TRALA White Paper – The Lease Accounting Project
Operating in the New Accounting World
By: Bill Bosco and Phil Hirsch

Background

The Lease Accounting Project has finally reached its conclusion after nine long years. The project has evolved for the better under the FASB version of the proposed rules. It should be noted that TRALA commented on the exposure drafts and worked with the Chamber of Commerce, ELFA and other US trade associations, playing an important part in improving the rules greatly from the original proposal for both lessees and lessors. The FASB recently met for their final time before the rules will be signed in early 2016. FASB decided the new standards would be effective for public business entities for annual and interim periods beginning after December 15, 2018 (for calendar year end companies this means their 12/31/19 financial statements have to reflect the new rules). For non-public business entities, the effective date would be annual periods beginning after 15 December 2019, and interim periods the following year. Early adoption would be permitted for all entities.

It will impact ***all*** lessees who provide audited financial statements – that means all public companies and those private companies whose lenders require audited financials. Lessees should not be lulled into a period of inaction considering the 2019 date as public companies must report comparative financial data (2 years' balance sheets – 2018 and 2019 and 3 years' P&L - 2107, 2018, and 2019). Both lessees and those lessors who lease in their assets (they are lessees too) should be looking at acquiring a lease accounting system, installing it and testing the data well in advance of the change in the new accounting rules.

Some lessors think lessee customers will buy rather than lease because operating leases will be shown on the balance sheet and leasing may attract greater scrutiny by the customer's CFO. That should not be the case as although there may be some negative aspects to the new rules, the reasons why a lessee uses the full service lease product remain strong.

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) attempted to work together to create a converged standard, but ultimately went in two directions for lessee accounting (regarding lessor accounting they have a substantially converged standard which is good news as they kept most of current GAAP in place).

The FASB retained the basic FAS 13 (FAS 13 will be called ASC 842 under the FASB's new accounting rules codification regime) framework for classification (the tests are virtually the same), P&L lease expense (they kept the straight line expense) and, although they put an operating lease liability on the balance sheet it is NOT classified as debt. This is great news for US companies who report their financial statements using US GAAP.

The IASB will adopt a one lease model for lessees where all operating leases will be treated as finance leases resulting in front ended lease costs and the lease liability classified as debt. This is not so good news, so be aware of this for your customers who have parent companies located in an IFRS country as they report their financials using IASB GAAP.

Some also think that lessor accounting will not change, as they heard that both Boards decided to keep the current rules in place. Although that is generally true, they have changed a few things, most notably, sales leaseback accounting rules and lessee capitalizing of operating leases when the lessee is a lessor (lease-in lease-out structures that some lessors use to finance their fleet) so that lessors who

acquire their assets through a lease, could see significant changes in their lessor accounting. The rules for which leases qualify for sales type up front gross profit recognition also will change.

Lessee Issues

There are 2 key issues for the lessee for both FASB and IASB customers. The first is capitalization of the lease and the resulting financial impact (balance sheet, P&L, debt covenants, credit rating and financial ratios/measures) – the FASB and IASB do not agree on the accounting and reporting in very important ways, thus the lessee impacts are different as explained below. Second is bifurcating non-lease elements in a full service lease and straight line expensing the service portion. In this case the FASB and IASB are in agreement, as both cause the lessee to capitalize only the rent portion of the bundled billed payment (on the balance sheet), while straight line expensing the service and non-lease charges (in the P & L). Capitalization of a truck/trailer lease will result in the lessee recording a right-of-use (ROU) asset and a lease liability on the balance sheet measured at the present value of the lease payments. Because trucks/trailers hold their value, the present value of the payments will be significantly less than the cost of the assets – a benefit to lessee financial ratios. The liability is ***NOT*** classified as debt – avoiding debt covenant breaches and minimizing impacts to financial ratios for US lessees only. -

Unfortunately IASB customers, will have classify the operating lease liability as debt, so the impact to financial ratios and debt limit covenants is more severe. The structuring objective of both FASB and IASB lessees will be to minimize the capitalized amount of operating leases. There are product options and structures that a lessor can employ to help meet the lessees' objective.

Bifurcation of the service portion of the rent is important to all lessees to minimize the rent payments included in the capitalization calculation so that financial ratios/measures look better. Lessees will ask the lessor to break down the bundled billed payment between lease and service/non-lease elements. Lessors may view the breakdown of service versus lease costs as proprietary. They may also be reluctant to give the lessee too much billing details as this may lead to the lessee negotiating each item, putting pressure on the lessor to reduce prices on several elements.

If the lessor is not willing to provide the lease portion of the rent, the lessee is permitted to estimate the lease portion of the payment, but must find observable pricing for either the lease or service portion to support their estimate of the breakdown. The estimate must be supported with evidence as it will be audited by the lessee's audit firm. Finding evidence of pricing of transactions with the same terms may not be possible. (I have a solution for this through an independent company that accumulates confidential pricing information from member lessor customers to provide their lessee customers via a certified letter disclosing the average rent for recent market transactions).

Bifurcating as much service and non-leases costs as possible is more important to IASB lessees for two major reasons – the lower the amount of payments in the capitalization calculation, the less assets and debt reported on the balance sheet and the lower the amount of lease costs that are front ended (the bifurcated service/non-lease costs are a straight line expense.) The bottom line is that, if a lessee cannot substantiate estimates to support its bifurcation, it will be forced to capitalize the full bundled payment – this will result in capitalizing more than the cost of the vehicle.

A few less important lessee issues will result from the proposed rules:
- Variable payments based on an index (like CPI) and/or a rate (like LIBOR) must be accounted for /capitalized - initially using the spot rate. When the index or rate changes, and changes the future contractual rents due, the FASB allows the lessee to account for the changes on a cash basis unless the

lease has to be rebooked for another reason initiated by the lessee. The IASB requires that the lease be rebooked whenever the payments change.
- Variable payments based on excess mileage charges are still accounted for on a cash basis.

Some lessee financial ratios and measures will change for the worse, and the results for US companies vs IASB companies will be different are as follows:

Key Ratios/Measures	FASB Version	IASB Version
EBITDA	no change	better – rent replace by amort & int
Gross Margin	no change	no change
Operating Exp Ratio	no change	better – rent replaced by amortization
Current Ratio	worse – ROU not cur.	worse – ROU asset not current
Quick Ratio	worse – add'l liab	worse – additional liability
Net Worth	no change	worse – asset amortizes faster than the liab
Debt/Equity Ratio	no change	worse – additional debt + eroded equity
Return on Assets	worse – add'l asset	worse – additional asset + front ended costs
Return on Equity	no change	?? Less equity but front ended lease costs

Lessee issues with structuring ideas/commentary are as follows:

Issue	FASB	IASB
Balance sheet classification	Best if lease is an operating lease = liability ***NOT*** debt	Doesn't matter as all leases are treated as finance leases = liability ***IS*** debt
P&L	Operating lease expense is the straight line average rent	All leases have front ended costs = imputed interest + straight line asset amortization
Bifurcation	The more services and non-lease costs bifurcated, the lower the rent to be capitalized.	The more services and non-lease costs bifurcated, the lower the rent to be capitalized and the lower the amount of costs front ended (non-lease elements are straight line expenses if bifurcated).
Structuring	Best option is an operating lease with the lowest PV of rents. Residual guarantees can lower rents. Lower rents thru product choice and bifurcating non-lease elements.	Best option is a lease with the lowest PV of rents. Residual guarantees can lower rents. Lower rents thru product choice and bifurcating non-lease elements.

The Lease vs. Buy Decision

The new rules should not change lessee behavior. The alternative to the full service lease is to borrow to buy the vehicle and then, purchase a separate service contract to maintain the vehicle.

The business reasons why customers won't borrow to buy, and buy a separate service contract are:
- outsourcing both the asset ownership and service is more cost effective and easier to manage,
- no money down and get immediate use of the asset vs. a loan typically requiring a down payment,
-avoid using capital in a non-core business asset,
- level fixed rate payments over a term that closely matches the useful life,
- the customer must dispose of the used truck, and
- convenience.

The financial reasons against a customer's borrowing to buy are:
- can lease customer even get a loan,
- will the rate be floating and high,
- how much down payment will be required,
- will the term and loan payments fit the customer's cash management budget,
- full asset cost is on balance sheet, reducing ROA which is often the basis for compensation and investment evaluation,
- the loan **IS** debt which may violate debt covenants,
- the costs are front ended (imputed interest and straight line depreciation),
- the customer's return on assets (ROA) is worse than under a lease,
- leasing provides a hedge against obsolescence.

A summary of the general reason why customers lease and how those reasons fare under the proposed new rules:

Reason for Leasing	Details	Status After Proposed New Rules
Raise Capital	Additional capital source, 100% financing, fixed rate, level payments, longer payment terms, avoid impacting debt limit covenants, lease cost in operating budget	Still a major benefit versus buying financed by a bank loan/debt especially for small and medium sized entities and non-investment grade lessees with limited sources of capital
Low cost capital	Low payments/rate due to tax benefits, residual and lessor low cost of funds; implied equity vs. the capitalized lease amount is less than actual equity required when borrowing to buy	Still a benefit versus a bank loan and owning the asset
Tax benefits	Lessee can't use tax benefits and the lease vs. buy analysis shows lease option has lowest after tax present valued cost	Still a benefit
Manage assets/residual risk transfer	Lessee has flexibility to return asset	Still a benefit

Service	Outsource servicing of the leased assets.	Still a benefit
Convenience	Quick and easy financing process often available at point-of-sale	Still a benefit
Regulatory	Capital issues	Still a benefit as regulators should still treat ROU assets as “capital free” as they are an accounting contrivance and do not represent an asset in a bankruptcy liquidation
Accounting	Off balance sheet	Still a partial benefit if the present valued capitalized amount is less than the cost of the asset, should be true for high residual assets and the impact of tax benefits

Lessor Product and Structuring Opportunities

Trucks and trailers have the widest array of financial product options due to the availability of TRAC leases and split TRAC leases in addition to “standard” FMV lease products. The TRALA member assets also hold their value well, so residuals may be sizeable thus lowering the rents capitalized by lessee customers. The “best” financial products for lowering the amount capitalized, allowing straight line expense and avoiding the lease liability classified as debt are noted below with the green text. The worst products (assuming a US customer) are noted in red text. For IFRS customers all products will result in debt and front ended lease costs. The IFRS customer is still motived to lower the PV of the rents to minimize the negative impacts to financial ratios and measures.

The assumption is that a TRALA member can use any of the products below and add services to create a full service truck lease. The TRAC, split-TRAC and synthetic lease products and variations (leases where the lessee guarantees the residual) can be offered without a lessee right to purchase the vehicle; so they look like an FMV lease with a residual guarantee. This 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 - can the lessee pay the guarantee?).

Product	**Term**	**Rent**	**Residual**	**Discount Rate**	**PV of Rents**	**Debt Yes/No**	**P&L FE/SL**
Conditional sale	60 mos	1.89%	0%	5.17%	**100%**	**Yes**	**Front Ended**
TRAC	60 mos	1.55%	20%	4.27%	**82.2%**	**Yes**	**Front Ended**
Split-TRAC	60 mos.	1.55%	20%	4.27%	**82.2%**	**No**	**Straight Line**
Synthetic	60 mos.	1.60%	20%	5.17%	**84.8%**	**No**	**Straight Line**
FMV	60 mos.	1.63%	16.8%	5.17%	**86.4%**	**No**	**Straight Line**

Separately billing Items the lessor passes on to the lessee like property taxes and insurance is a must as if gross billed they may be considered a lease payment. The FASB does not consider these items to be services provide by the lessor.

Shortening the lease term reduces the capitalized amount, but this has business issues for TRALA members – less profit and more residual risk.

Lessor Issues

The major accounting issue for the lessor is how to account for the asset if it is leased versus purchased, that affect both the balance sheet and P&L as well as ratios and measures. The analysis below will focus on the FASB version as most TRALA members follow US GAAP. The IASB version is covered only in the grid below. There are issues if the lessor uses sale leasebacks to acquire the use of the assets (buys the assets first, then, at a later date, does a leaseback with a non-bargain purchase option).

There are new rules regarding gross profit recognition if the lessor has a dealer profit element - a lessor can buy residual insurance, converting the lease to a finance lease for the lessor only, and accelerate the recognition of the gross profit element. Lessors will also have to bifurcate the rent revenue and service revenue/non-lease elements of the full service leases.

If the lessor acquires the 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 depreciates the asset like any other operating lease, and records interest expense on the loan. The revenue items are rent (straight lined average), service fee income and residual proceeds. The cost of providing the services is expensed as incurred.

If the lessor decides to execute a sale leaseback of those purchased assets and includes a purchase option in the leaseback as often occurs, if the leaseback is a TRAC, split-TRAC or synthetic, the new rules would ***not*** consider that a sale, so the whole asset cost would remain on balance sheet and the sales proceeds and leaseback are recorded as debt (a confusing and bad outcome).

If the lessor leases the assets in via a TRAC type lease, whether a spilt- TRAC, TRAC or synthetic, the lessor will record a ROU asset equal to the present value (using the implicit lease rate) of the lease payments including ***only*** the “value” (what they are likely to pay – that is zero in virtually all cases) under the residual guarantee it is providing to the lessor under the TRAC structure. If the TRAC amount is 20% in a five year lease, the amount capitalized will be 82% of cost (see above table).

If the lease in is a TRAC lease structure, the lessor will record an equal lease liability that is classified as ***debt*** (a TRAC is a finance lease to the lessee). The lease cost has an imputed interest and straight line asset amortization component. The revenue items from the lease to the customer are rent (straight lined average), service fee income and residual proceeds. The cost of providing the services is expensed as incurred.

If the lease in is an operating lease (synthetic or split-TRAC) the liability is classified as a ***non-debt liability***. The lease cost is the straight line average rent paid on the lease in. The lease liability and ROU asset amortizes but the asset amortization is a “plug” to achieve straight line lease rent expense. Lessors will need to buy or build a lessee lease accounting system to do the calculations. The revenue items from the lease to the customer are rent (straight lined average), service fee income and residual proceeds. The cost of providing the services is expensed as incurred.

Buy vs. Lease options and impacts:

Acquisition Method	FASB	IASB
Borrow to buy	100% of cost on balance sheet Front ended costs Liability is debt	Same
TRAC lease in	82% of cost on balance sheet Front ended costs Liability is **not** debt	Same
Split-TRAC/Synthetic in	82-85% of cost on balance sheet Level costs Liability ***is not*** debt	82-85% of cost on balance sheet Front ended costs Liability ***is*** debt
Sale Leaseback with a fixed purchase option	100% of cost on balance sheet Front ended costs Liability ***is*** debt	Same

In the case of manufacturers who sell to captives that are part of their consolidated group who then lease on to end-users under operating leases, the new lease and revenue recognition rules will not allow up front gross profit recognition if third party residual insurance is purchased to convert the lease to a direct finance lease for the lessee. If the lease is not converted to a direct finance lease, the gross profit is straight lined over the lease term. If residual insurance is purchased to convert the lease to a direct finance lease the gross profit is included in the revenue and implicit rate calculations such that the gross profit is recognized at a constant rate versus the declining lessor investment - just like any other direct finance lease.

Summary and conclusions

The rules are complex and lessors who best understand the rules and implications will be in a better competitive position, able to show consultative selling skills to their customers. They will also be able to better manage their own balance sheet and P&L under the new rules.

U.S. lessees will look to continue to get operating lease treatment, to minimize lease payments and to bifurcate non-lease elements – all contribute to more advantageous financial presentation and results. Structures with lessee residual guarantees can produce the lowest capitalized amounts. IASB lessees will also be motivated to minimize lease payments and bifurcate rents and residual guarantee structures can help lower rents to be capitalized.

Lessors will need systems for the new accounting if they lease in their vehicles. They will show the lowest capitalized amounts on their balance sheets and the best cost patterns if they lease in their vehicles under operating lease structures that include them providing residual guarantees to their lessor.

The lessor should develop a strategy for dealing with the need for lessees to have enough information to bifurcate the lease payment and non-lease elements.

Business should remain strong and there are new structuring opportunities to consider.