

Changes in Lease Accounting: The Benefits of Equipment Lease Financing Remain

This document is designed to help ELFA members:

- Understand what's in the new lease accounting rules
- Educate your sales teams, vendor partners and end-users about the rules
- Allay customer fears about the impending changes

Overview

After many years of drafts, discussion, debate and redrafts, the lease accounting project is coming to a close. It is anticipated that the final standard will be issued in early 2016. Though the end result is not a single, global accounting model, the FASB and IASB Boards are in agreement that virtually all equipment leases be brought on the balance sheet; however, they do not agree on a lessee model. Fortunately for the leasing and finance community, the FASB model is more favorable to our lessee customers. As we anticipate moving from the sandbox to a three-year-plus transition process, we find ourselves asking, “What was the purpose of this project, anyway?”

Proposed in 2006 by the FASB and IASB, the project's original intent was to increase transparency and comparability for lease accounting by bringing Operating Leases onto the lessee's balance sheet; however, this change is accompanied by a set of rules that complicates accounting responsibilities (especially for the end-user customer). And because it creates scenarios that might impact financial results, it also raises a fundamental question: “Does it make good financial sense to lease or finance equipment anymore?”

The answer is an emphatic YES, and the objective of this paper is to illustrate why. Here we will outline the new rules and relative impact to both vendors and end-user customers, and provide relevant logic that demonstrates the continued benefits of leasing over purchase transactions. By taking a proactive and consultative approach, equipment leasing and finance companies can provide educated guidance to their sales teams, vendor partners and end-user customers. You have the opportunity to allay customer fears about the “exposed” balance sheet and impending changes that lie ahead. In fact, many of the lease accounting changes are relatively neutral in their impact.

The Final Guidelines: What's New and Not New?

While the new guidelines are directed at organizations acquiring the use of business equipment, ELFA, with this paper, attempts to provide practical answers to the following questions:

- What are the changes?
- How do they affect my sales force, vendor partners and end-user customers?

The two key drivers of the lease accounting changes include: 1) the underlying transaction and 2) its attendant financing party, i.e., independent (third-party) or in-house (captive) providers).

Under the new guidelines, equipment lease transactions historically categorized as either capital or operating leases for lessees will be defined as **Finance** and **Operating** Leases, respectively (see Appendix A for Key Provisions of the Expected Final Standards). Expected lease accounting changes can be viewed from two perspectives:

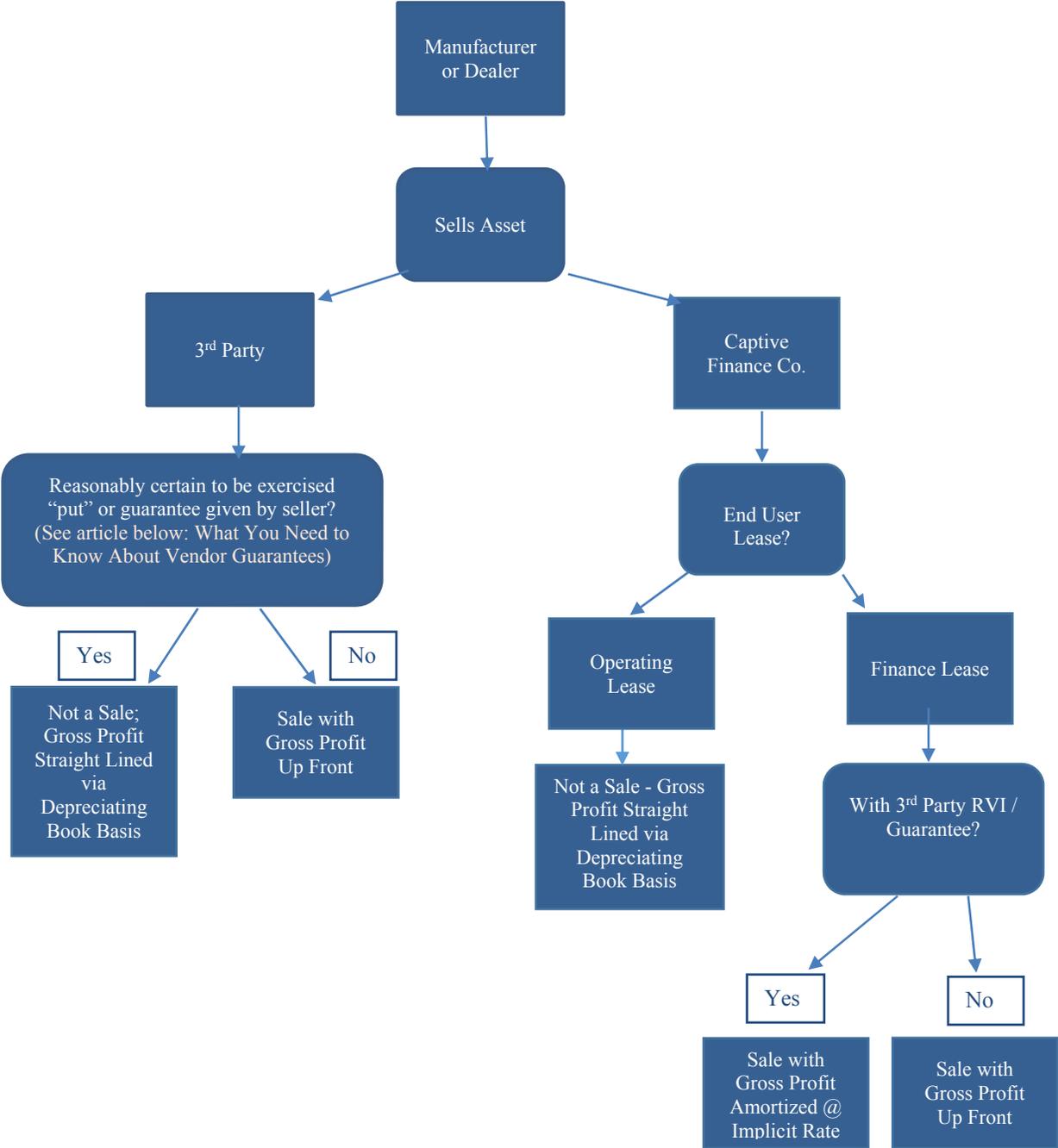
- Seller of equipment – may experience revenue recognition changes
- Lessee or purchaser of equipment – may experience balance sheet recognition and ongoing administrative changes

As we define the changes and outline their impact to each party below, we also offer relative talking points to both audiences. These points can help illustrate the net impact (often nominal or nonexistent) from a practical viewpoint. ELFA will also provide additional educational materials in the future to help communicate the changes to your clients, and deliver them with a strong, accurate message to your customers: Equipment leasing and finance still offer a range of valuable options and benefits.

1. Dealers/Vendor Partner Impact: Revenue Recognition

The new treatment of Operating Leases may *appear* to be problematic for the lessee (see **Table 1**), but such leases remain neutral territory for many sellers. In reality, manufacturers, dealers and distributors will see no revenue recognition impact for Operating Lease contracts. Generally speaking, manufacturers who sell through an independent dealer network will not have revenue recognition impact, as long as any “put” provided, or recourse or residual positions taken by the manufacturer, do not create an “economic incentive” for the buyer to exercise (i.e., the recourse cannot be more than 10% of the fair value of the asset sold). Dealers and manufacturers selling directly to equipment purchasers within the same group of consolidated companies (i.e., wholly owned captive finance companies) will not have up-front gross profit recognition if the captive’s end user leases are Operating Leases. See **Figure 1**.

Figure 1: Revenue Recognition Impact for Equipment Seller



For more information, see the related article, “What You Need to Know About Vendor Guarantees,” from the January/February 2015 issue of ELFA’s *Equipment Leasing & Finance* magazine, at http://www.elfaonline.org/news/IndNews/news_report.cfm?id=22177

Talking points for your dealer / vendor partners

- Emphasize the fact that there is no revenue recognition impact for Operating Leases - regardless of the finance provider.
- Educate dealers and vendors on the new standard with the emphasis that manufacturers who sell through an independent dealer network will not have revenue recognition impact, as long as there are no recourse or residual positions taken by the manufacturer. In cases where third-party guarantees are needed for classification purposes, revenue recognition will be deferred and there may be an opportunity for new cooperative partnerships. For instance, independent leasing companies could help captive finance companies optimize revenue by purchasing transactions where it may be economically beneficial to a captive to eliminate deferral of revenue.

2. End-User Customer Impact: Balance Sheet and P&L Impact

Educating the Customer

Unlike the relatively simple distinction between Finance and Operating Lease transactions for the seller, the lines are a bit fuzzier for the customer. And while at first glance there are indeed more accounting steps proposed for the end user, most of the classic benefits of leasing remain intact. The situation presents a great opportunity for leasing companies and their vendor partners to become advocates: by offering education and hands-on expertise to your customers, you'll put yourself on the path to being their trusted advisor.

From a customer perspective, the new guidelines propose changes to the purchaser's accounting practices; the rules for classifying new contracts as Finance or Operating are virtually the same as under current GAAP. Operating Leases will be capitalized—put on balance sheet. The lessee will recognize the “value” of the asset created by the leases as a right-of-use (ROU) asset on the balance sheet and book a corresponding liability for the minimum lease payments, discounted at the rate implicit in the lease (unless it's not known, in which case the lessee's incremental borrowing rate is used). The Operating Lease liability will NOT be classified as debt but rather it will be an “other” liability.

Talking points for your sales people

- Determining whether a new contract is Finance or Operating is virtually the same. The Board did add a criteria: if the asset is specialized, the lease is a Finance Lease. It's important to become familiar with the new guidance.
- Offer assistance with understanding that the new classification rules are virtually unchanged to overcome objections as customers make the transition to new guidance, which enables the customer to focus on the structure, terms and value of the lease.

Talking points for your end-user customers

- The new rules have no impact on the income statement.

- Presentation of the Operating Lease liability is an “other” non-debt liability.

Operating Leases, however, are at the heart of this project and the focal point of the new accounting rules; end users are now required to book both the asset and liability associated with the “right of use” of the underlying equipment. This is an improvement over the original proposal as we fortunately still have a two-lease model under the FASB version that recognizes the legal substance of leases. The Operating Lease liability will not be reported as debt in the lessee’s financial statements. The FASB specifically stated that a capitalized lease obligation (which does not meet the UCC definition of debt) is to be reported on the balance sheet as “non-debt.”

Therefore, with the potential exception of PP&E purchases, the capitalized liability should not result in a technical default under the customer’s debt limit covenants. The new guidelines are implemented retroactively. Under the new rules, all Operating Leases (except for short term leases) will need to be capitalized in the financials reported in the transition year (if comparative balance sheets are presented the Operating Leases must be capitalized in the earliest balance sheet).

Again, the income statement is not affected. New guidance requires Operating Lease payments to be expensed straight-line, reflecting current GAAP for customers.

Talking points for your sales people

- The many business benefits to leasing remain intact, including convenience, service, matching of payments to cash-flow needs, low-cost financing, residual risk transfer and potential tax benefits. **See Table 1.**
- The approval process with end users may change, requiring more involvement of their finance department before executing leases. This could lead to a longer closing cycle, but it also creates an opportunity for increased direct access to decision makers.

Talking points for your end-user customers

- Encourage discussions with auditors and banks/creditors with covenants to fully understand implications.
- Emphasize the limited effect on debt covenants and the many longstanding benefits of leasing that will continue with the new guidance. **See Table 1.**
- The accounting rules will be applied to all leases in place on the transition date, so all but short term operating leases will need to be capitalized under the new rules.

A Silver Lining: The Proof Is In the Benefits

Enter good news—and a few key reasons why, in many cases, a lease is still favorable over a loan for acquiring equipment. Under the new rules, customers with Operating Leases will find that the capitalized asset cost is lower compared to a loan or cash purchase. Why? Because the balance sheet presentation of an Operating Lease reflects only the present value of the rents due

under the contract as the asset amount; as a result, it is still “partially” off-balance sheet. In addition, since the cost of an Operating Lease is reported as a straight line expense of the full lease payment each period, there is no front-end loaded P&L impact that comes from expensing depreciation and imputed interest costs as there is when a customer borrows to make an outright asset purchase. The net result is that leasing, compared to borrowing to buy, will show a better ROA for the lessee, which can be the basis for bonus compensation, and ROA is a measure used by equity analysts.

Moreover, consider the discounted cost and built-in flexibility of financing, which offer additional savings, extended payment options and equipment upgrades or add-ons. Improved cash-flow management, keeping pace with technology and aligning capital asset acquisition strategy with business needs in real time all create economic and practical advantages compared to a loan.

Talking points for your sales people

- Although Operating Leases will add assets and liabilities to the balance sheet, the asset amounts (rental/ROU amount) will be lower than the cost of an outright purchase. Leasing continues to offer many benefits for clients, including flexible terms and structures, cash flow and tax benefits, and avoiding ownership of obsolete equipment. **See Table 1.**

Talking points for your end-user customers

- Leasing continues to offer many benefits for businesses, including flexible terms and structures, cash flow and tax benefits, and avoiding ownership of obsolete equipment. **See Table 1.**

Table 1: Leasing Benefits – Before and After

Lessee Benefits	Current Rules	New Rules
Capital Needs	<ul style="list-style-type: none"> • Added source of capital • Fixed rate (vs. revolver) 	<ul style="list-style-type: none"> • No change
Cash flow savings	<ul style="list-style-type: none"> • 100% financing, level payments • Lower payments resulting from tax benefits and residual investment by lessor • Skip / seasonal payments • Financing for training and installation costs 	<ul style="list-style-type: none"> • No change
Tax Benefits	<ul style="list-style-type: none"> • Trade potentially unusable MACRS benefits (AMT, NOL) for lower payments • Expensing of full payment on income tax returns 	<ul style="list-style-type: none"> • No change
Flexibility	<ul style="list-style-type: none"> • Options to fit varying business needs at end of lease term • Add-ons / upgrades made easy 	<ul style="list-style-type: none"> • No change
Asset Management	<ul style="list-style-type: none"> • Manage technology cycle / reduce obsolescence risk • Manage asset replacement cycles 	<ul style="list-style-type: none"> • No change
Financial Reporting Benefits (Operating Leases)	<ul style="list-style-type: none"> • Off-balance sheet asset and obligation • Improves debt, ROA and ROE ratios 	<ul style="list-style-type: none"> • Asset amount on balance sheet is less than cost • Liability on balance sheet, but as non-debt • On-book obligation lower than debt or cash due to residual investment • Will have little impact to debt ratios and financial measures
Convenience	<ul style="list-style-type: none"> • Streamlined financing process for many transactions • Often available at point of sale 	<ul style="list-style-type: none"> • No change

Lessee FAQs

Q: I have heard that under the new Lease Standard, I have to recognize all leases on the balance sheet. Is this true?

A: That depends. If you are reporting under IFRS / US GAAP, the answer is YES. However, if the contract duration is equal to or less than 12 months, the off-balance-sheet approach currently used for Operating Leases applies. If the contract qualifies as a service (check definition addressing control and specified asset), the contract does not have to be recognized on the balance sheet. For IFRS companies, the lease does not have to be recognized if the value of the asset is low (with a benchmark less than \$5,000), irrespective of term. (NOTE: This is not the case under US GAAP.)

Q: I have been informed that there is a divergence between US GAAP and IFRS with respect to lessee accounting—what exactly is that difference?

A: Under both rules, all leases have to be recognized on the balance sheet. Under IFRS, there is lease model (Finance) for lessees and the costs must be recognized in the P&L, similar to the way Capital Leases are booked today, i.e., imputed interest costs are a downward sloping curve (relatively higher at the beginning of the lease term) and asset amortization is level, thus creating a front-loaded expense pattern on the P&L.

Under US GAAP there are still two kinds of leases: Finance Leases (comparable to current Capital Leases) and Operating Leases (comparable to current Operating Leases) and their costs are reported accordingly in the P&L, which is no change from current practice. In other words, a Finance Lease reports front-loading of costs and a split in amortization and interest costs, while an Operating Lease shows only single level rental expenses in the P&L.

Q: Will my credit rating be changed by the additional liabilities?

A: Your credit rating should not change just because the FASB changes the rules for recording and capitalizing Operating Leases. Bank lenders and credit analysts already take into consideration the Operating Lease obligation included in your footnotes. They estimate the value of the implied asset and liability created by Operating Leases to adjust their measures and ratios used to make credit assessments. The proposed formula under the new rules is substantially the same as the method used by rating agencies today.

Q: Will the debt limit covenants in my borrowing agreements be broken when the new Operating Lease liability is on my balance sheet?

A: The FASB specifically stated that capitalized lease obligation (which does not meet the UCC definition of debt) is to be reported on the balance sheet as “non-debt.” The capitalized liability will not result in a technical default under your debt limit covenants.

3. Next Steps: Be Proactive

As we await the final issuance of the new leasing guidelines, we advise you to follow the developments of the new standards and maintain a dialogue with your customers to reassure them that you are keeping abreast of the changes. Help them be prepared by suggesting they make an inventory list of all equipment lease and rental contracts, and provide them the following guidance once the new standards are published:

- **Bank relationships:** Encourage them to proactively discuss the changes and possible impact on their credit lines and covenants.
- **Auditors:** Suggest they get advice and guidance about the support they can expect and how the new rules will impact their P&L and balance sheet.
- **IT systems and software providers:** They can help your customer understand the consequences for both proprietary and third-party systems and software.
- **Vendor finance relationships:** Your customers should seek advice and guidance about the expected impact of the new rules on the current cooperation and business models. They should also keep an eye on new financial products designed to conform to new regulations.

4. Exhibit Leadership and Leverage Your Relationship

Bringing closure to this initiative is more than a welcome reprieve from awaiting the uncertain enemy; it's an empowering tool to seize opportunity. As industry experts and trusted advisors, providing information and critical knowledge to decode the new rules breaks the cycle of inertia for all of our stakeholders and opens the door to positive conversations with your customers. By staying informed, projecting confidence and offering practical and profitable solutions, you can continue to help your customers grow—not in spite of transparency, but because of it.

Your ELFA membership provides access to the most current information and updates on the final rules; you represent a powerful, collective voice of reason. As industry experts and trusted advisors, we are a resource for targeted messaging and collateral materials, and an esteemed peer group who shares learnings and best practices. Last but not least, underscore the success your customers have achieved in the past and will continue to realize with the core benefits of leasing:

- An immediate source of lower-cost capital
- Flexible terms and structures
- Payment plans aligned with cash-flow needs
- Convenient and efficient execution
- Industry expertise and regulatory knowledge

For more information on lease accounting, visit the ELFA Lease Accounting Project webpage at www.elfaonline.org/Issues/Accounting/.

Appendix A: Key Provisions of the Expected Final Standards

Definition of a Lease	A lease is present only when an arrangement conveys the right to “control” the use of an “identified asset” for a period of time in exchange for consideration.
Balance Sheet	<p>Lessee: Recognize a <u>right-of-use asset</u> and a <u>lease liability</u> for all leases, subject to limited exclusions (e.g., lease terms \leq 12 months) based on the discounted payments required by the lease.</p> <p>Lessors: Accounting is substantially unchanged. Lessors continue to reflect the underlying asset subject to the lease arrangement on the balance sheet for leases classified as operating. For financing arrangements direct finance or sales-type leases, the balance sheet will reflect a lease receivable and the lessor’s residual interest.</p>
Income Statement	<p>Lessee:</p> <p>FASB - Dual approach:</p> <ul style="list-style-type: none"> • Finance Lease - Requires a lease to be presented as a financing (similar to capital leases today) in the income statement when (1) payments represent substantially all (90% can be used to help in the judgement) of the fair value of the asset, (2) the lease term is for a major portion (75% can be used to help with the judgment) of the asset’s economic life, (3) purchase of the asset is considered a bargain, (4) title transfer is automatic at the end of the lease or (5) if underlying asset is of such a specialized nature that it is expected to have no alternative use to Lessor at the end of lease term. • Operating Lease (All non-Finance Leases) – Costs are presented as lease expense and recognized on a straight line basis in the income statement over the lease term, the same as operating lease costs under current U.S. GAAP. <p>IASB - All leases accounted for as financings.</p> <p>Lessor: The Boards decided that a lessor should determine lease classification (Direct Financing or Operating) on the basis of whether the lease is effectively a financing or sale. In addition, the FASB decided that a lessor should be precluded from recognizing sales-type selling profit at lease commencement for any Direct Financing lease that employs third-party residual guarantees or insurance for classification as a Direct Financing Lease. To be classified as a sales-type lease the terms of lease contract alone must transfer control of the underlying asset to the lessee.</p> <p>The FASB and IASB agree that an arrangement that is effectively a sale should result in recognition of a day-one profit. The FASB, however, believes that when the lessee does not obtain control of the underlying asset, the profit should be deferred and recognized over the lease term, even if the lease is classified as a Direct Financing Lease. This could occur when a lessor purchases residual value insurance, thereby transferring the risks and rewards (but not control) of the underlying asset, to the lessee.</p>

	<p>Lessors would consider all other leases to be Operating Leases, with income statement and balance sheet treatment similar to today's operating leases.</p>
<p>Payments Included in Asset & Liability Calculations</p>	<p>All fixed contractual lease payments. Any renewal or purchase options that are reasonably assured of exercise by the lessee – basically bargain or compelling options.</p> <p>Variable payments (e.g., CPI-based and floating rate rents) are included on the basis of the rate or index at lease commencement. The FASB does not require re-measurement after lease commencement except where there is an action by the lessee that changes the lease assumptions. The IASB decided to require re-measurement whenever a change in the reference rate/index results in a change in cash flows.</p>
<p>Small Ticket Leases</p>	<p>The Boards decided to exempt short term leases (terms of 12 months or less) from capitalization. The IASB also allows a small item (<\$5,000) exemption.</p> <p>The Boards decided to permit the leases guidance to be applied at a portfolio level by lessees and lessors to ease compliance costs. The FASB decided to include the portfolio guidance in the basis for conclusions, while the IASB decided to include the portfolio guidance in the application guidance.</p>
<p>Separating Lease and Non-lease Components</p>	<p>Lessee must separate lease components from non-lease components in a gross or bundled billed lease with service unless it applies an accounting policy election by class of underlying asset to capitalize the full payment. This means the lessee must use observable market pricing of at least one element to split the lease and service elements of a bundled billed lease (reasonable estimates are allowed).</p> <p>Lessor should apply the guidance in Topic 606 on allocating the transaction price to separate performance obligations.</p>
<p>Transition</p>	<p>Final standards are expected around year end 2015, with implementation expected to be required for financial periods ending 2018, for companies with calendar year ends.</p> <p>Boards require that lessees compute lease assets and liabilities based on the remaining payments for operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. Capital leases are grandfathered for lessees and all leases are grandfathered for lessors. Lessees and lessors can elect certain practical expedient reliefs that avoid having to apply the new rules to leases existing at transition.</p>