The New Lease Accounting Standard's Impact on Lessor Product and Structuring Opportunities

Note: This is the third article in a four-part series of articles featured in the QuickBrief e-newsletter designed to help ELFA members prepare for the new lease accounting rules. The new rules are scheduled to take effect for financial periods starting after Dec. 15, 2018, for public companies and after Dec. 15, 2019, for private companies. This article is excerpted from information at ELFA's Lease Accounting webpage.

Under the new lease accounting standard, the structuring objective of both FASB and IASB lessees is to minimize the capitalized amount of leases. There are product options and structures that a lessor can employ to help meet the lessees' objective.

Lease product options include conditional sales, fair market value (FMV) leases, synthetic leases, and for vehicles, TRAC and split TRAC leases. The "best" financial products for lowering the amount capitalized, allowing straight line expense and avoiding the lease liability classified as debt are operating leases structured as FMV leases, synthetic leases or split TRACs. The most favorable products (assuming a U.S. customer) are conditional sales and TRACs as they are finance leases and capitalized generally at 100% of cost. For IFRS customers all products will result in the lease liability labeled as debt and front ended lease costs. The IFRS customer is still motivated to lower the present value of the rents to lower the amount of assets and liabilities capitalized to minimize the negative impacts to financial ratios and measures.

Residual guarantee products and variations may be attractive (remember a residual guarantee may eliminate tax benefits to the lessor) given that only the probable payment (not the full amount of the guarantee) under the residual guarantee is capitalized. At commencement the probable payment under the guarantee should be zero as the residual guarantee is generally structured with the strike price set at the expected future value—it is not "in the money." A residual guarantee allows the lessor to offer a lower rent by assuming a higher residual without the asset risk, as the lessee guarantees the residual (there is credit risk; that is, can the lessee pay the guarantee if needed?).

The following table of capitalized values for different lease structures shows that the split TRAC and synthetic leases offer the lowest capitalized values. The high residual assets offer lower capitalized values than low residual assts. Note that the PC lease with an interim rent would not be classified as an operating lease as the interim rent will be capitalized causing the present value to exceed 90% of the asset cost. These values are not purported to represent current market pricing.

Lease Type	Sample Terms	Estimated Capitalized Value @ 6% disc rate
PC lease	36 mos, 2.73% pmt, FMV with 15 day interim rent	91% of cost *
Auto fleet lease	12 mos, 2.5% pmt, 76% RVG (split TRAC)	29% of cost
Construction/Ag equip lease	36 mos, 1.6% pmt, FMV, 50% residual	52% of cost
Cat Scanner lease	60 mos, 1.5% pmt, FMV, 20% residual	77% of cost
Truck lease	84 mos, 1.24% pmt, FMV 23% resid	85% of cost
Corp jet lease	120 mos, 0.65% pmt, FMV	59% of cost
RE synthetic lease	60 mos, 0.5% pmt, 85% RVG	26% of cost

This article is an excerpt from "Navigating the New Lease Accounting Standard" available at www.elfaonline.org/industry-topics/lease-accounting.