EQUIPMENT LEASING AND FINANCING ASSOCIATION: NEWS

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TOP 10 QUESTIONS ON GAAP/IFRS CONVERGENCE ANSWERED BY CG COMMERCIAL FINANCE AND BILL BOSCO

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(Irvine, CA) – CG Commercial Finance (CGCF) released its update on the GAAP/IFRS convergence project. CGCF is providing this summary to assist its clients in better understanding the status of the project and how it may affect their business now and in the future. The content is the result of continuing collaboration between CGCF, an expert in accounting treatment of equipment leases, and Bill Bosco, a tax and leasing consultant and a member of the Equipment Leasing and Financing Association's Accounting Committee.

1. What is the update on the convergence project timeline?

Answer: As of 9/25/2014 the IASB and FASB Boards have begun final re-deliberation of the issues. Four meetings have taken place with several more to be held over the next few months. They are now making decisions quickly with many designed to reduce complexity and cost of compliance. The Boards plan on issuing the new standard in mid-2015. The implementation date is to be decided in these upcoming deliberations but is unlikely to be sooner than 2018.

2. I hear the FASB and IASB have disagreed on several key issues – what are they?

Answer: Correct, currently they disagree on the following:
A. Lessee lease classification and lessee cost accounting for operating leases.
B. When a lessee should re-book a lease for changes in variable payments based on a rate or index
C. The need for relief on small ticket leases

The lack of agreement between the two Boards on the above items are significant enough to conclude that the project's stated goal and purpose of the accounting convergence project on lease accounting between GAAP and IFRS will not be accomplished. Although they will continue to work together, it is very likely they will issue separate but "partially converged" lease accounting standards.

3. Is the disagreement on lessee accounting significant?

Answer: Yes, the disagreement between the IASB and FASB on lessee accounting is huge:

A. IASB wants lessees to account for all leases as though they are capital leases.
B. FASB believes all leases should be on lessee's balance sheet but operating leases should be reported differently from capital leases on the Balance Sheet and Income Statement
    - Operating leases will be reported on the P&L as a straight line expense.
    - Capital leases will have an amortized expense approach (depreciation of the asset and interest on the liability) wherein expense will be frontloaded.
    - FASB will change the operating lease classification tests to be similar to the current IAS 17 tests. That means no more bright lines in the useful life and PV tests. For example, auditors may push back on "borderline" 89.99% present value of minimum rents operating leases, i.e., require that residuals be larger (read lower PV) and match the reality of the equipment type.

4. Does the FASB approach mean the lease liability will not impact my debt limit covenants?

Answer: The balance sheet classification of an operating lease will be presented as a "right-of-use asset" and corresponding "lease liability". The operating lease liability is not considered debt so it should not impact debt limit covenants. Although the FASB recently stated that the "lease liability" should not be considered debt, it is yet to be seen how banks will classify this "right-of use-asset" and "lease liability" as it relates to key ratios governing bank covenants such as Debt to Equity (D/E), Return on Assets (ROA), Earnings Before Interest Taxes Depreciation and Amortization (EBITDA), and Capital Expenditure (CapEx) limitations.

5. What have the Boards done to reduce complexity and reduce compliance costs?

Answer: The FASB decided that lessees need to rebook for changes in variable payments based on a rate or index only when the lessee re-measures the lease liability for other reasons (for example, because of a reassessment of the lease term or a lease contract modification). This is good news for U.S. lessees as there will be many fewer re-booking adjustments for things like CPI change clauses which are common in lease agreements. The IASB does not agree as they require re-booking when the variable rent changes. In transition to the new rules (expected to occur in 2018) there will not be a requirement to re-classify existing leases under the new classification tests. Existing capital leases will be grandfathered. Existing operating leases will be capitalized prospectively, i.e., at transition to the new rules, existing off balance sheet operating leases will be recorded by capitalizing the remaining rents over the remaining term.

6. Have the Boards redefined short term leases for purposes of exemption from capitalization for lessees?

Answer: Yes. A short term lease is now defined as a lease with a 12 month or shorter lease term considering only those renewals that are part of the lease term. Said another way they are now only including bargain and/or compelling renewals (the same as under current GAAP). Previous draft proposals stated that any renewal would be part of the term to determine if a lease is short term for the capitalization exemption election. This change is great news for lessees as fewer leases will have to be capitalized.

7. Are there other open advocacy issues? How can I influence the remaining advocacy issue points?

Answer: Yes, there is a major issue remaining regarding sale-leasebacks. Based on a decision at a Board meeting on 8/27/14, the FASB decided that sale-leasebacks for any type of asset (not just real estate) will not be considered a sale if there is a fixed price purchase option in the leaseback. This means that the sale leaseback will not be booked as a sale, the asset “sold” will remain on the lessee’s books, the lease will be booked as debt, and the lease cost will be front loaded as in capital lease accounting – a bad outcome. We expect that they will grandfather existing sale-leasebacks from having to be re-booked in transition.

To comment on the sale leaseback issue or any other issue you would have to send in an unsolicited comment letter to the FASB/IASB as they are moving fast and will not issue another exposure draft. To send a comment letter, log into the FASB website for instructions.

8. Will this project ever end?

Answer: We predict that the project will be issued in 2015 as the Boards are very motivated to complete it. From a U.S. perspective it should turn out to be better than we hoped as the FASB listened to our feedback and has decided that they would rather have a standard that truly improves information for readers of financials than to have a converged standard that has serious issues.

9. How will the final form of the project affect the average company?

Ans.: As mentioned in the answer to question #4 above, the most important impact will be how a company’s financial ratios would be altered that could place it out of compliance with bank covenants.

10. What if anything should I do to prepare prior to implementation?

Answer: We think some important steps a company should take are as follows:

A. Write a comment letter to the FASB regarding the sale-leaseback issue.
B. Analyze your projected annual CapEx spend that has typically been financed via operating leases.
C. Analyze all off balance sheet operating lease transactions that will have to be prospectively added to the balance sheet as a “right-of-use asset” and “lease liability”.
D. Add the resulting total amount of assets and liabilities to the balance sheet accounts and recast your financial ratios involving Assets/Debt/CapEx (ROA, D/E, CapEx, EBITDA, etc.).
E. Compare the results with your bank covenants to see if there may be a future covenant compliance issue.
F. Meet with your banker to discuss how they expect to address the new accounting treatment as it relates to lending covenants, i.e., will the bank include or exclude the new “lease liability” in its lending covenants?

CGCF and Mr. Bosco are asking for feedback. Comments and questions can be sent to lease.project@cgcommercial.com and/or at http://cgcommercialfinance.com/convergence-lease-project/ where additional information, including the original animated video overview of the GAAP/IFRS convergence project created by CGCF and Mr. Bosco can be viewed.

About CG Commercial Finance

CG Commercial Finance is a global specialty finance company whose primary expertise includes financing for capital equipment, and structured project and debt financing for mid-sized and large companies. CGCF utilizes an advisory approach and discovery process to deliver highly customized leasing and financing solutions to meet complex operational, accounting, and treasury requirements. Projects typically range from $50MM to $100MM in cost and include diverse assets such as transportation assets (titled vehicles, air, rail, and marine), industrial plants (manufacturing, food processing, assembly, etc.), distribution centers, material handling, mining, energy, and technology assets.

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