Customer Reaction to The Leases Accounting Project

Has Their Behavior Changed?

By Bill Bosco, Leasing 101

The FASB/IASB Leases Project to re-write the lease accounting rules, with a primary goal to have our customers capitalize operating leases, has been going on since 2006. The project still has a long way to go as the next Exposure Draft is about to be issued in the first quarter of 2013. It is expected to be unpopular due to unresolved flaws (mainly with the expense pattern for equipment leases) which should mean another year of comment letters, meetings, debate and hopefully, re-writing. Current estimates are for the new rule to be finalized in 2014 with an implementation date of 2017. In any case we cannot expect that the main objective of capitalizing operating leases will not be achieved. We have naturally been anxious about customer reaction as off-balance sheet accounting afforded by current operating lease accounting is a benefit to leasing that some customers value. Although there are many reasons for leasing, the importance of off-balance sheet treatment can only be judged by customer reactions. This is a summary of the responses I got when I asked a cross section of leasing industry people what they are seeing in customer behavior changes, if any, in light of the leasing project to capitalize operating leases:

Big 4 Leasing Partner:

- I have seen no change in behavior. While more seem to be skeptical than before that it will happen, most do believe that operating lease liabilities will get on the balance sheet eventually. I have seen only a handful make changes/build in possibilities in existing lease arrangements as a result. While I don't see everyone's debt agreements, I don't have the impression that they are changing much yet either.

IT Lessors:

- No changes at all.
- Our sales reps get a variety of comments and some behavioral changes. Mostly it's mixed. Some have reversed course and started buying. Others have held up projects due to the news of the continuously impending Exposure Draft version 2 release. More questions keep coming up like "what have you heard?" " How will that affect what we are doing with you?, etc
- We haven't seen too much change in behavior. Customers started asking our sales professionals questions about the possible changes for the first time about it a year ago, when there were several articles about the pending changes in leading CFO and industry publications. That has now subsided. Even when we were receiving more inquiries, we didn't see much change in customer behavior. Please keep in mind that many of our clients lease for reasons having to do with *technical obsolescence* and *technology refresh cycles,* as opposed to managing the balance sheet. Our customers' choice of an operating lease is not balance sheet driven. Many are non-profits as well; any income tax considerations of the structure also become non-existent. I also do sense from time to time that because the project has gone on for so long that it has maybe drawn attention away from it.

General Equipment Lessors:

- No change yet.
- No noticeable change in behavior, some talk about buy v. lease, but still leasing.
- At this point no change at all. In fact 2012 was a record year.
- I don't believe we have seen any significant change in behavior. Only the larger, more sophisticated lessees are aware of any changes on the horizon.
- We haven't seen specific behavioral changes due to proposed accounting changes.
- We have not witnessed any differences. We ask clients who are entering into synthetics if they know that the product will be on sheet potentially during its life (if it's longer term) and they all say they know and they're okay with proceeding. Honestly, we don't see a lot of clients' decisions driven by accounting objectives other than a handful of investment grade big ticket clients doing synthetics.
- For the most part no. The majority of our clients seem to be continuing business as usual. They are interested in what's happening but generally are staying on the sidelines until they know what the new rules are. On the other hand, there are some clients that are avoiding leasing completely because of all the uncertainty and avoiding it all together until there is a clear picture of the future landscape.

Fleet Lessors:

- We have not seen any change in behavior.
- We have not -- just wait and see at this point. Additionally, this process has dragged on for so long that it is off the radar screen and not worth folks spending energy on.

Tax Exempt Lessor:

- We are not very active in the equipment leasing side (mostly tax-exempt) so no real feedback from equipment lessee perspectives. From real estate tenant's we have seen a few people start to use "adjusted GAAP accounting" language in covenants to address the capitalization of their building leases or other changes to GAAP – (AKA “frozen” or “static” GAAP used to calculate debt covenant measures and limits).

Real Estate Lessor:

- Everyone following it feels it is not going to happen.

Large Ticket Lessors:

- Clients have developed new low opinions of this project and don't think anybody is going to follow anything that will be recommended. Clients are going to continue with the system that is in place. The market understands the current system and nobody is going to spend the money to implement new systems.
- I have not seen any change in behavior yet from our customers in anticipation of the proposed accounting rules.
- I have not seen or heard a change for the most part in the last few years

Truck Lessor:

- Regarding your questions about lessee behavior in anticipation of the proposed accounting rules changes to capitalize operating leases, I never received much feedback from customers. The attitude was more along the lines of acceptance of a change in accounting rules, and so be it. The more pressing issue is the ever more complicated maintenance of rolling stock, and the shortage of qualified drivers. Just this year (2013) the government issues new EPA rules to lower greenhouse gases from the exhaust of heavy duty diesel vehicles. This added twelve (12) more sensors to the exhaust component of motor vehicles. The additional monitoring devices will add cost, add maintenance, and add to the increasing need to have qualified technicians who can diagnose, and repair today's complicated computer controlled vehicle. There was more attention paid to the woes of switching engine technologies than there was to the last round of FASB discussion on the impending switch to balance sheet treatment of capital vs. operating lease treatment. Customers are more interested in making sure their product is delivered to its destination on time, and in quality condition, than they are in how the vehicle is financed. Full service lease customers are traditionally the three (3) to five (5) truck user, who has a truck as a means to control the delivery of their product to the buyer. Their main focus is on their business not the accounting treatment of their leases. The same goes for trucking companies who haul goods for others.

Conclusion – This informal survey confirms the ELFA’s belief that the Lease Project will not change customer behavior in a significant way because of the many reasons customers lease that will continue to exist (see summary below).

Reason for Leasing	**Details**	**Expected Status After Proposed New Rules**
Raise Capital	Additional capital source, 100% financing, fixed rate, level payments, longer terms	Still a major benefit versus a bank loan especially for SME & non-investment grade lessees with limited sources of capital
Low cost capital	Low payments/rate due to tax benefits, residual & lessor low cost of funds	Still a benefit versus a bank loan
Tax benefits	Lessee can’t use tax benefits & lease vs. buy shows lease option has lowest after tax PV cost	Still a benefit
Manage assets/residual risk transfer	Lessee has flexibility to return asset	Still a benefit
Service	Outsource servicing of the leased assets.	Still a benefit
Convenience	Quick & easy financing process often available at point-of-sale	Still a benefit
Regulatory	Capital issues	Partial off balance sheet benefit (less capital required compared to buying) if the present value of the payments (capitalized amount) is less than the cost of the asset, should be true for high residual assets with tax benefits
Accounting	Off balance sheet	Partial off balance sheet benefit if the present value of the payments (capitalized amount) is less than the cost of the asset, should be true for high residual assets with tax benefits

About the Author:
Bill Bosco is the President of Leasing 101, a lease consulting company. He can be reached at 914-522-3233, bill@leasing-101.com or www.leasing-101.com