Leases Accounting Project

Analysis and commentary re: the new Exposure Draft

By Bill Bosco, Leasing 101

The FASB and IASB issued the second Exposure Draft (ED) of the proposed new leasing rules on May 16, 2013 with a deadline for comments of September 13, 2013. The ED is an improvement over the 2010 ED in that it is closer to current GAAP in areas like the definition of the lease term and lease payments. The major impacts versus current GAAP to lessees in the ED will be: capitalizing all but short term operating leases as an asset and liability, debt covenants may have to be revised if the new capitalized operating lease liabilities are considered debt, it will cause most equipment leases to have front loaded P&L lease costs and sale lease backs with purchase options will not be accounted for as sales and leasebacks. The major impacts versus current GAAP for lessors will be: a portion of upfront sales type lease profits will be deferred, leveraged lease accounting will be eliminated, tax credits and grants will not be reported as revenue and most residual guarantees/ insurance will not be considered financial assets. The plan is to issue a new lease accounting rule in 2014 after review of comment letters to the ED and re deliberating identified issues. The effective date when all lessors and lessees implement the rules is likely to be 2017 although lessees and lessors will have to show comparative results for 2015 and 2016 in their 2017 financial statements. The work to transition existing leases to the new rules will be a big undertaking, more for lessees but also problematic for lessors.

The ED has several controversial issues and should attract a high volume of comment letters. I believe the Boards will make some changes to the proposal to improve its effectiveness in providing useful information to readers of financial statements. The following is an analysis of the key elements of the proposal and the likely outcome:

Element	Commentary	Likely Outcome
Definition of a lease: A contract that conveys the right to control the use (direct the use and derive the benefits) of a specified (identified) asset for a period of time in consideration for periodic payments.	This is good news. It means fewer contracts will be considered leases than under current GAAP. As examples - some power purchase contracts (lessee does not control use) and leases of part of the capacity (not an identifiable asset) in a fiber optic cable will not be leases.	No change expected
Lease term includes renewals where the lessee has “significant economic incentive” to exercise that option. Note that leases with terms of 12 months or less without the right to renews may still be accounted for as	This is good news. It is virtually the same definition as in current GAAP, but with new terminology. The fact that operating leases will be capitalized at the present value of rents may motivate lessees to try to shorten lease terms, but lessors will resist due to increased residual risks in equipment leases and the desire to provide the highest amount of	No change expected

operating leases (off balance sheet) at the lessee's and lessor's option.	collateral in financing real estate projects.	
Lease payments – The lessee includes variable payments based on a rate (like LIBOR) or index (like CPI) set when the rate or index change impacts contractual rents, "bargain" purchase options and the amount expected to be paid, if any, under residual guarantees. The amount expected to be paid under residual guarantees must be reviewed and adjusted each time the lessee reports earnings to shareholders.	This is a bit more complex than current GAAP but it does make sense under the new model. It may lead lessees to negotiate against CPI adjustment clauses to reduce complexity caused by having to rebook when contractual payments change. It may increase use of lessee residual guarantees in structuring, putting pressure on true lease opinions.	No change expected
Bundled payments, where there is a lease and non lease component, must be bifurcated with the non lease portion expensed on a straight line basis (normal accrual accounting for an executory contract cost) or else the whole bundled payment will be capitalized. This issue is common in real estate leases and full service leases like truck leases and PC leases.	This rule applies to lessors and lessees. Lessors will have no problem bifurcating the payment as they know the lease/non lease breakdown. This is bad news for lessees. Under current GAAP both the lease and service portion of a bundled lease were accounted for as off balance sheet executory contracts by accruing the average payment as an expense. Real estate and equipment lessees will want to avoid capitalizing the non lease portion as it is typically significant. A higher amount capitalized exacerbates the front loading of costs in a Type A lease. Lessees will have a difficult time bifurcating the components as the rules will require them to find market rates for comparable transactions for at least one of the components (like a service only or a lease only contract). The lessee will likely demand a breakdown of its bill from the lessor.	
Lease classification – They have devised new classification criteria. They decided there are 2 types of leases: Type A (front end loaded cost) and Type B (straight line rent expense) with most real estate leases being Type B leases while most equipment leases are Type A leases. The new tests are not based on risks and rewards for equipment leases while they are for real estate leases.	This is possibly the most problematic issue regarding providing a benefit to lenders and credit analysts. Result is that equipment lease classification will not be in line with legal and tax views of lease classification. Type A amounts reported on the balance sheet will be a comingling of former capital and operating leases. Lessees will have to maintain records using current classification tests to comply with tax rules for income, property and sales tax and to answer questions from potential lenders regarding which leases are capital leases and which are capitalized operating leases.	This is a controversial area where they may change back to classification tests that are more in line with the legal and tax views.
Lessee accounting for operating leases will result in capitalization of an asset and liability calculated at the present value of the lease payments recorded as an asset and liability. Existing capital leases need not be adjusted but any operating lease	Unless the capitalized operating lease liability is labeled as being other than debt, debt covenants that limit debt according to GAAP could be breached. Debt limit covenants are designed to prevent a lessee from incurring additional long-term debt (or require that additional borrowing be subordinated to the lenders loan). Since an	They may change the definition of debt and label the assets and liabilities related to executory

that is on the books on the transition date (likely to be 2017) must be converted to the new rules.	operating lease obligation is not “debt” that would compete with the lender’s loan in bankruptcy it should be labeled as to its nature – meaning not as “debt”.	contract leases (the former operating leases) more clearly with no comingling so that one can determine their nature in a bankruptcy analysis.
Sale lease back accounting will change for equipment leases such that the presence of any purchase option set at an amount less that the sales price will negate sales treatment. In transition existing sale leasebacks will be re examined versus the new criteria and rebooked if not considered a sale. Any existing sale lease back that is still a sale under the new criteria will be capitalized.	This is bad news as sale leasebacks are very common in equipment lease transactions with the purposes generally for convenience and to ease complexity. To avoid sale treatment, lessees will have to be careful not to be caught in an ownership position in the chain of events (progress payments, down payments, etc). The form of the transaction will be important. As a planning point any sale leasebacks under consideration will be impacted if the leaseback term extends beyond 2017.	Unlikely to change
Lessor accounting for most equipment leases will be similar to current direct finance lease accounting (the new name is the Receivable and Residual method) where a PV receivable (financial asset) and PV residual (non financial asset) are recorded as the lease assets. Operating lease accounting as under current GAAP will apply to short term leases and most real estate leases.	This is good news for “financial” lessors as they will not have to buy residual insurance to turn operating leases into finance leases.	Unlikely to change
Sales type lease accounting will change such that the portion of the gross profit related to the residual will be deferred until the asset is sold or released. Residual insurance and residual guarantees unless structured with TRAC terms (full residual guarantee and full upside to lessee) will not change the nature of the residual to a financial asset.	Manufacturers and dealers will experience some delay in revenue recognition. Unless structures like all TRACs, residual guarantees and insurance are deemed to turn residuals into financial assets it will not impact profit recognition and it will not enable securitization of guaranteed/insured residuals.	Unlikely to change
Leveraged lease accounting will be eliminated with no grandfathering.	Rent and non recourse debt will be shown on the lessor’s balance sheet and revenue will be amortized at the pre tax implicit rate. ITC/grants will not be included in the implicit rate calculation and will be reported as a reduction in tax expense. In transition there will be major revenue reversals from	Unlikely to change

	re booked leveraged leases. Leveraged leases are rare events due to the pending ED so as a planning point any leveraged lease being contemplated would be re booked when transitioned to the new rules.	
ITC and tax grant accounting	ITC and tax grants will no longer be included in revenue. Instead they will be a credit to tax expense. This will have a negative impact on the presentation of revenue for bank lessors who are measured on net revenue and operating efficiency.	Unlikely to change

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