LEASE ACCOUNTING EXPOSURE DRAFT

What you need to know now

By William Bosco and Shawn Halladay

At long last, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have issued the exposure draft for the proposed change in SFAS 13, the lease accounting standard. The complex proposal to overhaul lease accounting will have a significant impact on both lessees and lessors, beginning as early as 2013. This article explains the proposed changes to the lessee and lessor accounting rules.

TIMELINE

The FASB/IASB released the exposure draft on Aug. 17, 2010. The comment period ends on Dec. 15, 2010, and ELFA members are encouraged to submit a letter (see "Get Involved: Send a Comment Letter" on page 40). The FASB/IASB plan to review comment letters and then re-deliberate any changes to the exposure draft in the first quarter of 2011. If there are significant changes, a second exposure draft could be issued, but this is rare. If changes are not viewed as significant, the final rules will be completed, voted on and issued by midyear 2011 without further solicitation of public comments. This is the normal track. The effective date of the new rules is likely to be 2013, so companies with calendar year ends will begin accounting for leases under the model in January 2013.

EVENT	EXPECTED TIMING
Issue Exposure Draft	Aug. 17, 2010
End of Comment Period	Dec. 15, 2010
Re-deliberation of Issues	First Half 2011
Issue Final New Rules	Mid-2011
Implementation	2013

SCOPE

The proposed lease accounting rules cover leases of property, plant and equipment (same as SFAS 13). Leases that are equivalent to financed purchases are excluded from the scope; they are treated as a purchase and loan obligation by the lessee and as a sale and loan receivable by the lessor. Two criteria are used to determine which leases are financing: automatic transfer of title to the leased asset and the presence of a bargain purchase option. The lease accounting project defines a lease as:

> "A contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration, and the contract conveys the right to control the use of the underlying asset."

BACKGROUND

ELFA has been following the lease accounting project since 1995 when the G4+1 first proposed capitalization of operating leases in a discussion paper. At the time, most leasing "experts" expected lessees to capitalize operating leases using a rating agency capitalization model. That was a stated objective of the new approach to lease accounting, since the adjustments to the balance sheets made by rating agencies and other users were often cited as a financial reporting deficiency.

The basis of the new approach was the capitalization of the rights and obligations in a lease rather than the leased asset itself. At the same time, most leasing "experts" thought that lessor accounting would be symmetrical and follow the same concepts so that all but short-term leases would be accounted for as direct finance leases. The FASB/IASB viewed this expected change in lessor accounting as an improvement because they believed operating lease accounting did not reflect the economics of most equipment leases. There was some concern about the overall approach to lessee accounting but the industry accepted the balance sheet changes for the lessee and were looking forward to the possible lessor accounting changes.

Over the past few years, the project and the proposed lease accounting model have evolved in ways that the industry, and indeed ELFA, did not expect. For lessees, the proposed rules capitalize far more than what the rating agencies currently consider. The rules will also completely change the P&L and cash flow treatment of leases. For lessors, the proposed rules create several models that are not as transparent as the direct finance method or as straightforward as the operating lease model, and create uncertainty as to which model to use. In many cases, the proposed lessor accounting is not symmetrical with lessee accounting. It appears that the benefits of sales-type lease accounting will be reduced and leveraged lease accounting will be dropped.

Lessee Accounting

RIGHT-OF-USE APPROACH

The proposed lessee accounting method is called the right-of-use approach. Lessees will initially recognize an asset representing its right to use the leased item for the lease term (the right-of-use asset) and a liability for its obligation to pay rentals. Lessees will record

the present value (PV) of the *estimated* lease payments discounted by their incremental borrowing rate, plus any initial direct costs incurred. (The interest rate implicit in the lease can be used if it is readily determinable.) The lessee will determine the most likely lease term considering any options to renew, and include the renewal payments in the estimated lease payments to be capitalized. Past behavior in renewing leases, such as month-to-month renewals, is an indication that the lessee is more likely than not to renew for some period and will therefore have to include month-to-month renewals in the payments to be capitalized. The lessee will also include in estimated lease payments any interim rents, estimated payments under contingent rent and residual guarantee provisions in the lease. Purchase options will be ignored unless they are bargains, in which case the lease is a financed purchase and out of the scope.

Disregarding nonbargain purchase options is an important new development and will reduce the amount capitalized for some leases with purchase options. As a result of the change to the definition of lease payments, the amount of lease liability the lessee will record may be significantly greater than their fixed liability to the lessor, and the lessee will be capitalizing far more than the rating agencies do when they evaluate the credit rating of companies. Lessees who show interim rents and a history of renewing leases may find the capitalized amount is equal to or even greater than the cost of the equipment.

For leases with services like full-service leases, the lessee should split the service portion and account for the services as an executory contract (i.e., recognize the costs in P&L as the services are performed, generally straight line expensing). If the lessee cannot determine the breakdown of lease payment versus service payment or get this information from the lessor, the *full* payment must be capitalized. For subsequent accounting, lessees will amortize the right-of-use asset as they would an intangible asset. That method will be straight line over the lease term. The expense will be labeled in the P&L statement as amortization rather than as rental expense. Subsequent accounting for the lessee's obligation to pay rentals would be to amortize the obligation using the effective interest method. The rent payment will be accounted for as if it were a loan payment with an interest and an amortization of "principal" component.

Rent expense under SFAS 13 is straight lined in the P&L statement, while the proposed method front-ends lease expense because the reported lease cost will be the sum of the asset amortization and the imputed interest on the lease obligation. Lessees will therefore have to report higher costs in the first half of the lease term and lower costs in the last half of the lease term, which is generally contrary to the economic flows in a lease contract. Since the IRS tax accounting policy of allowing deduction of the cash paid for rent will not change, the lessee will have to record a large deferred tax asset, further ballooning the assets on the balance sheet. The deferred tax accounting adds to the complexity.

REASSESSMENT OF LEASE TERM

Under the proposal, at each reporting date, lessees will have to reassess the lease term and estimate payments for contingent rents and residual guarantees. This will be a significant burden for lessees. The FASB/IASB believe they gave lessees relief by stating that detailed examination of every lease would not be required unless there is a change in facts or circumstances that indicates that the lease term or estimated rents may need to be revised. In practice, a company with a significant number of lease transactions will not be able to make this determination unless it reviews all leases and accumulates the impact of the adjustment. Once this detail is accumulated, the company will frequently book the adjustment.

Any change to the obligation to pay rentals resulting from a reassessment of the lease term would be recorded as an adjustment to the right-of-use asset. Changes to contingent rents and residual guarantees will be split between expense for the current period portion of the adjustment and the right-of-use asset for the future period portion. The lessee's discount rate should not be revised when there are subsequent changes in the estimated lease payments.

In the year the lease is booked, the acquisition of the right-of-use asset will be shown as a capital expenditure and an increase in borrowings in the statement of cash flows. Cash rent payments would be shown as interest and principal repayments and classified as financing activities separately in the statement of cash flows. No additional disclosures of the total cash rentals paid would be required on the face of the financial statements. Since that information would be disclosed in the notes to the financial statements, analysts will have to continue to search in the footnotes to determine the amount of cash paid for rents. It will also mean that certain measures of cash flows from operations will now improve, as rent expense will not be considered an operating cash outflow. In other cases, particularly for certain long-term leases, there will be a negative amortization as imputed interest may exceed the amount of cash paid for rent. This will further confuse analysts and readers of financial statements when they try to determine the impact of leasing activities. The proposed treatment of leases also means that leases will be capital budget items as opposed to operating budget items.

Lessee disclosures will include much of the same information as under SFAS 13, but they will also report breakdowns and explanations of the estimated amounts of contingent rents, renewals and residual guarantees that have been capitalized but may in fact not be paid.

TRANSITION PROCESS

To transition to the new rules, lessees will have to book all leases that are outstanding on the date of initial application of the proposed new leases guidance, except for capital/finance leases with no options, contingent rents and residual guarantees. Lessees would apply the proposed new requirements by booking an obligation to pay rentals and a right-of-use asset measured at the PV of the remaining lease payments, discounted using the lessee's incremental borrowing rate on the transition date. Additional adjustments for prepaid or accrued rentals should be made when lease payments are uneven over the lease term.

The transition process will also require adjustments to all financial periods presented (usually at least two years). Lessees should be paying attention to this project now, given that implementation is expected in 2013. This will be a daunting task for most large companies due to the number of smaller-dollar leases they may have and for other companies with significant real estate leases because of scale and the complex terms of many of these lease transactions.

LESSEES SHOW INITIAL INDIFFERENCE TO PROPOSED CHANGES

Increased Costs of Proposed Rules:

LEASE TERM	1ST YEAR INCREASE IN LEASE COST: PROPOSED RULES VS. CURRENT GAAP
3 years	7%
5 years	11%
7 years	16%
10 years	21%
17 years	26%

Given the reporting impacts of the proposed changes and the fact that they do not reflect the economics of lease contracts, it is surprising that so few lessees commented to the FASB/IASB on the Lease Project Discussion Paper issued in March 2009. There are strong arguments for a different approach to the amortization of the leased asset and against the proposed definition of lease payments; unfortunately, a few comment letters gave the FASB/IASB an implied confirmation of their proposed accounting. ELFA has worked to raise lessee awareness through articles in business and financial publications, direct mail contact, lessee and trade association meetings, and webinars. The reaction has been slow but is growing as more companies delve into the details of the accounting using examples of specific leases.

Lessor Accounting

FOUR PROPOSED MODELS

There likely will be multiple accounting models for lessors. The four models proposed are the partial derecognition, performance obligation, short-term lease and investment property methods. The existing lessor models, including leveraged leases, will no longer exist. The short-term model applies to leases that have terms of 12 months or less with no renewal options, and the investment property model applies to real estate leases only. Therefore most ELFA members will use either the partial derecognition method or performance obligation method.

Lessors that have significant risks or benefits associated with the following factors will be required to use the performance obligation method:

- Significant contingent rentals during the expected lease term that are based on the use or performance of the underlying asset
- Options to extend or terminate the current lease term
- Material nondistinct services provided under the current lease contract
- A lease term that is short relative to the useful life of the asset
- A significant change in the value of the underlying asset expected at the end of the lease term. In making this assessment, the lessor should consider the PV of the underlying asset at the end of the lease term and the effect that any residual value guarantees may have on the lessor's exposure to risks and benefits.

These are subjective criteria and the exposure draft's initial wording and guidance are subject to change. The interpretations adopted by the Big Four accounting firms will also have a significant impact on how these factors are interpreted in practice. Lessors may have a difficult time getting accounting that reflects the business transaction and economics.

PARTIAL DERECOGNITION METHOD

ELFA believes that most member companies will find the partial derecognition model closest to their business model and to the economics of lease transactions. The partial derecognition model is a step back from today's direct finance lease model, but it is better than the alternative.

In the derecognition model, the lessor books the PV of estimated rents at a rate similar to the implicit rate (FASB/IASB call it the rate the lessor is charging the lessee) and "plugs" the residual asset (no longer called residual value), which is essentially the PV of the expected residual. Lease revenue is finance revenue on the lease receivable, and sales-type revenue and gross profit, if any. The residual asset is left on the balance sheet unchanged except for impairment (this is the major weakness). ELFA plans to challenge the residual accounting in its comment letter as it is a step backward from today's direct finance lease accounting, which treats the start of a lease as an event to be measured at fair value. Revenue will be somewhat back-ended compared with current direct finance lease accounting because of cash basis accounting for the residual.

PERFORMANCE OBLIGATION METHOD

In general, the performance obligation approach does not reflect the legal and economic framework associated with equipment leasing. Because of these issues, ELFA is likely to challenge any potential widespread use of this model.

In the performance obligation model, the lessor leaves the leased asset on its books, books a receivable at the PV of the estimated payments (using the implicit rate or similar rate as the discount rate), and books a performance obligation liability. The "performance obligation" is not a real liability but rather more similar to deferred income. The three components (undepreciated leased asset, present valued lease receivable and the unamortized performance obligation) are netted for balance sheet presentation. The residual is ignored, so it is accounted for on a cash basis by default. Lease revenue has a finance component and straight line amortization of the deferred liability, and there is also depreciation on the leased asset. Currently, the FASB thinks depreciation should be netted with the lease revenue, but the IASB thinks depreciation should be shown as an expense. Industry experts believe depreciation should be netted, and this is an important issue for banks or any lessor that uses operating leverage as a key performance measure. Depreciation of a leased asset should not be considered an operating expense but rather a component of the return on the lease investment.

Revenue may be more front-ended under the performance obligation model than under the operating lease model because the depreciation expense, net of the performance obligation amortization, is lower. The proposed depreciation model for leased assets is straight line over the economic life to a zero salvage, resulting in depreciation expense that may be too low. Since the lease term is typically less than the economic useful life, the salvage value at the end of the lease term usually is different than the expected residual. This will likely cause impairment issues.

Industry experts believe that the performance obligation method is not appropriate for most equipment leases as they do not include services that are nondistinct. The performance obligation method leaves the leased asset on the books, which fails to recognize that the lessor has transferred the value of the right of use to the lessee. Full-service equipment leases have distinct services that are accounted for separately. The exposure draft includes an alternative view that the performance obligation model should be used only when there is an ongoing performance obligation that has significant risk of non-performance. Many in the industry believe this view to be appropriate.

OTHER LESSOR MODELS

The short-term lease method would apply to leases with terms of less than one year and involves accrual accounting with no discounting. The investment property method is for actively managed real property leases. The method essentially involves SFAS 13 operating lease accounting but the residual is fair valued with gains or losses flowing through P&L.

Captive finance subsidiaries of manufacturing entities should be concerned if the proposed new rules are adopted. Sales-type lease accounting will be negatively impacted. Any lease that is deemed a financed sale will result in gross profit recognition. Leases that are classified as partial derecognition leases will result in partial gross profit recognition based on the ratio of the PV of the rents to the fair value of the asset. This is less than what SFAS 13 allows under its fair value approach. No gross profit recognition will be allowed for performance obligation or short-term leases.

Leveraged lease accounting will be eliminated under the proposed new rules. In transition, leveraged leases will be booked gross and the MISF yield income amortization method will not be used. The total gross rents remaining will be present valued and the leveraging debt principal balance will be recorded as a liability. Leveraged leases may be classified as either performance obligation leases or partial derecognition leases. This means the existing residual asset will be removed and rebooked according to the applicable lessor accounting method. The deferred tax liability account will also be adjusted. The net balance in the adjustment will be charged or credited to retained earnings.

TRANSITION PROCESS

For transition under the proposed new rules, lessors would be required to re-book all leases going forward. If the transition year is 2013, work should begin now because all periods presented in financials will need to be adjusted. This will be a major undertaking for lessors and it is likely ELFA and industry experts will push for grandfathering of existing direct finance leases and leveraged leases.

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How Will the Proposed Lease Accounting Rules Affect Your Business?

By William Bosco and Shawn Halladay

After careful analysis of the exposure draft on lease accounting, ELFA and industry experts anticipate the following impacts from the proposal:

CHANGES IN LESSEE BEHAVIOR

Undoubtedly some lessee behavior will change. The following observations should be taken into consideration as one contemplates doing business under the proposed new lease accounting rules:

- The costs associated with a lease will be more transparent.
- Although the lease vs. buy economic answer will be the same, noneconomic accounting issues may influence the decision to buy despite the economics.
- Capital budget constraints were a reason for leasing that will be eliminated. A lease will be viewed as a capital budget item and this will raise the level of attention and change the approval process to a more centralized or higher-level authority. This will at the very least slow down the approval process if not change the decision to buy.
- The sales cycle for equipment may be extended if lessees choose to buy. For example, one truck lessor who had customers that normally financed full-service leases reports those same customers

LESSEE IMPACTS

Many reasons for leasing will still exist if the present value (PV) of the rents is less than the cost of the asset.

IMPACT ANALYSIS: Reason for Leasing

	RAISE CAPITAL	LOW-COST CAPITAL	TAX BENEFITS	RESIDUAL RISK TRANSFER	CONVENIENCE	REGULATORY	ACCOUNTING
DETAILS	Additional capital source, 100% financing, fixed rate, level payments	Low payments/ rate due to tax benefits, residual and lessor cost of funds	Lessee can't use tax benefits, and lease vs. buy shows lease option has lowest PV cost	Lessee has flexibility to return asset	Quick and easy process often tied in with the sales process	Capital issues	Off balance sheet
STATUS AFTER NEW RULES IMPLEMENTED	Still a major benefit, especially for small and medium-size non-investment grade lessees	Still a benefit versus a bank loan	Still a benefit	Still a benefit	Still a benefit	Still a partial benefit if the PV is less than the cost of the asset	Still a partial benefit if the PV is less than the cost of the asset

were choosing to buy the trucks as well as a service contract. Historically, leased trucks were returned with significant useful life remaining.

- Some customers may decide it no longer makes sense to lease. For example, a computer lessor reported that one customer has already announced that it will no longer lease owing to the accounting changes.
- Level payments that fit the operating budget will not do so any longer. Rent expense will be replaced by front-ended lease cost.
- Trade-ups negotiated with a line manager, swapping one off balance sheet operating lease for another, will be more difficult. The operations manager will have to get finance/accounting involved because the existing lease will have to be closed out on the books and replaced by a new lease booking. Ironically, the front-ended cost pattern will likely result in a gain being recorded when the new lease is closed out. In any case, the trade-up will be on the radar screen of the accounting, finance and treasury departments.

ECONOMICS AND PRICING FOR CAPTIVES, BANKS AND INDEPENDENTS

Lease costs will rise for lessees who had been using leveraged leases, as lessors will have return on assets (ROA) issues if the leases are booked gross. The leveraged lease product will likely morph into a partnership structure. This more complex structure may not work for all asset types and will have to involve multiple lessors. The returns will be lower as the MISF yield will be replaced by a less accelerated method of income recognition, so the lessor will likely increase pricing.

Lease costs will rise for lessees that used to qualify as sales-type leases because captives/dealers will realize less profit, and the benefits of deferred tax benefits may not make up for the loss of gross margin. Captives and dealers may sell leases to third-party lessors, allowing recognition of the gross profit up front. This will create a taxable event for the captive/dealer so there will be no tax deferral on the gross profit. This will likely result in higher costs for lessees.

Lessor pricing may rise because residual accounting is a cash basis under the partial derecognition model. Lessors who use an ROA pricing model will find that back-ended earnings are a drag on reported earnings performance, so they may increase prices to compensate.

Banks will likely avoid performance obligation leases if depreciation is classified as an operating cost, and captives and dealers will also avoid leases that are classified as performance obligation leases as gross profit will be deferred. Some leases may then be pushed to independents, whose cost of funds is typically higher, so overall lessee pricing will probably rise.

LESSOR AND LESSEE CAPITAL ISSUES

Leveraged lease gross-ups will put capital pressure on banks and finance companies. Negative catch-up adjustments from the transition accounting method will reduce capital. Bank lessors may also indirectly suffer from the impact of the lessee rules on banks. Banks have large operating lease obligations related to retail branches and general office space. The additional right-of-use assets, deferred tax assets and front-ended lease cost will be drains on capital. Regulatory capital relief may be helpful but ROA and return on equity will suffer in the eyes of investors.

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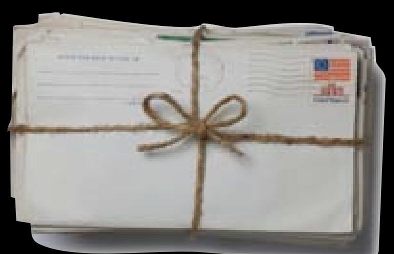

Get Involved: SEND A COMMENT LETTER

Commenting to the FASB or IASB is the most powerful tool you have at your disposal. As a business concern impacted by the proposed accounting rules changes, you are a constituent of the boards, and you have the right to request a meeting with their staff or board members. Or you may wish to write a comment letter that provides your company's views of the changes being contemplated. Visit the ELFA website at *www.elfaonline.org/ind/topics/Acctg/* for links to view previous comment letters and instructions for how to submit a letter. You may also wish to speak with an ELFA staff person or subject matter expert to assist you in this effort. You may contact Ralph Petta at *rpetta@elfaonline.org*. Stay informed, plan for the transition as a lessor and develop customer and product strategies to stay ahead of the curve. At a minimum, send a comment letter!

ELFA Takes a Leadership Role on Proposed Lease Accounting Rules Changes

ELFA HAS BEEN CLOSELY MONITORING AND ANALYZING developments In the proposed lease accounting rules, which would dramatically revise U.S. GAAP. The association has several initiatives under way to press for eliminating undue compliance burdens on businesses and to help members understand the proposed changes and the impact of the changes on their businesses.

ELFA and other industry organizations will continue to work with the national and international accounting standards-setting bodies to ensure that the new rules do not provide disincentives for businesses to choose lease financing as an equipment acquisition tool. These efforts will include the following:

- Ensuring that the lessee P&L does not reflect artificial accounting charges that exceed or are less than the amount of rent a lessee would have recorded
- Preventing the capitalization of estimated contingent rents and nonbargain renewal options for lessees
- Preventing constant adjustments to estimates for lessees
- Retaining direct finance lease-like accounting for lessors for all leases
- Retaining leveraged lease accounting
- Expanding the universe of leases that qualify for sales-type lease accounting
- Alternatively, grandfathering existing leveraged leases, direct finance leases and sales-type leases

Given the challenges presented by the proposed new rules discussed in this issue of *ELT*, ELFA is pursuing a strategy of positive engagement with the FASB and IASB and staff to analyze and communicate the real-life impact of the rules on the decision to select and book a lease. To this end, the association is collaborating with a number of lessee organizations, including the U.S. Chamber of Commerce, the Real Estate Roundtable and others, to conduct for their members a comprehensive analysis of the proposed new rules and what they may mean to businesses, both large and small. It is, after all, these businesses who look to the leasing product as an important tool to acquire productive assets. This campaign also involves regular communications with ELFA member organizations—through magazine articles, conferences and web seminars, and e-mail—all designed to help them anticipate and plan for the coming changes. It is not a matter of "if the changes will occur"; rather, it is a matter of "when."

In September, ELFA offered information and analysis of the proposal rules at the 2010 Lease and Finance Accountants Conference and a web seminar on Changes in Lease Accounting for Captives. A recorded archive of the web seminar is available for ELFA member Captive Finance companies at *http://webinars.elfaonline.org/session .php?id=4979.*

In October, the ELFA 49th Annual Convention will provide members with the most accurate and up-to-date information on the lease accounting proposal in order to evaluate the potential effects of these changes on member companies' financial statements and business operations. Sessions will include:

- **THE PROPOSED CHANGES TO THE LEASE ACCOUNTING STANDARDS** – A discussion of proposed changes to lease accounting, and implications for lessees and lessors.
- **THE PROPOSED LEASE ACCOUNTING STANDARDS: PRICING AND PORTFOLIO MANAGEMENT IMPLICATIONS** – A discussion and analysis of the likely pricing, marketing and management implications of the proposal.

ELFA will submit a comment letter detailing the association's specific concerns before the Dec. 15, 2010, comment deadline, and encourages all ELFA members to do the same (see "Get Involved: Send a Comment Letter" on page 40). The ELFA letter will be posted on the association's website at *www.elfaonline.org/ind/topics/Acctg/.*

In addition, the Equipment Leasing & Finance Foundation is developing a research paper, tentatively titled "Equipment Finance After FASB Changes," to help lessors formulate contingency plans to address the changing lessee behavior and adapt to the new rules. The paper is expected to debut in October and will be available at *www.leasefoundation.org.* ELT