still exist. In the end I predict the vehicle leasing segment may lose minor amounts of lease volume with investment grade customers who can pay cash or raise cheap debt and placed a high value on off balance sheet treatment, but the small and medium sized companies and those that value service will continue to lease.

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