The New Lease Accounting Standard's Impact on Lessor Internal Accounting Issues

Note: This is the second 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 on ELFA's Lease Accounting webpage.

Under the approved lease accounting standard, the good news for lessors is the FASB decided that there were no major deficiencies in lessor accounting so they left most of it in place. The classification of leases as either Operating or Finance leases remains the same. The revenue accounting models for both also remain the same so there will be no major systems changes required.

The need for residual value insurance (RVI) to convert Operating leases to Finance leases will remain a useful tool for financial institutions as the income pattern is better. More importantly finance lease accounting avoids depreciation of Operating lease assets that negatively impact operating efficiency ratios which investors focus on.

Sales type changes

The definition of a sales type lease will change only where third party residual insurance was needed to convert the lease from an Operating lease. The reason for this change is to conform to the new revenue recognition rules that define a sale as being based on a transaction between two parties (third party involvement cannot create the sale).

If the Operating lease is not converted to a Finance lease, the gross profit is straight lined over the lease term. If residual insurance is purchased to convert the lease to a finance lease the gross profit is included in the revenue amortization and implicit rate calculations so that the gross profit is recognized at a constant rate versus the declining lessor investment—just like any other Finance lease. The impact here is for those manufacturers and dealers who do need to use RVI. Their revenue pattern will suffer in the short run although it is only a timing difference; once they reach a level state where old leases are replacing new leases the negative impact will disappear.

An alternative strategy to accelerate gross profit recognition is to use a third party vendor lessor to buy the leases which will give the seller sale treatment although there is a tradeoff of loss of control of the customer and loss of finance revenue.

Lessor portfolio funding options

If a lessor acquires its portfolio of leased assets by borrowing and buying, there is no change from current GAAP, that is, the lessor records the asset at cost (100%) and the loan that finances the purchase as debt. The lessor accounts for the asset it leases out as a finance lease or operating lease, and records interest expense on the loan.

If the lessor decides to execute a sale leaseback of those purchased assets and includes a purchase option in the leaseback as often occurs, the new rules would ***not*** consider that a sale, so the sales proceeds and leaseback are recorded as debt (a confusing and bad outcome). The end user leases would be recorded as either operating or finance leases. Under current GAAP many lessors use sale leasebacks with early buyout options (EBO) or purchase options to remove their portfolio of operating lease assets from their books—that will not be the case under the new rules without careful structuring. It would still be advantageous to do a sale leaseback with a fixed price purchase option if structured so that it qualifies as a sale (lessors need to be considered an agent arranging the sale leaseback). The benefits are the liability is not debt and the value of the asset is likely to be lower as it would be the ROU asset resulting from capitalizing the operating leaseback.

IDC changes

The definition of initial direct costs (IDC) will change to include only external incremental direct costs. Many lessors allocate internal initial direct costs to be included in IDC as allowed under the previous definition. The financial impact to this change is an acceleration of operating costs (it is a timing difference so it will level off when the new leases are replacing old leases at an even pace). The operational impact is that the definition of loan IDC will remain unchanged so lessors who are also lenders will have two different IDC processes.

Full service lessors

Full service lessors will have to bifurcate their payments into lease and non-lease components in the P&L. This should not be too great an issue as it just puts the service revenue on a different line. The more problematic issue is that lessees will ask for a breakdown of payment components for both new leases and all existing leases that will be in effect on the transition date. Lessors may view this as proprietary pricing information. If they refuse to provide the information it may be difficult for lessees to find observable market pricing for the lease and service components. Lessees can use reasonable estimates but it remains to be seen as to how the auditors will deal with the issue if market information is not available.

The issue of divulging the breakdown of lease and non-lease components may turn out to be a competitive issue. If some lessors provide the breakdown it may force other lessors to do so as lessees will likely demand it.

Leveraged leases dropped but existing leases grandfathered

The leveraged lease rules for new leases have been dropped from the rules. The FASB did allow existing leveraged leases at the transition date to be grandfathered. This is an opportunity to continue to do leveraged leases as the rules will allow them to continue to be accounted for as leveraged leases even after they are traded.

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

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