LEASE ACCO CHANGES & THE FLEET

Newly proposed accounting rules will have a slight impact on the fleet leasing industry. Lessees and lessors should be aware of the potential changes. By Bill Bosco

The Lease Accounting Project is moving along slowly, but surely, and will impact both fleet lessees and lessors. The good news is the financial impact will be small. The bad news is that lessees must do more work to account for their leases. There will be a new exposure draft of the proposed rules issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), which has slowed down the project. FASB and IASB have made significant changes (mostly positive for the industry) to the original exposure draft and needed to re-expose the project. The second round is good news because it allows the industry one more opportunity to comment and influence the outcome on the few remaining troublesome issues.

AT A GLANCE

The new exposure draft of the proposed lease accounting rules is expected to be issued in first quarter 2012. Changes include:

- Operating leases to be capitalized as an asset and liability, measured by the present value of estimated lease payments.
- Two proposed accounting methods for equipment lessors: current GAAP operating lease and a method similar to current GAAP direct finance leases.

Overview of Changes

As of Oct. 24, 2011, the proposed new accounting rules appear to pose little impact to the fleet leasing industry. Lessees will continue to lease for all the reasons they do now, except that the lease will be capitalized on balance sheet at about 26-30 percent of its cost for a typical 12-month floating rate level principal amortization open-end fleet lease (see figures 1 and 2 for an example). This is still a meaningful accounting benefit versus borrowing to buy, which naturally would capitalize 100 percent of the vehicle cost. In a three-year fixed rate level payment closed-end fleet lease, the lease will be capitalized on the balance sheet at 67 percent of the vehicle cost (see figure 3) which is also significantly less than borrowing to buy the vehicle.

The lessor rules will be an improvement over current operating lease accounting in that a lease receivable and a residual will be recorded on the balance sheet and the revenue pattern will be similar to current direct finance lease accounting. Under current accounting rules, most fleet leases were classified as operating leases for the lessor (not a favorable accounting method).

For those lessors who are manufacturers or dealers and had an inherent gross profit in the lease, there will likely be a partial recognition of the gross profit and the finance portion of the lease payment will be recognized as revenue using the implicit rate in the lease.

As a result of not having to apply operating lease accounting, the lessor will have a more rational profit and loss (P&L) pattern than current generally accepted accounting principles (GAAP). The lessor will also have a financial asset on books that can be securitized off balance sheet with no need to buy residual insurance to get that accounting result (the lease receivable is considered a financial asset, but strangely, the guaranteed residual is not considered a financial asset).

Time Line of New Draft

The new exposure draft (ED) of the proposed rules is expected to be issued

UNTING LEASING INDUSTRY

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FIGURE 1

OPEN-END FLEET LEASE
TYPICAL 12-MONTH FLOATING RATELEVEL
PRINCIPAL AMORTIZATION

Vehicle cost	$20,000
Lease term	12 months
Level principal	2 percent/month
TRAC (12 months/percent of cost)	$15,200 @ 76%
Delivery date	Jan. 1
Lease rate LIBOR + 250 bps	3%
Lessee incremental borrowing rate	3%

TRAC = FMV so no payment expected under residual guarantee

Capitalized value under proposed rule: $5,248.68 (26.24%)

Lessee Financials	**Inception**	**Year-End**
Assets	$5,248.68	$0
Liability	$5,248.68	$0
Amortization of ROU asset		$5,248.68
Imputed interest cost		$5,334.00
Annual rents		$5,334.00

Lessees will continue to lease for all the reasons they do now, except the lease will be capitalized on balance sheet at about 26-30 percent of its cost for a typical 12-month floating rate level principal amortization.

in first quarter 2012. The public will have 120 days to submit a comment letter. The boards will review the comment letters and meet to re-deliberate the issues. At the earliest, a final rule can be expected by the end of 2012.

The likely transition year will be 2015 or 2016, which mean lessees and lessors will not have to begin accounting for leases under the new rules until then. However, that does not mean the rule changes can be ignored until then, as they will require complex calculations. Both lessees and lessors will likely need to buy, build, or modify existing accounting and administration systems.

Impact on Lessees

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, occurring during the estimated lease term. Variable payments based on usage, such as 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 such as CPI (consumer price index) 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 ex-

FIGURE 2

CURRENT GAAP			PROPOSED GAAP							
MONTH	ACCRUED RENT PAYABLE	RENT EXPENSE	MONTH	ROU ASSET	LEASE LIABILITY	AMORTIZATION EXPENSE	IMPUTED INTEREST	TOTAL LEASE COST	PROPOSED GAAP B/(W) VS CURRENT GAAP	% DIFF
1	($5.50)	$444.50	1	$4,811.29	$4,811.80	$437.39	$13.12	$450.51	($6.01)	-1.35%
2	($10.00)	$444.50	2	$4,373.90	$4,374.83	$437.39	$12.03	$449.42	($4.92)	-1.11%
3	($13.50)	$444.50	3	$3,936.51	$3,937.76	$437.39	$10.94	$448.33	($3.83)	-0.86%
4	($16.00)	$444.50	4	$3,499.12	$3,500.61	$437.39	$9.84	$447.23	($2.73)	-0.62%
5	($17.50)	$444.50	5	$3,061.73	$3,063.36	$437.39	$8.75	$446.14	($1.64)	-0.37%
6	($18.00)	$444.50	6	$2,624.34	$2,626.02	$437.39	$7.66	$445.05	($0.55)	-0.12%
7	($17.50)	$444.50	7	$2,186.95	$2,188.58	$437.39	$6.57	$443.95	$0.55	0.12%
8	($16.00)	$444.50	8	$1,749.56	$1,751.05	$437.39	$5.47	$442.86	$1.64	0.37%
9	($13.50)	$444.50	9	$1,312.17	$1,313.43	$437.39	$4.38	$441.77	$2.73	0.61%
10	($10.00)	$444.50	10	$874.78	$875.72	$437.39	$3.28	$440.67	$3.83	0.86%
11	($5.50)	$444.50	11	$437.39	$437.91	$437.39	$2.19	$439.58	$4.92	1.11%
12	-	$444.50	12	-	$0.00	$437.39	$1.09	$438.48	$6.02	1.35%
	Total	$5,334.00				$5,248.68	$85.32	$5,334.00	$0.00	0.00%

Proposed generally accepted accounting principles (GAAP) for lessee accounting for lease costs front-end lease costs as rent expense under current GAAP is replaced by amortization and imputed interest expense.

ecutory (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.

Lessees will demand a detailed breakdown of the components of a bundled payment to avoid capitalizing the whole 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 present value (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 must 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 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 must also be changed to reflect the revised term. Lease terms of 12 months or less with no renewal options can be accounted for under the current operating lease method if so elected. The proposed rules will require much more work for fleet administrators than under current GAAP where fleet leases are operating leases (off balance sheet).

The P&L cost will not 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.

Impact on Lessors

Lessor accounting has been decided with two proposed methods for equipment lessors. Short-term leases for which 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 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

FIGURE 3

CLOSED-END FLEET LEASE (THREE-YEAR FIXED RATE LEVEL PAYMENT)

Vehicle cost	$20,000
Lease term	36 months
Rent payment $/% of cost	$416 @ 1.82%
Residual/% of cost	$8,000 /40%
Delivery date	Jan. 1
Lessee incremental borrowing rate	7.5%
Capitalized value under proposed rule	$13,373.53 (66.87%)

LESSEE FINANCIALS		YEAR END	YEAR END	YEAR END	
	Inception	**1**	**2**	**3**	**Totals**
Assets	$13,373.53	$8,915.69	$4,457.84	$0.00	
Liability	$13,373.53	$9,244.53	$4,794.98	$0.00	
Amortization of ROU asset		$4,457.84	$4,457.84	$4,457.84	$13,373.53
Imputed interest cost		$863.00	$542.45	$197.02	$1,602.47
Total expenses		$5,320.84	$5,000.29	$4,654.86	$14,976.00
Annual rents		$4,992.00	$4,992.00	$4,992.00	$14,976.00
RENTS PAID vs. BOOK EXPENSE		($328.84)	($8.29)	$337.14	$0.00
Tax timing difference		($328.84)	($8.29)	$337.14	$0.00
Tax rate		35.00%	35.00%	35.00%	
Deferred tax amount		($115.09)	($2.90)	$118.00	

In a three-year fixed rate level payment closed-end fleet lease, the lease will be capitalized on the balance sheet at 67 percent of the vehicle cost, which is also significantly less than borrowing to buy the vehicle.

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.

Summary & Conclusions

Although the lease project as it is currently proposed is a significant change from current GAAP for fleet leases, the structure fares much better than other lease structures as less is capitalized and the short term minimizes any negative front ending of lease costs. Real estate leases and long-term equipment leases fare the worst as the amounts capitalized will be higher, and the longer the lease term, the more significant the effects of front ending lease costs.

Companies lease for seven reasons:

1. Raise capital.
2. Lower capital cost.
3. Manage taxes.
4. Manage financial presentation.
5. Manage assets.
6. Deal with regulatory constraints.
7. Convenience/outsourcing.

Fleet leasing meets all those needs and the proposed rules will not completely eliminate the off balance sheet accounting advantage, which is most often not the driving reason for fleet leasing. This is especially true for non-investment grade, smaller, and private companies. Lessors will likely experience some improvements in their financial presentation somewhat offset by having to defer a portion of their dealer profit, if any.

The impact of the proposed rules on lessee behavior will be minimal. There may be a slower process for decision-making and ordering new vehicles by lessees initially as the lease will be a capital item necessitating a different internal approval process. After the period of adjustment, the market participants should return to business as usual. It's expected lessees will continue to use the lease product as they have in the past.

Lessees and lessors should follow the project and comment on the new exposure draft when it is issued. ■

About the Author

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