IASB/FASB Leases Accounting Project To Be Re-Exposured

Status as of October 2011, Issues and Implications

By Bill Bosco

The FASB and IASB have made significant changes to the Leases project responding to many of the issues raised by 780+ comment letters to the Exposure Draft ("ED") dated August 17, 2010. Most of the negative issues raised by the Equipment Leasing and Finance Association (ELFA), the leasing industry, lessees and others have been addressed favorably by the FASB and IASB Boards in their re-deliberations, lessening the financial and compliance impacts, but several major issues remain. There is one major negative issue with several sub-issues that remain for lessees:

- First, the P&L cost for leases will be front ended with amortization of the right-of-use (ROU) asset and imputed interest on the lease liability replacing straight line rent expense. This is the major issue.
- The sub issues include:

- There is an open issue for lessees in operating leases of equipment used in completing cost plus contracts. Cost reimbursement regulations and cost plus contracts allow for reimbursement of rent paid under operating leases but not for the proposed front ended lease costs. This will create temporary short falls in cost plus contract revenues versus costs reported in the first half of lease terms.

- When adjusting the lease term in the event a lessee has a "significant economic incentive" to exercise a renewal option (or for that matter is a lessee in fact signs a renewal) the original lease term is extended to encompass the renewal and the resulting accounting front loads the lease costs. This creates a saw toothed lease cost pattern rather than straight line rent expense.

- When a lease is terminated the lessee will report a gain due to the front ended cost pattern. This is a strong indicator that the accounting is not matching the values reported on the balance sheet and cost reported in the P&L statement.

There still are issues of complexity and cost burden of the capitalized lease accounting especially for small and medium sized lessees and for lessees with large lease portfolios. The more extensive disclosures required for lessees will be a burden. Users of financials may still have make adjustments to P&L and cash flow analyses for the effects of operating leases.

For lessors the current status is a mixed bag.
-A major positive is that there will be one basic direct finance-like model for all equipment leases other than short term leases.
- The loss of leveraged lease accounting will be a blow to the large ticket segment causing existing portfolios to be grossed up for lessors along with decelerated earnings while lessees will experience higher lease costs without the product.
- Sales type lease profits will be limited with the portion associated with the residual deferred which is a negative but that is somewhat offset by the elimination of operating lease accounting so that all but short term leases will be allowed sales-type up front gross profit recognition.
- Guaranteed or insured residuals are not considered financial assets as they are under current GAAP, negatively impacting gross profit recognition and funding of lease assets.

Fortunately the Boards decided to re-expose the project allowing the public another opportunity to comment. The ELFA and the leasing industry will continue to push for reconsideration of the above noted negative issues in comment letters on the grounds that they do not reflect the economic effects of leases to users of financial statements.

Overview of Proposed Lease Accounting Rules

Timing

Event	**Expected Timing**
Issue New Exposure Draft	First Quarter 2012
End of Comment Period	Second Quarter 2012
Re-deliberation of Issues	Third Quarter 2012
Issue Final New Rule	Fourth Quarter 2012
Implementation/Transition Year	2015

Scope

Includes leases of assets that are property, plant and equipment as well as non-depreciating spare parts, operating materials, and supplies, and that are associated with the leasing of another underlying asset. The scope may be written to accommodate leases of software (to be determined).

Definition of a lease

Regarding leases vs. installment purchases, the Boards decided to eliminate the scope exclusion but lease contracts should be accounted for in accordance with the leases standard and lease contracts that represent a purchase or sale of an underlying asset should be accounted for in accordance with other applicable standards (e.g., plant and equipment and loan accounting by lessees).

The Boards agreed to tentatively confirm the 'specific asset' notion versus a notion of an asset of a certain specificity. Physically distinct portions of a larger asset can be specified assets and non-physically distinct portions are not specified assets (a "lease" of capacity in a fiber optic cable is not a lease of a physically distinct asset). The Boards agreed that the right to control the use of a specified asset is conveyed if the customer has the ability to ***both*** direct the use of the asset and receive the benefit from its use. Under the newly-proposed guidance, any one of the following may indicate the customer has obtained the right to control the use of a specified asset: (a) The customer controls physical access to the specified asset; (b) The design of the asset is customer-specific and the customer has been involved in designing the specified asset; (c) The customer has the right to obtain substantially all of the economic benefits from use of the specified asset throughout the lease term.

They did not conclude on but are in favor of concepts like not including in lease accounting assets that are incidental to the provision of a service or insignificant to the services provided. The decisions will mean fewer contracts are considered leases vs. current GAAP, including EITF 01-08 (the revised guidance would result in certain contracts that are considered leases under current standards (e.g., certain take-or-pay contracts) to no longer be considered leases.).

Lessee ROU approach in summary with details on key areas following

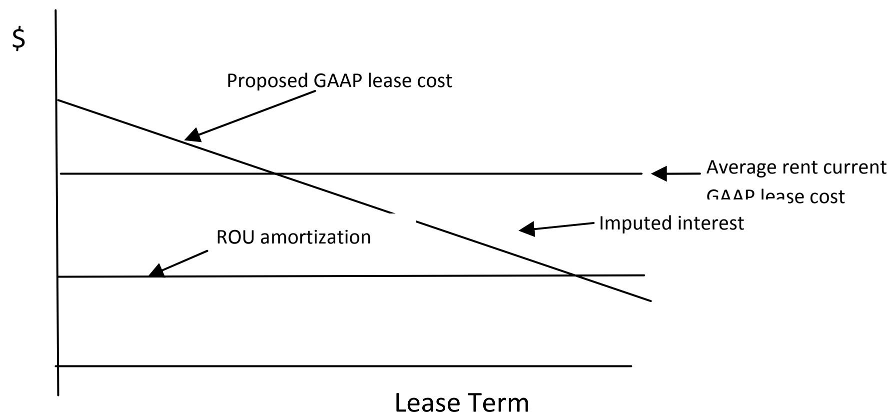
The lessee accounting method is called the Right-Of-Use ("ROU") approach. The theory is that the lessee should account for its rights and obligations arising from the lease contract. So, we are accounting for the contract not the leased item. The contract is the unit of account, not its components (components of a lease contract being contractual rents, renewal and purchase options, contingent rents and residual guarantees). For all leases, 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. The amount they will record will be the present value of the ***estimated*** lease payments discounted using the lessee's incremental borrowing rate, plus any initial direct costs incurred (the interest rate implicit in the lease can be used if it can be readily determinable and is lower than the incremental borrowing rate).

The lessee will include in estimated lease payments contractual lease payments, bargain/compelling renewals, interim rents, estimated payments under contingent rent based on an index or rate (using the “spot” rate), contingent payments based on usage or lessee performance only if they are “disguised” minimum lease payments and residual guarantee provisions in the lease. Termination payments are to be included in estimated lease payments if the lessee assumes it will terminate the lease. Purchase options will be ignored unless they are bargains in which case the lease is a financed purchase and not accounted for as a lease. Disregarding non-bargain purchase options is an important new development and will reduce the amount capitalized for some leases with purchase options.

For subsequent accounting, lessees will amortize the ROU 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 (mortgage or sinking fund amortization). The rent payment will be accounted for as if it was a loan payment with an imputed interest cost and an amortization of “principal” component. Rent expense under FAS 13/IAS 17 is straight lined (the average of the minimum lease payments) in the P&L statement while the proposed method front ends lease expense as the reported lease cost will be the sum of the asset amortization and the imputed interest on the lease obligation. This will cause lessees to report higher costs in the first half of the lease term followed by lower costs in the last half of the lease term, which is generally contrary to the economic flows in a lease contract. Since the US 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.

It appeared that the Boards would allow former operating leases (now called “other than finance“ leases) classified using IAS 17-like criteria to have straight line P&L cost pattern labeled as rent expense, but they reversed that tentative decision unexpectedly. This is an extremely unpopular decision. It will have unintended consequences regarding contracts and regulations that allow cost reimbursement for rent paid versus accounting lease cost (the cash paid for rent will be reimbursed and reported as revenue yet the lease costs will be front ended creating a mismatch). Another unintended consequence is whenever a lease is extended or renewed lease costs will be front ended and whenever a lease contract is terminated it will create a gain all of which will be confusing to readers of financial statements. The temporary differences caused by front ending lease costs will be a drag on profits and will have to be explained in footnotes to the financials. In general the front ended lease costs are non-cash expenses will reduce reported capital and profits for banks, retailers, transportation companies and any lessee with significant long term operating leases. It will create huge deferred tax assets as a large portion of reported lease costs in the early years of every lease will not be tax deductible until the future (a book versus tax timing difference). Despite the fact that the proposed lease cost pattern reverses, for a growing company lease costs will never level off. Inflation alone will mean most companies will never see lease costs leveling off unless they cut back on leasing. The reason the Boards reversed their view is they could not justify using other than straight line to amortize the right-of-use asset of what are now classified as operating leases as their Conceptual Framework does not contemplate capitalizing executory contracts. In my opinion they are working too fast to analyze capitalized executory contract issues and amend their Conceptual Framework. If the accounting profession does not recognize that some leases are different (rentals versus financings of the underlying leased asset) it will break the long standing view held by the US tax and legal regimes which is consistent with FAS 13 and IAS 17. I do think the best course is to continue to account for lease costs in operating leases using the straight line rent as the expense as it will resolve the issues of rent cost reimbursement and distortions to P&L, capital and deferred taxes. This will only be achieved if there is a large volume of well thought out comment letters from lessees, users of financials (lenders, banks, debt analysts, equity analysts and investors) and regulators.

The front ended pattern is best illustrated as follows:



The increase in lease costs is exacerbated the longer the lease term. The effect of increased first year lease costs by lease term is as follows:

The Effect of Front Ending Lease Costs	
Lease Term	**First Year Increase in Lease Cost – Proposed vs. Current GAAP**
5 Years	12%
10 Years	21%
15 Years	26%
20 Years	28%

Lease term and renewal options
The lease term is tentatively defined as the contractual term plus renewals where the lessee has a "significant economic incentive" to exercise the options. This is essentially the current GAAP definition. The decision to revert to a definition similar to current GAAP was a very important change as their initial proposal to include more likely than not renewals would have increased the amounts capitalized and increased the complexity in the ongoing adjustment of estimates. Hopefully they decide that a renewal or extension is a treated as a new lease rather than an adjustment to the existing leases to avoid complex adjustments and P&L volatility (due to front ending of the renewal's lease cost), but that remains to be seen. New leases are booked only when they commence, not when they are signed.

Termination option penalties
The accounting for termination option penalties should be consistent with the accounting for options to extend or terminate a lease. If a lessee determines it will terminate a lease early and would be required to pay a penalty, the term is shortened and the termination penalty is considered a lease payment to be capitalized. If a lessee would be required to pay a penalty if it does not renew the lease and the renewal period has not been included in the lease term, then that penalty is considered a lease payment to be capitalized.

Purchase options
They decided the exercise price of a purchase option should be included in the lessee's liability to make lease payments and the lessor's right to receive lease payments only when there is a *significant* economic incentive to exercise the purchase option. If so, the ROU asset should be amortized over the useful life of the asset. Other non-bargain purchase options are not considered lease payments to be capitalized. These conclusions are consistent with their conclusions on the lease term and renewals so it is good news except for the concerns re: reassessment.

Reassessment of options
The Boards tentatively decided that a lessee and a lessor should consider whether it has a significant economic incentive to exercise an option to extend or terminate a lease and to purchase the underlying asset for both initial and subsequent evaluation. Changes in lease payments that are due to a reassessment in the lease term should result in adjusting a lessee's lease liability and right-of-use asset; and a lessor adjusting its right to receive lease payments and any residual asset, and recognizing any corresponding profit or loss. The lessee adjustment when recording a renewal before it commences results in recognizing front loaded costs of the renewal immediately – this creates a "saw toothed" lease cost pattern.

Variable payments
Variable lease payments will be included in the lease payments to be capitalized by the lessee and to be included in the lessor's lease receivable, but the specific variable payments will be limited vs. what was proposed in the ED. Details are as follows:

- All variable lease payments that that are based on an index (e.g. CPI) or a rate (e.g. LIBOR based floating rate leases) must be estimated and booked using the spot rate and assuming that spot rate remains unchanged throughout the remaining term. Using the spot rate rather than attempting to predict future LIBOR or CPI is a welcome change, but changes to the rate or index will mean the lease will have to be adjusted whenever the rate or index impacts the future payments – for CPI that usually means an annual adjustment but for LIBOR it will probably mean a change each month. The adjustment to record the current period impact of a change in lease payments due to an index or rate change is to P&L. The adjustment related to future payments is to the ROU asset and the capitalized lease liability. This still means complexity for floating rate equipment leases, like US fleet leases. In the case of a floating rate lease, the future payments may change but the PV will not change as the rate used to estimate future payments will be the same rate used to discount the payments. The complexity of capitalizing and adjusting leases with CPI variable rent clauses will still be burdensome as the future rent will change but so will the PV so the ROU asset amortization and the lease liability amortization schedule will change. The adjustments will also cause P&L volatility as the front ended P&L pattern means that CPI increases in future lease payments are recognized in current period lease costs, this again appears to be an argument for a straight line P&L cost pattern;
- Other variable lease payments based on usage (e.g. cost per mile) or lessee performance (e.g. rents based on sales) will not be capitalized unless they are deemed to be "disguised" minimum payments. This is good news for both the equipment and real estate leasing industries as it will lessen the complexity and amounts capitalized. Guidance on determining when variable rents are disguised lease payments are to be decided. The object is to capture transactions structured to lessen capitalization by having below market contractual rents but with variable rents that are virtually certain to occur and will "make up for" under market contractual rents;
- Disclosure of contingent rent leasing arrangements will be required within the notes.

Residual guarantees

They concluded that:

- a third party residual guarantee is not a minimum lease payment for the lessor. The residual guarantee is only recorded at expiry if it results in a claim. They concluded that a guarantee or residual insurance does not change the nature of a residual to a financial asset. This is not good as it does not reduce the residual for gross profit recognition purposes and this is not good news as a guaranteed residual is not a financial asset that can be securitized;
- lessees should only record the likely payment under a residual guarantee – this is good news as it is not the full amount of the residual guarantee but rather the amount it is in the money;
- residual guarantees should be reassessed and adjusted by lessees when events or circumstances indicate that there has been a significant change in the amounts expected to be payable under residual value guarantees.

Short term leases

The Boards allow election of the current operating lease method for short term leases by asset class. This election applies to lessees and lessors. Lessees are required to disclose the future expectations to use short term leases so that users of financials can determine future lease costs and uses of cash

A short term lease is defined as, a lease that at the date of commencement of the lease has a maximum possible lease term, including any options to renew or extend, of 12 months or less. This means that typical US fleet/spilt TRAC/synthetic leases that have 12 month terms and month to month termination/renewal options will not be considered short term leases.

Sale leasebacks

If the transaction is considered a sale under the revenue recognition standard (means that control of the asset has been transferred) account for the transaction as a sale leaseback, otherwise consider it a financing/loan. When the sales price and leaseback rents are at fair value, gains or losses arising from the transaction are recognized immediately. When sales price and rents are not at fair value, the assets, liabilities, gains and losses should be adjusted to reflect the current market. This is good news as the criteria for determining a sale are less onerous than current GAAP (FAS 98) and the profit recognition is up front for most deals versus current GAAP that requires deferral and, in most cases, amortization of gains in sale leasebacks. This is bad news for the banks that did sale leasebacks of owned real estate to raise capital. Not only will the asset come back on books but the P&L cost will be accelerated as the ROU asset is written off over the lease term not the economic useful life as well as the impact of the front loaded lease cost pattern of the proposed lessee accounting.

Contract modifications

A modification to the contractual terms of a contract that is a substantive change to the existing contract should result in the modified contract being accounted for as a new contract. As a result, the existing lease would be closed out and a gain would result because of the front ended pattern of accounting for the lease costs. A new lease would then be recorded.

Lease inception vs. commencement

Lessees and lessors initially measure (calculate the amount capitalized) and recognize (book) the lease assets and liabilities at the date of lease commencement. Lessees use incremental borrowing rate at lease commencement to calculate the amount capitalized. This is good news as it simplifies the lessee accounting.

Pre-commencement payment/interim rents

Interim rents are recognized by the lessee as a rent prepayment and at the date the commencement the prepayments will be included in the cash flow discounting to determine the value of the right-of-use asset and capitalized lease obligation. Interim rents are now officially part of the capitalized lease amount and as a result, lessees will be more aware of the cost of the lease. Although it is yet to be clarified, as it reads, for leases with interim fundings, the lessor's earnings on the interim rents will be deferred and amortized over the lease term beginning at the commencement date of the lease.

Lease incentives

Cash payments received from the lessor are included as a cash inflow in the cash flow discounting to determine the value of the right-of-use asset and capitalized lease obligation.

Bundled lease payments

Payments must be bifurcated by lessees and lessors. The lessee bifurcates the payment using observable stand alone prices, if known, for all elements, consistent with the revenue recognition project; if only one element is observable assume the cost of the other is the residual cost. Where no observable market prices are available, lessees must capitalize the whole bundled payment as a lease. Unless they are more lenient in allowing estimates when observable market rates are not available to the lessee, this will mean that lessors will be forced to disclose the breakdown of elements in a full service lease as lessees will not accept capitalizing the full bundled payments.

Initial direct costs

These are costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made. These are third party costs.

Lessees should capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset and as a result the initial direct costs will be amortized straight line over the lease term. Lessors will include the initial direct costs as a reduction in the amount of the right to receive lease payments placed at time zero. The effect is to reduce the implicit rate and as a result the lease revenue recognized over the lease term will be reduced.

Lessee disclosures

The lessee must:

-Describe the nature of, and restrictions imposed by, lease arrangements.

-Provide information about judgments and assumptions relating to amortization methods, renewal options, contingent rentals, termination penalties, residual value guarantees, and discount rates and changes to those judgments and assumptions.

- Sale and leaseback terms and conditions, gains and losses.

- A reconciliation between the opening and closing balances for right-of-use assets and liabilities to make estimated future lease payments. The ROU reconciliation must be disaggregated by class of leased property.

- A maturity analysis of the gross undiscounted liability to make estimated future lease payments on annual basis for the first five years, and a lump sum for the remainder, showing contractual maturities, reconciled to the liability recognized.

-Lessees applying U.S. GAAP would be required to include in their maturity analysis cash flows related to services embedded in lease contracts that are accounted for separately from the leases.

- A tabular disclosure of all expenses related to leases not included in the lease liability and right-of-use asset, and short-term lease expense.

-Separately disclose the cash paid relating to the lease liability.

-A qualitative disclosure about circumstances or expectations that the entity's short-term lease practices would result in a material change in the next reporting period.

In the statement of cash flows, the imputed interest expense on the capitalized lease obligation will be a deduction from operating cash flows and the imputed principal repayments will be a deduction in financing activities cash flows. The cash paid for rent under operating leases will not appear in the cash flows statement or elsewhere on the face of the financial statements. Since that information would be only disclosed in the notes to the financial statements analysts will have to continue to search in the footnotes to find out the amount of cash paid for rents under operating leases. 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. It is important to note that they will not differentiate cash paid for rent in the former operating leases from cash paid for rent in the former capital leases and in my opinion this means that readers of financials will know less about the cash flow and P&L effects of leases than under current GAAP presentation and disclosures.

In my opinion the lessee disclosures are inadequate for users who view operating leases as creating a straight line cost pattern and an operating cash outflow. The proposed disclosures do not deal with the lease cost reimbursement of operating lease payments issue. The Boards are ignoring this issue and I predict a large outcry in the comment letters to the new exposure draft. I think the disclosures are extensive. In my opinion large organizations will have a difficult time describing leasing arrangements without either very long footnotes or use of very general descriptions that will give little useful information. The reconciliation of the ROU asset by asset class and the reconciliation of the lease liability will mean the lease disclosures will be voluminous. The biggest change to simplify reporting and compliance and improve transparency is to change the P&L lease cost for operating leases to what we have in current GAAP.

Subleases

A head lease and a sublease should be accounted for as separate transactions. An intermediate lessor, as a lessee in a head lease arrangement, should account for its assets and liabilities arising from the head lease in accordance with the decisions-to-date using the ROU model for all lessees. An intermediate lessor, as a lessor in a sublease arrangement, should account for its assets and liabilities arising from the sublease in accordance with the decisions-to-date using the Receivable and Residual (R&R) model for all lessors. This sounds simple but it will be difficult to apply the R&R model in a sublease as the asset to be derecognized is a right of use, not the underlying asset. Since subleasing is very common in real estate leases it will result in significant new systems needs to comply with the lessor accounting requirements.

Lessor accounting model

The Boards decided that there will be one lessor accounting method for all leases called the "receivable and residual" ("R&R") method. There are 2 exceptions – short term leases can be accounted for under the current GAAP operating lease method and certain real estate leases can be accounted for at fair value using the investment properties method. The assets under the R&R method are the PV of the rents using the lease's implicit rate and the residual. They can be reported on the balance sheet as separate amounts totaling "lease assets" or as one sum but with footnote disclosure of the breakdown. The residual is the difference between the PV receivable and the leased asset fair value. Under the R&R method upfront sales-type profit is allowed for all leases as long as profits are "reasonably assured" (this should not be an issue for equipment leases as the considerations to determine "reasonably assured" earnings are uncertainty about the residual value, uncertainty re the split between executory costs in a lease with services and uncertainty about the fair value of the leased asset at inception) but upfront profit is limited to the ratio of the PV of the rents to the fair value of the asset. The balance of the profit related to the residual portion is deferred. A guarantee of or insuring the residual does not change the nature of the residual so it impacts gross profit recognition (one would expect that the guarantee or insurance would mean the residual is reasonably assured and would be considered a financial asset). The residual is accreted to its estimated value at lease expiry using the implicit rate in the lease. If profits are not "reasonably assured" the sales-type gross profit is spread over the term by accreting the residual at the IRR of the plugged residual (difference between the PV receivable and the ***cost*** of the leased asset) and the expected salvage value (that is the value one would depreciate the asset to over the lease term) at expiry.

Leveraged lease accounting will not be included in the new rule. They will not allow grand fathering of existing deals. They will not allow a tax affected revenue recognition method. There is also a low probability that netting in leveraged leases will be allowed for new leveraged leases under a "Balance Sheet-Offsetting" project that they are separately working on. This is another FASB/IASB project that leveraged lease lessor community should be following and commenting on. It is unlikely they will allow tax affected yield revenue recognition because they say they would have to take up a revision to income tax accounting which they do not have time for now.

Lessee and lessor transition methods

Early adoption will be allowed for IFRS preparers and first time IFRS adopters. To lessen the negative lessee accounting P&L impact of using a prospective method in transition they are ***considering*** the full retrospective method as either an option or a requirement. The full retrospective method will smooth the lessee P&L impact as it would move the initial "hit" of front ending lease costs to the inception of each lease. This will result in a large hit to retained earnings and the creation of a large deferred tax balance. This will be a problem for a capital strapped banking industry as well as the retail and transportation industries. It will also be burdensome for lessees to go back to the inception of each lease. The proposed modified retrospective approach would start the new accounting method for each lease beginning in the earliest period presented when a lessee converts. This means that each existing lease will have a front ended pattern as though it was a new lease but with a term equal to the remaining term. This method will create large increases in reported lease costs until the lessee's lease portfolio reaches a point where an equal amount of expiring leases are replaced by an equal amount of new leases.

In transition lessors would be required to rebook virtually all leases going forward under the new rules. The leases that won't have to be rebooked are short term leases and fixed rate capital leases with either a zero residual, automatic transfer of title or a bargain purchase option. The major concern for lessors with large leveraged lease portfolios will be the gross up of their balance sheet and reversal to equity of previously taken earnings. They have not discussed the adjustments to sales-type leases in transition, but if they use their same logic there will be reversal of profits as a charge to equity on existing sale-type lease but there will be "new" sales-type leases (the former operating leases) where there would likely be a credit to equity for sales-type profits that would have been recognized in the past.

Lessee impacts

The many business, tax and accounting reasons for leasing will still exist for lessees as follows:

Reason for Leasing	Details	Status After New Rules Implemented
Raise Capital	Additional capital source, 100% financing, fixed rate, level payments	Still a major benefit especially for small and medium sized non-investment grade lessees
Low cost capital	Low payments/rate due to tax benefits, residual and lessor low cost of funds	Still a benefit versus a bank loan
Tax benefits	Lessee can't use tax benefits & lease vs. buy shows lease option has lowest PV cost	Still a benefit versus a bank loan
Residual risk transfer	Lessee has flexibility to return asset	Still a benefit versus a bank loan
Service	Outsource servicing of the leased assets.	Still a benefit versus a bank loan
Convenience	Quick and easy financing process often tied in with the sales process	Still a benefit versus a bank loan
Regulatory	Capital issues	Still a partial benefit if the capitalized amount is less than the cost of the asset as it is in many leases due to residuals assumed and tax benefits
Accounting	Off balance sheet	Still a partial benefit if the capitalized amount is less than the cost of the asset as it is in many leases due to residuals assumed and tax benefits. Leases will be a capital item.

Undoubtedly some lessee behavior will change:

- The cost of a lease will be more evident.
- Although the lease vs. buy economic answer will be the same, non-economic accounting issues may influence the decision.

- Capitalization will raise the level of attention of leases in the lessee's organization and change the approval process to include a centralized or higher level decision. This will at the very least slow the approval process of new leases down.
- Trade ups negotiated with an operations manager will have to get finance/accounting involved as 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.

Unintended consequences
Many contracts and regulations are based on accounting treatment and definitions in current GAAP. Cost reimbursement for rent expense will be an issue. As an example, hospitals in the US get reimbursement from government health programs (Medicare/Medicaid) for rent payments made under operating leases of non medical equipment but they don't get reimbursed for amortization and imputed interest expense. This will mean that revenue from rent reimbursement will not match reported lease costs. Debt covenants define debt as debt under current GAAP. The new accounting for leases will create a new GAAP liability. Covenants will have to be negotiated, but the task will be enormous and lessees may find lenders charging fees or calling a default to accelerate payment of debt.

Lessees may be motivated to negotiate shorter term leases and leases with CPI based variable rents. Lessors of equipment will be averse to short term leases as the residual risk would increase – they may not offer shorter terms at any price or they will assume lower residuals than the lessee expects so the rent rate will increase. Lessors of real estate will be averse to shortening lease terms as they use the leases as collateral for financing real estate projects and shorter lease terms mean less availability of funding. Eliminating CPI rent escalators will mean the lessors will attempt to charge higher base rents. All these are negatives in terms of availability of lease financings and the cost of leases to lessees.

The low cost leveraged lease product will cause the cost of large ticket leased asset like aircraft, rail cars and power plants to increase significantly as the alternative structures put more assets on balance sheet for lessors. This means higher lease rates in order for the lessor to maintain the same levels of returns on assets and returns on equity.

Conclusions
In conclusion I present my views as to the impacts of the proposed rules change.

- Banks
  - The lessee accounting rules will create capital needs as non-cash front ended expenses erode retain earnings permanently (this could be avoided by retaining straight line rent expense as the lease cost), the capitalized lease assets will attract capital (which cannot be avoided), and deferred tax assets are created (this can be avoided if the lease cost is straight lined) that attract 100% capital if the amounts exceeds certain regulatory limits (this will be an issue due to the large deferred tax assets that exist from the current banking crisis).
  - The lessor rules changes will gross up balance sheets for leveraged leases creating a capital need and ROAs will deteriorate. On the plus side there will be no negative impacts from operating lease accounting which currently causes returns on operating leases to be back ended.
- Captive finance companies and dealers.
  - Sales-type lease gross profit recognition will be allowed for all leases but at a reduced amount due to the deferral of profit on the residual portion. Depending on the individual lessor's current mix of lease types (operating versus direct finance leases) offered this may be a net benefit. There will be no need to buy residual insurance to avoid operating lease treatment. Those captives and dealers negatively impacted may change their policy of offering a lease product to maintain the current levels of profit recognition. This means more third party financing which means less availability of lease

financing and at a higher cost to lessees (captives and dealers have more tax benefits and are more risk tolerant than third party lessors).

- Bundled full service leases
  - Lessees will want to renegotiate leases to disclose or bifurcate the service/executory portion of the payment incurring legal expenses and staff time spent.
- Large ticket leases
  - The demise of the leveraged lease model will increase lessee costs.
  - Tax benefits that are part of new "green" energy asset initiatives and fiscal stimulus like accelerating depreciation tax write offs have traditionally been handled most efficiently through leveraged leases. Not only are the tax benefits transferred to a lessor who values them more efficiently than the lessee, but the reporting of the net investment at risk allows for a very price effective financial product. That will be lost and energy project and large ticket financing costs will be higher than under current GAAP.
- Municipal leases
  - US municipal leases will remain as operating leases as government accounting rules appear to be unaffected
- Financial impact to the US economy
  - The reduced profit for lessees who are heavy users of long term operating leases caused by increased lease costs will be large and confusing to readers of financial statements. The more lease dependent retailers will find that earnings decline by as much as 6%. With the economy being fragile, this proposed P&L pattern will negatively impact retail, banking and transportation companies which may cause them to raise prices and or cut costs like closing locations and laying off workers. These impacted industry segments are key to economic recovery.
  - The changes in the balance sheet and P&L and cash flows statement are extensive and measures and ratios will need to be adjusted. Although the credit and equity ratings of companies should not change because of an accounting rules change that does not change cash flows, the extensive nature of the proposed changes will cause market confusion. Stock market values are likely to decline putting more pressure on the underfunded pension crisis in the US as well as the world wide economy.

It appeared that the industry (both lessees and lessors) would fare very well in the re-deliberations but that is now not entirely so. Most of the views expressed by the ELFA, the leasing industry and lessees were adopted. Those views were also held by the vast majority of lessees and many users of financial statements. The 3 major issues that have not been adopted are straight line lessee P&L cost, the retention of sales type lease accounting and the retention of leveraged lease accounting. I urge you all to stay current on the project as it progresses. Commenting to the FASB or IASB is the most powerful tool that you the reader have to impact the outcome of the Lease Project. You should all comment when the re-exposed ED comes out in early 2012. Visit the fasb.org web site to view previous comment letters to get an idea of the form of a letter and some of the arguments used against the proposed methods. You can also visit the iasb.org website. Those websites will give you instructions as to how to submit a comment letter. The elfaonline.org website contains additional information on the accounting project. Stay informed, plan for the transition as a lessor and develop customer and product strategies to stay ahead of the curve. Above all, send in a comment letter.

About the Author:

Bill Bosco is the President of Leasing 101, a lease consulting company (www.leasing-101.com). Bill has over 36 years experience in the leasing industry. He has been on the Equipment Finance and Leasing Association accounting committee since 1988 and was chairman for 10 years. He is a frequent author and speaker on leasing topics. He has been selected to the FASB/IASB Lease Project working group. His areas of expertise are accounting, tax, financial analysis, structuring, pricing and training. He can be reached at wbleasing101@aol.com or 914-522-3233.