

# HOW WILL CHANGES TO ACCOUNTING OFF-BALANCE

*The FASB and IASB have put a new leasing project on their agendas. The outcome will be the creation of one leasing standard applied worldwide. Is this the beginning of the end of off-balance sheet accounting for fleet leases?*

**By Bill Bosco**

On July 19, 2006, both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) put the project to rewrite the lease accounting rules on their agendas. The expected outcome of this joint project is one leasing standard applied worldwide. Is this the beginning of the end of off-balance sheet accounting for fleet leases? Time will tell, but the odds are not in our favor. On the other hand, will accounting changes really hurt the fleet leasing business?

## Background

This story started in 1995 with the issuance of the first report by the G4+1, (a group made up of representatives from the accounting standards boards of the U.S., the UK, Canada, Australia, New Zealand and a representative of the IASB) on the asset and liability approach to lease accounting that they called the “New Approach” to lease accounting. Since the issuance of FAS 13 in 1976, the thinking on lease accounting in the accounting world has changed from the risk and rewards approach, the basis for lease classification in FAS 13, to the asset and liability or financial components approach. The risks and rewards approach deals with the leased asset as the asset that is either capitalized, or not, depending on the risks and rewards analysis. If the lease is not a capital lease, it is an operating lease or “off-balance sheet.” The asset and liability approach considers the financial components in the lease contract as lessee’s rights and obligations and puts the lessee’s rights and

obligations — not the leased asset — on balance sheet.

Inherent in this approach is FASB’s current definition of an asset — “an existing resource to which an entity has a present right or other privileged access.” The theory is the right to use a leased asset should be recorded by the lessee. The current definition of a liability — “an existing economic burden for which an entity is presently obligated” — is the basis for requiring the minimum lease payments to be recorded by the lessee. There is only one type of lease under this New Approach to lease accounting, and it is not an operating lease!

The asset and liability method was examined in depth with the issuance of the second, much more detailed G4+1 report in 2000. The paper was issued for public comment by FASB in the U.S. and by IASB in the developed countries and only 17 comment letters were received. Most responses were from accounting firms and leasing trade associations. The G4+1 report prompted Dennis W. Monson, a KPMG partner, to write a paper in 2001 entitled “The Conceptual Framework and Accounting for Leases” which introduced a concept that he called the “Whole Asset Approach” that he feels deals with shortcomings in the asset and liability method. The paper was published in Accounting Horizons magazine and did not get much publicity.

Nothing of note happened with lease accounting until the Enron scandal spotlighted off-balance sheet transactions. In recent years, IASB and FASB advisory committees ranked leasing high on the potential projects list, but they had too

## AT A GLANCE

The Financial Accounting Standards Board and the International Accounting Standards Board joint effort to rewrite lease accounting rules will follow this timetable:

- 2006: Research.
- 2007: Board deliberation.
- 2008: Preliminary document issued.
- 2009: Final rule issued.

RULES AFFECT

# SHEET LEASES?

many other projects underway to free up time. The SEC issued its report on off-balance sheet arrangements that was highly critical of FAS 13, citing the all-or-nothing capitalization method, the rules-rather-than-principles-based approach, the bright line tests, and the complexity of the rules that contribute to the financial engineering of lease transactions to be off-balance sheet. All the regulatory bodies feel that material operating lease obligations (the SEC estimates an undiscounted figure of \$1.25 trillion in operating lease payments reported in the footnotes of public companies. Seventy percent is from real estate leases.) must be capitalized to show a truer picture of the lessee's financial position. This all culminated in the addition of the joint project to the two standards boards' agendas.

issues and alternative accounting methods. Their action plan is as follows.



## The Timetable

The joint project will take a long time, much to the chagrin of the SEC and FASB. This is due to the complexity of the issues, the due diligence process of FASB, and the fact that the current board and staff were not around when the G4+1 reports were issued. The SEC and FASB publicly announced they will examine all the

**1 Research phase – remainder of 2006.** The FASB/IASB staff of five-and-a-half people assigned to the project will research lease products, lease contracts, alternative lease accounting approaches and

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other issues. The staff will compare decisions made on issues such as conceptual framework, definitions of assets and liabilities, and on other accounting topics to the research on lease accounting alternatives.

**2 Board deliberation – 2007.** The staff will present their work to the board as they progress, and the board will make decisions that will guide the work. A working group will be organized to provide technical input and resources. The working group

will be made up of people from various interest groups including preparers of financials, investors, lenders, rating agencies, accounting firms, subject matter experts, and industry groups such as the Equipment Leasing Association (ELA).

**3 Preliminary views document – 2008.** This document will be issued for public comment and will detail preliminary views on the new lease accounting rules. Comments will be used to help develop the final rule.

**4 Issuing final rule – 2009.** An exposure draft will be issued for public comment. This is a draft of the final rule. Comments will be reviewed and processed and changes will be made. Additional exposure drafts may be issued if changes are significant. When deliberations are complete, the new rules will be issued.

#### Alternative Methods

The staff and board have mentioned several alternative lease accounting methods they will examine.

■ **The New Approach** (asset and liability or financial components approach). This approach causes the lessee to capitalize all material leases at value of the lessee's rights and obligations, under the lease. The amount capitalized is the value of the rights and obligations, which will typically be the present value (PV) of minimum lease payments using the lessee's incremental borrowing rate as the discount rate since it will be difficult to figure any other value

(items like purchase options, renewal options, and residual guarantees are hard to value). Lessee costs that flow through P&L would be depreciation and imputed interest cost on the capitalized lease obligation.

This approach is a leading contender and has been fleshed out quite well in the G4+1 reports, although at points in the reports alternative views are presented with no conclusions. This approach offers some hope in that the amount capitalized by the

*Even if a lease is capitalized, there should still be a cost of capital advantage as long as the present value of the payments is less than the economic value of the asset.*

lessee can, in some cases, be significantly less than the economic value of the leased asset. Some key points in the asset and liability approach from a lessee perspective are:

■ **The Terminal Rental Adjustment Clause (TRAC)** -like end-position in a synthetic or split-TRAC lease may be treated as an option. This means that its initial value is zero if the TRAC is set at expected fair market value. Another view treats the TRAC amount as minimum lease payment since the lessee bears much of the risks and all of the rewards in the leased asset. The latter view is the UK Generally Accepted Accounting Principles (GAAP) view, and Sir David Tweedie, the current IASB head, was the head of the UK Accounting Standards Board when they adopted that view.

■ **Contingent rents based on usage** will continue to be off-balance sheet. Contingent rents based on factors other than usage would be capitalized at their estimated amounts.

■ **Material lease** has not been defined and may still allow accounting

for some leases as operating leases.

From a lessor's perspective, all leases would be direct finance leases, which is good as the earnings pattern is attractive and the lease receivables would be easier to securitize than operating lease rents. There is a good possibility that the after-tax yield will be allowed for amortization of lease revenue in single investor leases, also a good thing, but it is likely that leveraged lease accounting will be lost. Losing leveraged lease treatment is a very bad thing for the large-ticket segment of the leasing industry, including some vehicle lessors who use the product to finance fleets.

■ **The Whole Asset Approach.** As noted previously, Dennis W. Monson championed this approach in his 2001 paper, "The Conceptual Framework and Accounting for Leases." This approach would have the lessee record the leased asset's fair value as an asset. The lessee would record two liabilities, one being the present value of the minimum lease payments discounted at the lessee's incremental borrowing rate (same as in the asset and liability method) and the other being the obligation to return the asset (a plug to make the entry balance), which is like a residual.

The P&L items are depreciation of the asset and imputed interest expense on the capitalized lease obligation similar in total annual amounts as in the New Approach, but with a different mix between depreciation (less since the life is the useful life rather than the lease term) and interest expense (more because of the higher imputed principal). This approach is also a leading contender. It appears to be the worst-case approach for the industry as the lessee would have to capitalize the fair value of the asset (the amount the lessee would pay to buy the leased asset).

Less is written on this approach, but many of the concepts in the G4+1 paper would seem to apply. As stated, materiality would still be a concern and may provide a benefit to the leasing industry if FASB defines it and the materiality threshold

is high enough so it encompasses a significant number of equipment types, including vehicles. The lessor accounting would likely be the same as with the asset and liability approach as explained previously.

■ **The Risk and Rewards approach.**

This is the current model that regulators think is not an acceptable approach.

■ **The Executory Contract approach.**

This method considers the legal and commercial aspects of contracts, meaning that most true leases would be operating leases. FASB's current thinking for leases is that although a lease may be an executory contract, the execution on the lessor's part is completed when the asset is delivered. Any method that would allow many material leases off-balance sheet, as this method would, is not a serious possibility.

■ **The Variable Interest approach.**

This method is used in FIN 46 where the concepts of control and risk of loss determine who records the asset. This approach would still allow off-balance sheet accounting for material leases with significant residual interest retained by the lessor. That would not fit the objective of capitalizing all material leases.

Despite assurances by FASB that members will consider all approaches to lease accounting, FASB and SEC continue to talk only of the objective of capitalizing all leases.

**Business Impact**

The business impact of only the asset and liability and whole asset approaches will be analyzed here since most likely the other alternatives will be rejected. The impact on lessees and lessors will vary by business segment. There is the potential for some good news, besides the possible bad news.

■ **Materiality.** The definition of materiality drives the possibility of good news under both the asset and liability and whole asset approaches. That is, if a vehicle is considered immaterial, it would still be off-balance sheet (presumably immaterial leases

## WHAT MIGHT THE NUMBERS LOOK LIKE?

Assuming a split TRAC or open-end vehicle lease with the following terms:

Vehicle cost .....	<b>\$20,000</b>
Lease term .....	<b>3 years</b>
Delivery date .....	<b>June</b>
TRAC amount .....	<b>50% or \$10,000</b>
Pre-tax MISF* Yield .....	<b>7.50%</b>
Monthly rent in arrears.....	<b>1.82% or \$364</b>
Lessee incremental borrowing rate.....	<b>7.50%</b>

\* Multiple Investment Sinking Fund.

Under the asset and liability method two likely outcomes would result in the following entries:

If the TRAC is considered an option with zero value, the capitalized amount is \$10,527, calculated by present valuing the rents at the lessee's incremental borrowing rate. The entry is:

Leased Asset.....	<b>\$10,527</b>
Capitalized Lease Obligation.....	<b>\$10,527</b>

If the TRAC were considered the equivalent of putting the lessee in the ownership risks and reward position, the capitalized amount would be the sum of the present values of the rents and the TRAC amount at the lessee's incremental borrowing rate. The entry is as follows:

Leased Asset.....	<b>\$19,693</b>
Capitalized Lease Obligation.....	<b>\$19,593</b>

Under the whole asset method, the capitalized asset is the vehicle cost of \$20,000, and the capitalized lease obligation is the present value (PV) of the minimum lease payments (see tables) of \$10,527 or \$19,593 depending on the view of the TRAC amount. There is also a credit or liability for the obligation to return the leased asset, calculated as the difference between the asset cost and the capitalized lease obligation. Assuming a zero value for the TRAC, the entry would be:

Leased Asset.....	<b>\$20,000</b>
Capitalized Lease Obligation.....	<b>\$10,527</b>
Obligation to Return Asset .....	<b>\$9,473</b>

Assuming the TRAC amount is considered the equivalent of a minimum lease payment, the entry would be:

Leased Asset.....	<b>\$20,000</b>
Capitalized Lease Obligation.....	<b>\$19,593</b>
Obligation to Return Asset .....	<b>\$407</b>



Assuming a closed end or fair market value (FMV) option vehicle lease with the following terms.

Vehicle cost .....	<b>\$20,000</b>
Lease term .....	<b>3 years</b>
Delivery date .....	<b>June</b>
FMV residual assumed .....	<b>40% or \$8,000</b>
Pre-tax MISF* yield .....	<b>7.50%</b>
Monthly rent in arrears.....	<b>2.08% or \$416</b>
Lessee incremental borrowing rate.....	<b>7.50%</b>

\* Multiple Investment Sinking Fund.

Under the asset and liability method, the capitalized amount in the FMV lease is \$13,374, calculated by present valuing the rents at the lessee's incremental borrowing rate. The entry is:

Leased Asset.....	<b>\$13,374</b>
Capitalized Lease Obligation.....	<b>\$13,374</b>

Under the whole asset method, the capitalized asset in the FMV lease is the vehicle cost of \$20,000, and the capitalized lease obligation is the present value of the minimum lease payments (see table) of \$13,374. There is also a credit or liability for the obligation to return the leased asset, calculated as the difference between the asset cost and the capitalized lease obligation. The entry would be:

Leased Asset.....	<b>\$20,000</b>
Capitalized Lease Obligation.....	<b>\$13,374</b>
Obligation to Return Asset .....	<b>\$6,626</b>

would be treated as rentals, in other words, as operating leases). Small-ticket items (the idea here is that a vehicle is a small-ticket/immaterial asset to many large companies) may be immaterial to lessees, even if the individual assets are lease schedules subject to a large master lease, as each schedule is a lease unto itself.

Each schedule can have a unique rent factor and capitalized amount. This is due to differences in lease rates based on delivery month of each asset and changes in lessee incremental borrowing rates due to general interest rate changes. As a result each leased asset can have a unique capitalized asset and liability. Also, small-ticket true leases (TRAC and FMV leases) would require deferred tax accounting.



It sounds complex and it is. Fortunately, several FASB members are sympathetic to the complexity and cost/benefit issue. If all small-ticket leases are immaterial, there should be no negative impact to lessees since immaterial leases presumably will be accounted for as operating leases. On the other hand, if there is no carve-out for small-ticket leases, lessees may reconsider lease to avoid the administrative burden of compliance with the new accounting rules.

Under both likely approaches to lease accounting, small-ticket lessors will have all leases recorded as finance leases or sales type leases, which is favorable.

■ **Open-End Operating Leases (Split TRAC Leases).** This lease type is usually a true lease (some fleet leases are synthetic leases — a lease with the same structure as a split TRAC, but where the parties agree to allow the lessee to take the tax benefits) with minimum payments with a present value of the rents and the lessee's capped residual guarantee in the range of 80-89.9 percent under the current risks and rewards present value classification test. The rents alone would present value to 50 percent or so depending on the size of the TRAC amount.

## COMPARATIVE ANALYSIS OF LEASE ACCOUNTING

Approach	Assets and Liabilities Approach	Whole Asset Approach	Risk and Rewards Approach
Description	Capitalizes all leases at value of the lessee's rights and obligations under the lease, typically the PV of minimum lease payments.	Capitalizes the FMV of the leased asset with offsetting credits: a liability to return the asset and the PV of the minimum lease payments.	The economic significance of the lessor's retained interest would determine the nature of the transaction.
Likelihood of acceptance	Most likely	High chance	No chance
Synthetic and Split TRAC lease treatment	PV of minimum lease payments capitalized and TRAC will either be treated as an option or as a minimum lease payment.	Fair market value of the asset capitalized.	Off-balance sheet.
FMV operating lease treatment	PV of minimum lease payments capitalized.	Fair market value of the asset capitalized.	Off-balance sheet.

Anywhere from 50 percent to 100 percent of the value of the vehicle would be capitalized under the asset and liability approach, depending on the amount of the TRAC and the view taken by the FASB on the value of the TRAC, while the fair value of the asset at inception would be capitalized under the whole asset approach. As a result, under both approaches, lessees will capitalize more assets, and that may reduce lease volume. One fear expressed by a fleet lessor is that the fleet lease decision will be caught up in the capital budget process. That may slow volume initially, but the decision to replace a car is not an accounting decision, but rather a business decision. The bigger fear for lessors is that lessees will just

buy their cars and only use fleet lessors for their services.

Even if a lease is capitalized, there should still be a cost of capital advantage as long as the present value of the payments is less than the economic value of the asset, theoretically requiring less capital, and the P&L costs of depreciation and imputed interest are less than under a debt-financed purchase of the vehicle.

Under both approaches, lessors will record all leases as finance- or sales-type leases, which is favorable to lessors.



■ **Closed-End Operating Leases (FMV Leases).** This lease is always a true (tax) lease in which the lessor takes the tax benefits. The minimum lease payments (rents) will present value to 50-60 percent

# ALTERNATIVES

Executory Contract Approach	Variable Interest Approach
The nature of the contract under commercial law and a substantive analysis of economic performance would determine the nature of the transaction.	The concepts of control and risk of loss determines who records the asset.
Low to no chance	Low to no chance
Lease capitalized at fair market value of leased asset.	Lease capitalized at fair market value of leased asset.
Off-balance sheet.	Result based on analysis of lessee/lessor risks in the asset.

or so depending on the residual value of the vehicle, and the amount capitalized will directly relate to the residual assumed by the lessor in the case of the asset and liability approach. This could create a distinct advantage over open-end leases if the TRAC is capitalized as opposed to being treated as an option with a zero value. Of course, under the whole-asset approach, 100 percent of the asset is capitalized. The same fears for lessors exist with closed-end leases — that leases may buy or volumes will slow as fleet leases are treated as capital items. The combination of the depreciation and the imputed interest cost will provide some P&L benefit to lessees.

Lessors will benefit from the finance lease accounting as previously described.

■ **Other Reasons for Leasing.** The other reasons for leasing fleet may cause lessees to keep leasing as the rules change. Fleet lessors provide the benefit of volume discounts on vehicle costs that may cause lessees to continue to lease. The services and convenience of using a fleet lessor has reduced operating costs for lessees, and lessees may not want to bring the functions back in-house.

### Conclusion

The overall concern for lessors, of course, is that the volume of lease business will decline. Lessees may consider switching to debt financing, but strong reasons for using the fleet leasing product will remain. Those

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reasons, not necessarily in order of importance, are: to raise capital for lesser credits, to reduce the cost of acquiring the use of vehicles, to reduce after-tax financing cost for lessees who are non-full taxpayers, to transfer residual risk to the lessor under some structures, and to provide services and convenience. I cannot predict how fleet lessees will react.

There will continue to be a benefit for lessees in minimizing the capitalized value of the minimum lease payments under either likely new method of lease accounting. This can be achieved through pricing in tax benefits, making rents contingent based on usage and assuming residual risk. There may be an opportunity to supply the lessee with the accounting compliance informa-

tion (book and tax entries and disclosures under whatever new accounting method is chosen) to ease the compliance burden that may cause them to reconsider using the lease product.

Do not think that the rules will not change or that they will be delayed beyond 2009 as the FASB is committed to seeing the changes through and feels time is of the essence. The SEC will pressure them for completion of the project on a timely basis as they view off-balance sheet accounting for leases by lessees a major financial reporting deficiency. This is not the beginning of the end of the fleet leasing industry, but there will be a period of adjustment as lessees get used to the new rules. Lessors and lessees should track this project and comment to the FASB as it publishes drafts with the hope to minimize the complexity that lessees will face if the rules change. It is important that lessors understand the potential new rules and how they may impact their structures. Lessees know the project is underway. On sales calls, lessees will ask lessors how any proposed new deal might be accounted for in the future. To the lessors of the world: be ready to respond.

The rules will change, but there will still be business opportunities. As a matter of fact, certain provisions may be beneficial. We've seen tax and accounting changes before and the industry has more than survived, it has thrived. 📺



### About the Author:

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