

Strategic Advisory

IT finance and the proposed changes to lease accounting

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For some time now, the Federal Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been developing possible revisions for lease accounting, as part of the effort to converge US and international accounting standards under the International Financial Reporting Standards (IFRS). They are convinced that lease accounting and reporting need a major overhaul for greater transparency of these arrangements in financial statements.

While the Boards' proposal attempts to address a number of issues, the most controversial is perhaps the proposed change to require capitalization of all leases. Such a change would eliminate operating leases, so that companies who leased solely for reasons of off balance sheet treatment would not be able to use this tactic in equipment financing.

Although the vast majority of operating lease expense dollars today are either for long-term real estate/office rentals or for large-dollar transportation vehicles (eg airplanes), many organizations have used operating leases to implement technology refresh programs or to fund IT investments apart from the normal capital budgeting processes.

Most professional accounting firms, auditing firms, and industry trade groups have already published extensive reports on the proposed changes and on the likely impact of those on corporate finance. This was also the subject of an earlier version of this paper (The Road Ahead: IT Finance and the Proposed Changes to Lease Accounting, October 2010). However, there have been many subsequent changes in what the Boards are proposing.

Public responses to the exposure draft (ED)

The Boards invited the public to respond to their early 2009 Discussion Paper (Leases: Preliminary Views) and August 2010 Exposure Draft (Leases) of the proposed changes. Almost 800 comment letters were received, mostly voicing strong opposition. Subsequent roundtables, survey groups, workshops and other outreach meetings were held, soliciting further feedback on additional tentative changes the Boards made on the basis of the initial feedback.

The main criticisms were that:

- the costs of implementation outweighed the benefits
- a one-size-fits-all lease definition did not reflect the different economic types of leases (eg financing versus rental-type leases)
- the valuation of renewal options was too subjective ('more likely than not')
- placing all leases on the balance sheet was unnecessary (ie investors and ratings agencies already had adequate information on leases, as disclosed in the Notes to the public financial statements).

The Boards began soliciting feedback on implementation timelines in April 2011, but have not yet released any discussion documents on that topic.

Responses of the boards

Shortly after the comment period closed, the Boards began revising the Exposure Draft (ED) content, making several major changes and even reversing some of those changes later on. They also delayed their target finalization date from June 2011 to December 2011 (without committing to this final date). But, they still maintained that all leases greater than 12 months be reflected on the balance sheet as a right-to-use asset and as an obligation-to-pay liability (for the

entire term plus 'reasonably certain' renewals).

On the four main issues raised above, the Boards proposed the following changes:

- **Cost of implementation greater than the benefits.** Instead of requiring every lease to be reevaluated in every accounting period, the proposal now specifies that lease-asset values only need to be reassessed upon the occurrence of some triggering event. This greatly reduces the ongoing costs of lease reporting.
- **One-size-fits-all.** Since the comment letters 'overwhelmingly' argued for two types of leases (finance leases and non-finance leases), the Board adopted a two-type approach [Note A]. However, this change was itself reversed shortly thereafter, due to counter-arguments that this added additional complexity to an already complex proposal. Currently, the Boards only have one type of lease in the proposal.
- **Subjectivity of renewal valuations.** The value of the right-to-use asset was computed by adding the lease payments for the full lease term and the payments for any and all renewal periods which were 'more likely than not' to occur (adjusted for Present Value, of course). This, of course, added significant subjectivity to the value of the asset. The Boards then modified this calculation to consist of the lease payments during the term, plus any payments for future renewals that provided 'significant economic incentive' so as to be 'reasonably certain'. Although this is not perfect, it is much closer to reflecting the 'obligation' aspect of many popular types of leases.
- **Capitalization of leases unnecessary.** The Boards continued to maintain that capitalization was necessary for financial transparency and has developed several positions designed to prevent subterfuge of

their efforts (eg additional detail on embedded leases and leases in service contracts; additional ways to detect 'disguised' leases).

All in all, the proposed standards are still a 'work-in-progress' and CFO surveys indicate that organizations are not yet beginning to staff for implementation of these proposed changes. Most firms—while actively assessing various scenarios and monitoring the deliberations of their accounting firms—are taking a 'wait-and-see' stance, prior to making significant investments or changes.

Impact on financial position and profile

Under the proposed changes, all leases (except those of intangible assets, assets used for exploration/use of natural resources, and biological assets) would be represented in the balance sheet as a right-to-use asset and corresponding liability. The asset and liability valuations are computed as the PV (Present Value) of all lease payments, including all future extensions that are very probable (high threshold) and excluding certain transaction-related costs. And, if the proposals were implemented in the near term, the large amount of then-current operating leases would have to be brought onto the balance sheet as capital leases (with some 'simplified retrospective' recording method).

Accordingly, this capitalization of operating leases could result in changes to the following financial items (depending, of course, on how much off balance sheet financing has to be integrated into the balance sheet):

- Asset Turnover Ratio would decrease (negative impact)
- Debt-to-Equity Ratio would increase (generally negative impact)
- EBITDA would go up ('rental expense' gets removed from 'Earnings' into 'Interest' and 'Amortization' categories, resulting

in an improvement in EBITDA; (positive impact if the organization is measured by EBITDA)

- Pre-Tax Profit would decrease (interest on the right-to-use asset is 'front loaded')
- Return-on-Capital would go down.

The economics of lease versus buy decisions would change very little or none at all (the pre-tax might be the only factor in it), cash flow would not be impacted by the change itself, and all after-tax benefits would still be available.

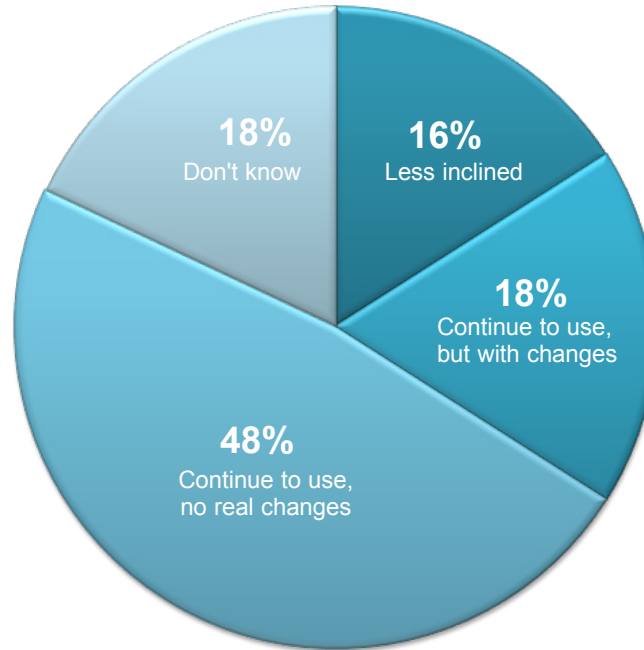
However, the two big issues are (1) the rise in the debt-to-equity ratio (which means that some financial covenants might need to be renegotiated) and (2) the drop in return-on-capital (which means that pressures from investors will increase to get the number back up).

Impact on usage of lease-type financing

Most of these proposed changes were disclosed by FASB in 2009 in their first Discussion Paper, so these are not major surprises to large organizations. Since most operating leases are already disclosed in financial statements (as Notes), disclosure of off balance sheet arrangements are not the issue—investment groups, rating companies, and other financial services groups have factored these into their analysis for a long time.

A survey of public company CFOs in Spring 2010 by Grant Thornton indicated that most firms will continue to use lease-type financing, most with no real changes (Note B):

Public companies' usage plan for leasing after FASB changes



Part of the reason that lease-type financing will still be used by large companies is that most of the original reasons for leasing will still be of benefit under the proposed changes. William Bosco (who served on the FASB/IASB Working Group and serves as a consultant to the Equipment

Leasing & Finance Association (ELFA) and Shawn Halladay point out that most of the benefits of IT equipment leasing (which tends to be residual value-based with lower present value (PV) figures than purchasing) would still be available (Note C):

Reason for leasing	Details	Status AFTER new rules implemented
Raise capital	<ul style="list-style-type: none"> ▪ Additional capital source ▪ 100 percent financing ▪ fixed rate ▪ level pymts 	Still a major benefit especially for small and medium-sized non-investment grade lessees
Low cost capital	<ul style="list-style-type: none"> ▪ Low payments and rates due to tax benefits, residual and lessor cost of funds 	Still a benefit vs. a bank loan
Tax benefits	<ul style="list-style-type: none"> ▪ Lessee can't use tax benefits and lease vs. buy shows lease option has lowest PV cost 	Still a benefit
Residual risk transfer	<ul style="list-style-type: none"> ▪ Lessee has flexibility to return asset 	Still a benefit
Convenience	<ul style="list-style-type: none"> ▪ Quick and easy process often tied in with the sales process 	Still a benefit
Regulatory	<ul style="list-style-type: none"> ▪ Capital issues 	Still a partial benefit if PV less than cost of asset
Accounting	<ul style="list-style-type: none"> ▪ Off balance sheet 	Still a partial benefit if PV less than cost of asset

However, many analysts believe the changes would likely result in a trend toward shorter lease terms (to reduce the asset and liability amounts in the financials).

Reality Check: If, what, when

The standards process for accounting moves very slowly, largely due to the semi-legislative nature and consensus-based nature of such standards. The FASB/IASB groups repeatedly request feedback on their proposals and actively solicit for alternatives.

This particular issue is complicated both by the economic and regulatory situation in which it's occurring and by the fluctuating status of IFRS adoption.

There are legitimate concerns over the possible impact of balance sheets worsening throughout the economic ecosystem and over the possible impact of the regulatory changes on the banking and related industries—all occurring at the same time and in a recovering-but-still-fragile economy. One analysis (Credit Suisse, August 2010) found that \$US549b would be added to the balance sheets of the S&P 500 and that at 34 companies, the operating lease liabilities would exceed one-fourth of their market capitalization [Note D].

IFRS adoption—and its attendant IAS/FAS convergence—is facing some new challenges in its acceptance. For example, India had earlier stated it would adopt IFRS, but has since reversed its position and is now adding its own exceptions and exclusions to the IFRS as implemented in their country. Even the SEC in the US has softened its stance over adoption of IFRS recently.

The Boards are working on several major initiatives at the same time (eg leasing, financial instruments, insurance, revenue recognition) and many of these intersect. For example, the financial instruments standard affects vendor financing and loans

to customers and the revenue recognition standard would affect how changes in lease valuations are reported.

So, many industry participants and leasing users are asking the 'reality check' types of questions:

- Will these changes eventually be mandated?
- What modifications to the original proposal will the final version of the standards contain?
- When will the changes have to be applied to current and future leases?

As for timing, the proposals have been silent. Analysts generally take the position that none of these changes would be implemented or required before 2015 at the earliest, and many have questioned how close to this ED the final standard will be. In fact, the Boards issued a press release on July 21, 2011 stating that there would be a re-exposure of the now-modified proposed standard later in 2011. They stated that additional feedback was required, since so many changes had been made to the ED during 2011H1. This, of course, pushes the entire approval/implementation process even later. Additional uncertainty arises from the possibility of the major new standards being implemented in a staggered timeline and from the possible changes in the role of FASB announced in the May 2011 SEC paper on IFRS [Note E].

Several of these acceptance and implementation factors create timing challenges for the Boards. As noted earlier, these standards are still evolving and the if/when/what questions are still very much up in the air.

Action item: Prioritize leasing rationale

As noted earlier, the majority of CFOs in the Grant Thornton survey stated that they plan to continue using lease financing since many of the benefits still remain even if the ED standards go into effect. Companies today should review their rationale for using leasing in such a scenario.

Even if operating lease treatment becomes disallowed, the top two reasons for leasing will still be relevant. According to a survey by Global Insight in 2004, the top two reasons are asset management process improvement and protection against obsolescence:

TOP 5 REASONS FOR LEASING PCs*	
Discipline imposed on maintenance and replacement	cited by 65%
Protection against obsolescence	cited by 54%
Off balance sheet accounting	cited by 53%
Convenience	cited by 51%
Efficient use of tax incentives	cited by 36%

*Based on Global Insight survey findings reported in "(Don't) Look Deep into My Lease," *CFO Magazine* (7/1/06).

A controlled refresh and protection against obsolescence will still be significant issues into the future, so companies should review and prioritize their IT equipment strategy in light of this. Some firms will recognize—that after such a review—that nothing much has changed for them and that leasing will continue to be used as the main tool to stay current and to minimize TCO in their technology footprint. These technology-side imperatives will dictate the future policy regarding lease financing.

From the fiscal side, the priorities will actually remain the same (apart from the off balance sheet issue). Colliers International summarized their analysis in this way [Note F]:

Once codified, the new accounting rules will remove a major incentive for leasing by corporations [ie operating lease treatment]. However, the lease versus buy decision will likely still be driven by the realities of a corporation's cost of capital and its access thereto. In short, cashflow based decision drivers will continue to have a more direct impact on lease versus buy activities, rather than that of balance sheet considerations alone."

Organizations should review each of the contemporary reasons for leasing (noted immediately above and in the earlier chart by Bosco/Halladay) and assess them for relevance in their IT equipment plans—even under the scenario of the modified ED proposals being adopted. Different projects, different business units, different types of equipment, and even different business risk investments could match up with different values of the lease financing models.

Action item: Review refresh plans

Under almost any version of the proposed standards, there will be a financial incentive (ie lower balance sheet liability) to move to shorter lease terms.

Many technology planners currently use operating leases to implement technology refresh cycles in line with the recommendations of industry TCO studies. They use the shorter refresh cycle afforded by leasing to avoid the higher lifecycle costs of years 4-5 (eg extended warranty, support, failure replacements). For those who have wanted to do so, but have not been able to make the financial case clear enough to management, this will be an opportunity to finally do so. There will now be a financial statement argument

along with the TCO argument for moving to and keeping a shorter refresh cycle (ie 24, 30 & 36 months).

Because lease finance pricing will still be able to operate under residual value investment models, the buy-and-hold-long models will become even less attractive than lease-short-and-refresh ones.

Organizations should take a quick look through their IT infrastructure plans for the next couple of years and re-assess refresh cycles. 'In a perfect financial world, how soon would I want to move to the next generation of equipment?' should be asked of each class of asset (eg desktop, laptop, x86 server, switches, routers, telecomm, storage) and of each class of usage (eg mission critical core production, business standard core production, mission critical support, business standard support, development). At this point, financial models could be developed by Macquarie personnel for scenario exploration and evaluation.

Action item: Assess pre-standard need for operating leases

As mentioned earlier, the majority of operating leases in effect in 2010 for North American firms are long-term facility leases or long-term non IT equipment leases. As opposed to most IT equipment leases in place today, these long-term leases will still be in effect at the time the new standards are implemented.

From a planning standpoint, we can only assume the 'worse case' scenario: that all operating leases have to be capitalized in the first period of reporting after the standards go into effect. We might hope the eventual standard might grandfather some of these and that some class of exclusions might be added to the eventual standard, but we cannot plan on such good fortune.

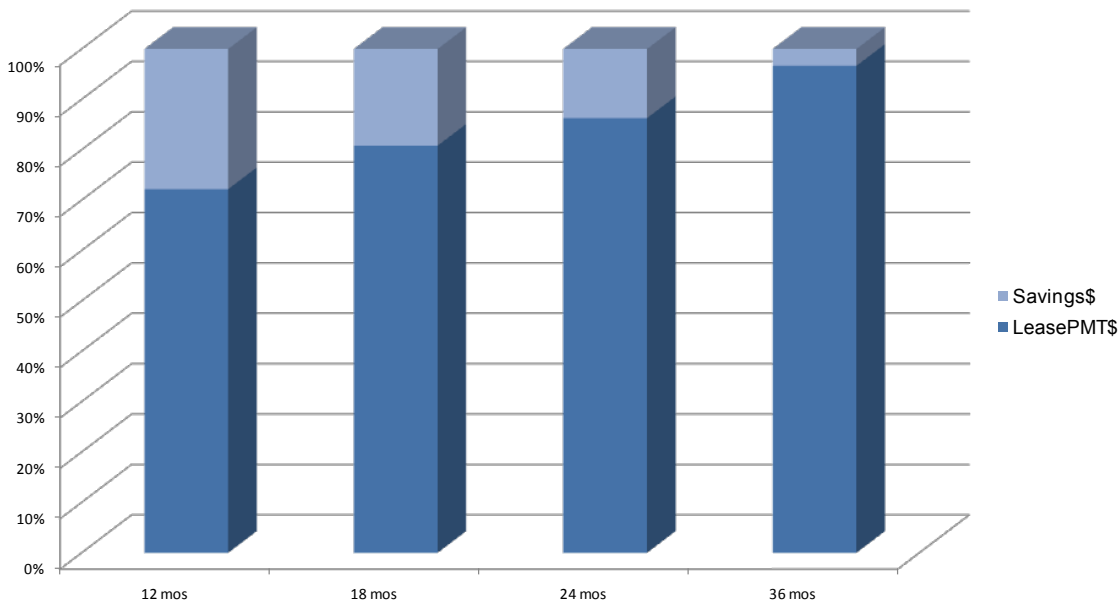
What this means is that many firms will find themselves in the awkward position of having decreased return-on-capital numbers at the same time they have reduced borrowing capacity due to elevated debt-to-equity ratios. They will have the pressure from the investors to get the return-on-capital numbers back up to where they were before the accounting change, without having the ability to invest in the PP&E (property, plant, and equipment) necessary to get productivity up to even higher levels.

They essentially have three options:

1. Borrow at elevated cost-of-funds rates after the accounting change to acquire PPE (assuming the re-negotiated debt covenants allow this);
2. Purchase PPE before the standard is implemented, inflating the balance sheet early, but creating pressures to keep the assets longer than TCO might dictate;
3. Use operating leases with terms that end before the standards apply to get PPE into service without affecting the balance sheet.

Option three must be recognized as a tactical solution only—and not a strategic one—since this type of financial vehicle may not exist after the final standard is mandated. [There are still groups that are arguing for operating lease treatment for distributed IT assets, but they have an uphill battle at this point.]

As a tactical option for the next three to four years—option three represents an opportunity for organizations to exploit. An operating lease of leading-edge IT equipment on a 2-3 year lease term is the lowest cash-out-the-door method of getting enabling technologies and production equipment into service. For example, on a \$1,000 asset, the cashflow comparison by length of term versus outright purchase looks as follows:



Organizations should look quickly at the need for extra PPE (based on how they will try to address the return-on-capital ‘hit’ under the new standard) during this ‘window of opportunity’ and discuss the various scenarios with their accounting firm and their Macquarie representative.

It is a truism in financial management that it is always easier to get capital before you need it, than after you do. Operating leases in this pre-standard period is a good way to marshal productive resources in preparation for the post-standards economic world.

Concluding comments

Most organizations are already in planning exercises and discussions with their accounting teams and firms about the possible impact of these proposed changes on their financial statements. For some, these will represent pressures to buy rather than lease and/or lease for shorter terms.

For some assets, these options might not make a huge difference. For IT assets, however, being forced to hold onto assets for periods longer than three years because ‘they are still on the books’ (ie not depreciated yet) or ‘we cannot fight the capital budget battle again so soon’ (ie uneven expenses due to spikes in IT spend) subjects the organization to extra maintenance costs, inflated TCO costs, vendor support cost increases, and increased risk of obsolescence. Gone are the days when ‘buy and hold’ and ‘sweat the asset’ were safe strategies. Technology change, vendor support dynamics, and increased dependency upon these assets have escalated the need for fast refresh and rapid exploitation of technology innovation.

To be sure, the financial services industry and savvy enterprise-class organizations will create new ‘versions’ of leasing that both comply with the mandated standards and also provide the many benefits of today’s operating leases. The needs of large

organizations for both technology and financial flexibility were the main creative forces which gave rise to the various forms of leasing in use today and it is expected that those same needs will continue to foster innovation in lease-type financing.

As the pie chart at the beginning of this paper showed, large firms will still leverage the flexibility and power of leasing as a business tool regardless of these changes. The accounting entries may change for those leases, but at the end of the day, the business values of cash flow management, cost containment, flexibility, support for productivity gains, and enablement of innovation will carry the argument for the strategic use of lease financing for IT assets.

NOTES

[A] "FASB Chairman: No Retreat on Leases", in Journal of Accountancy, 2011 April 7, accessed at <http://www.journalofaccountancy.com/Web/20113940Part4.htm>]

[B] "Survey of Senior Financial Executives, Fall 2009", Grant Thornton LLP. Summary at <http://www.grantthornton.com/portal/site/gtcom/menuitem.550794734a67d883a5f2ba40633841ca/?vgnextoid=67dbb3271e6d8210VgnVCM1000003a8314acRCRD&vgnextchannel=f51ecbbdad9c4010VgnVCM100000368314acRCRD>; Full study at <http://www.gt.com/staticfiles/GTCom/Grant%20Thornton%20Thinking/Surveys/CFO%20survey%20Fall%202009%2012-29-09.pdf>

[C] "Impact Analysis: How Will the Proposed Lease Accounting Rules Affect Your Business?", by William Bosco and Shawn Halladay. Published in ELT Magazine, Sept/Oct 2010 issue. Available online to ELFA members at <http://www.elfaonline.org/ind/topics/Acctg/pdfs/mbrs/AccountingImpact.cfm> .

[D] "Leases Landing on Balance Sheet", by David Zion and Amit Varshney, Credit Suisse, 17 August 2010, accessed at <http://www.complianceweek.com/s/documents/LeasesLanding.pdf>]

[E] "SEC IFRS Plan Would Change FASB's Role", in CFO, 27 May 2011, accessed at http://www.cfo.com/article.cfm/14578834/c_14578703]

[F] "Something to Think About: Corporate Lease Accounting--An in-depth look into the pending accounting changes". By Bret Hardy of Colliers International. (No Date) Available at http://www.colliersires.com/content/wp-content/uploads/2010/06/Colliers-Corp-Lease-Accounting_White-Paper_June-2010.pdf

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