Lease Accounting Rules Issued in 2016

Bill Bosco. Advisor to the US Equipment Leasing and Finance Association, provides an update on the latest developments in the lease accounting project

The Lease Accounting Project has finally concluded as the IASB issued their version in January 2016 (IFRS 16) and the FASB issued their version in February 2016 (ASC Topic 842). This paper will focus on the FASB version and point out key differences from the IASB version. For US public companies the transition will occur in 2019 in financial statements for periods beginning after December 15, 2018. It should be noted that the SEC requires 3 years of comparative income statements and two years comparative balance sheets. This means that for public companies 2017 is the start for capturing data for reporting in 2019. For private companies the transition year is one year later or 2020.

The lease accounting change project began as a joint project with an objective of converging on a worldwide set of rules. The idea of convergence was dropped when the FASB and IASB took different views on whether all leases were the same for lessee accounting. They did continue to meet jointly and the rules are not too far apart in most other areas. The major objective of capitalizing most operating leases was achieved in both standards. The two standards have major differences in lessee accounting but lessor accounting is substantially converged as they adopted existing GAAP for lessors with a few changes. One difference in the versions of lessor accounting is the FASB decided to incorporate concepts from the new revenue recognition standard for determining when a sale takes place in sales-type leases, whereas the IASB did not.

Overview of the Impact

Although for lessees there will be a dramatic change in assets and liabilities, the resulting financial ratios and measures and the work to account for leases, there should not be a major change in the propensity of US companies to lease. The business reasons for leasing in the US remain strong. Also the accounting presentation and cost recognition for operating leases by US companies will be favorable as the FASB recognized that operating leases should be accounted for differently than finance leases. Only the present value of the operating lease payments goes on balance sheet – not the full cost - and the liability is not classified as debt. The operating lease cost remains as the straight line average of the lease payments. US lessees will continue to want operating lease classification but there will be an increased emphasis on keeping the amount capitalized as low as possible. The IASB version is not so true to the substance of operating leases as the liability is classified as debt and the cost pattern is front loaded just like a financed purchase of the asset.

Preparing for the New Standard

It is important for both lessors and lessees to plan ahead for the new lease accounting standard. Lessors will have only minor changes to systems since the lessor models are retained with few changes. Lessors be motivated to tweak product offerings but there is time to do that. Lessees should be more concerned with transition due to the enormity of the project and the added complexity in accounting for the operating lease on balance sheet. They'll need a lease accounting system. They will also need to gather all their existing lease documents and begin extracting key data on rent payments, variable lease payments, separating elements of gross lease payments, and renewal and purchase options. They also should be thinking of changing their leasing strategies to minimize the capitalized value of future leases and sale leasebacks that they are working on. This is a large project for big companies and merits a project team and plan.

Lessees will also have to develop a process for accounting for new leases with internal controls. Since operating lease obligations were only reported in the footnotes, existing processes are inadequate. More information will be required regarding the determination of the lease term and lease payments. Lessees will need to evaluate renewal and purchase options to determine if any are reasonably assured of exercise. They will need to determine if any payment is likely under residual guarantees it is providing to lessors. They will need to track variable rents based on an index (like CPI) or a rate (like LIBOR) and possible payments under residual guarantees.

There are concerns regarding how preparers and their audit firms will deal with judgement areas under the new rules. Because operating lease payments will be capitalized there will be more scrutiny on lease payments and the lease term. Examples of areas of concern are: defining the lease term where renewal options exist (especially synthetic leases) and estimating the lease and non-lease portions of gross billed leases with services (full service leases).

Lessor Issues

As for lessor classification, both Boards agreed to retain their respective lessor models. IASB lessors will look to the IAS 17 model for classification while the FASB will retain their FAS 13 model with minor changes. The FASB dropped the 75% useful life and 90% present value bright lines from the actual classification tests, but formally stated that those values could continue to be used as guidance. Overall, the decision to maintain the basic lessor models is viewed as good news because it means lessors can continue to use their current lessor accounting systems with minor changes.

The new rules changed the definition of initial direct costs (IDC) to be incremental costs of a **lease** that would not have been incurred if the lease had not been obtained. This excludes most legal costs and all internal allocations of overhead. Sales commissions are still included. This is a major change for those lessors that allocated overhead associated with originating leases under the existing rules for IDC. Also the IDC is included in the implicit rate to amortize lease revenue making it clearer as to how IDC is amortized.

The FASB included Investment Tax Credits (ITC) in the definition of the implicit rate. This is good news as ITC, although only allowed for alternate energy assets, can now be included in lease revenue and amortized.

The FASB decided to conform certain issues to the new Revenue Recognition concept of control to define whether a sale has occurred. As a result, sales type classification is only allowed under the FASB version where the terms of the lease alone transfer control to the lessee. This approach ignores any third party involvement such as a residual guarantee or residual insurance to increase the cash flows considered in the Present Value test. Third party involvement would still be a consideration in determining if a lease is a finance or operating lease. The difference is if third party involvement is needed to increase the PV to qualify as a finance lease, it is not a sales type lease and the 'gross profit' is deferred and amortized as lease/interest revenue. Said another way, the implicit rate used to recognize lease revenue is very high as it considers the asset cost as the investment amount in the implicit rate calculation. This change impacts US vendors and dealers who have used residual insurance to achieve sales type lease treatment. They will have to evaluate their options under the new rules as the timing and presentation of revenue will change dramatically. To preserve gross profit presentation they may have to sell their leases to a third party or a non-consolidated partnerships.

Sale leasebacks with purchase options will need careful review and structuring to avoid loss of sale treatment and operating lease treatment for lessee customers. The FASB does provide additional guidance versus the IASB to determine if a sale has taken place in a sale leaseback when a purchase option is included in the lease terms. The FASB allows sale treatment where the purchase option is at fair market value and the asset is not specialized and is readily available in the marketplace. Both the FASB and IASB do not allow sale treatment if there is a fixed purchase option in the leaseback even if they are non-bargain options.

Leveraged leases will be grandfathered for US lessors but leveraged lease accounting will not be allowed for new leases commencing after the transition date. This impacts only large ticket transactions and the market will adjust to other structures like partnerships to achieve almost the same benefits as in a leveraged lease.

Lessee Issues

The FASB and IASB versions differ as to when a lessee must adjust a lease for changes in variable payments due to a change in an index or a rate. The IASB requires lessees to adjust lease accounting when the contractual rents change. To simplify compliance, the FASB only requires recording a change only when an action by the lessee modifies the lease, changes the lease terms, elects an option or does something in its control to change whether it is reasonably certain to exercise an option.

Bank and securities regulators have not opined on the regulatory capital treatment of the new capitalized operating leases. There is a concern as their policy generally is to follow GAAP. It is not the intent of the FASB to drive economic activity so it will be up to the leasing industry and regulated lessees to fight to retain the same "no capital needed" treatment afforded operating leases as they are executory contracts that have no impact on a liquidation.

Impact to lessee ratios and measures

Key Ratios/Measures	FASB Version	IASB Version
EBITDA	no change	better: rent replaced by amort/interest
Gross Margin	no change	no change
Operating Efficiency Ratio	no change	better: rent replaced by amortization
Current Ratio*	worse-asset not cur/additional liability	worse asset not current/additional liability
Quick Ratio*	worse-additional liability	worse-additional liability
Net Worth	no change	no change
Liabilities to Net Worth*	worse-additional liability	worse-additional liability
Debt/Equity Ratio	no change	worse-additional liability + eroded equity
Return on Assets (ROA)	worse-additional asset	worse-additional asset + front ended costs
Return on Equity (ROE)	no change	worse front ended costs

*it can be argued that including operating lease liabilities that disappear in a liquidation is not correct

US investment grade lessees will not see much change on the ratios and measures as their analysts and lenders are sophisticated and 'get into the numbers' in detail. Small and medium-sized companies many have to assist their lenders, which often are smaller banks and finance companies (possibly not as sophisticated as those that deal in the investment grade market) with calculations, especially in treating the operating lease liability as a non-debt liability. Return on Assets will be the most important measure lessees will focus on and try to improve through lease structuring.

The IASB one lease model will cause most ratios and measures to change for the worse. IFRS companies will see the ratios and measures deteriorate for three reasons – more assets on balance sheet (reduced ROA, Quick Ratio), accelerated costs (reduced ROA) and permanent lost equity (increased Debt to Equity). Strangely, EBITDA increases as above-the-line rent expense is replaced by below-the-line interest and amortization.

It is likely the market will adjust to the new rules as an accounting change like capitalizing leases should not change the financial strength of a company. In addition, the change in lease accounting will impact all companies. One concern is that there will be more significant changes to the financial statement of those companies that have longer-term leases and/or lease more assets than their peers.

A Look Ahead

The US market should see little impact when the rules take effect because of the FASB's decision to retain the two lease model where capitalized operating leases are separately reported in ways that reflect their substance. The business reasons for leasing remain strong as lessees lease for reasons of preserving bank lines and capital, low cost 100% financing/liquidity, managing tax benefits, managing assets (need, use and obsolescence), outsourcing service, and convenience of point of sale financing. The accounting reason for leasing will remain to the extent that only the present value of the asset is on balance sheet, the liability is not debt and the lease expense matches the use benefit (straight line). The regulatory benefits should remain if we successfully advocate with the regulators.

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