No Casualties in Leasing: Implications for Revenue Recognition

by Rita E. Garwood

In part two of a three part series, Monitor editor, Rita E. Garwood, sits down with members of the ELFA's Financial Accounting Committee — Bill Bosco, John Bober and Rod Hurd — at the ELFA's 2015 Lease and Finance Accountants Conference to discuss the implications of the new revenue recognition standard.

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In the first part of this series, *Monitor* asked members of the ELFA's Financial Accounting Committee what would be at the top of their to-do lists if they were ultimately accountable for a company's smooth transition to the new accounting standards. This time, the panel discusses the new revenue recognition standard and its implications on the ultimate performance outcome of an equipment finance company.

A recent *Wall Street Journal* article reported that U.S. companies have "hundreds of billions of dollars of deferred revenue on their books," which demonstrates the magnitude of the revenue recognition changes.

John Bober, Global Technical Controller at GE Capital, says that since the leasing standard is changing in various ways because of the concepts in the new revenue recognition standard, the boards decided to integrate the changes into lease accounting on what has been called a "plug and play" basis, by incorporating general governing guidance and then applying it without customization. Bober adds that many of the new changes are more related to revenue recognition than to lease accounting, which can be confusing. "People need to think of each [accounting standard as a] building block by itself and then figure out where they're impacted," he says.

With that thought in mind, let's examine the aspects of revenue recognition for leases that will change. According to a recently published Equipment Leasing and Finance Association (ELFA) white paper, operating lease contracts will see no revenue recognition impact. However, sales-type leases and sale leasebacks will be affected.

Sales Type Leases

Bill Bosco, principal of Leasing 101, says revenue recognition rule changes will narrowly affect sales-type leases. Specifically, manufacturers or dealer leasing companies that need to buy residual value insurance from a third party to have a lease classified as a direct finance lease, and ultimately a sales type lease, will feel the impact.

"The revenue recognition rules won't allow that as a sale because there is a third party providing an additional guarantee," Bosco explains. "Some captives may have to adjust their forecasted revenue because they're not going to be able to get gross profit recognition up front. They'll get the gross profit recognized over time, as part of lease income amortized at a higher implicit rate versus their declining investment in the lease." Bosco says this may not be a bad outcome if the leases are short-term since the company will receive income on an accelerated basis and it's all a timing issue – the revenue differences will normalize at the point of the average life of the leases in their portfolio. The alternative will be selling the leases to a third-party vendor lessor in order to recognize the gain on sale.

Rod Hurd, CFO of Bridgeway Capital, adds that regulatory changes often lead to a reevaluation of business operations. "I think it's going to cause captives to rethink whether they should keep their captive or enter into a vendor finance program. It depends what your business models is," Hurd says. "I think that's going to be one dynamic to watch. It will be an opportunity for those who provide vendor finance."

Sale Leaseback vs. Failed Sale

There is still uncertainty regarding sale leasebacks of equipment containing a purchase option done at or near delivery of the asset where the lessee has no profit element. According to Bosco, a lease with a fixed purchase option cannot receive sale treatment under the new rules even if the option is a non-bargain option. "If you sell something but have an option to buy it back, it's not a sale under the new revenue recognition as the new standard is based on who controls the asset. The boards think that a fixed non bargain purchase option gives leaves control with the lessee in a sale leaseback," Bosco explains.

Instead of receiving sale treatment, sale leasebacks will be considered "failed" sales, according to one of Bosco's recent *Monitor* articles.

The boards have opted for symmetry of accounting. If the seller lessee has a failed sale, the buyer lessor is viewed as having made a "failed" purchase for accounting purposes. Bober, who has been involved in comment letters that address this major change, explains that, in a failed sale and purchase, the seller lessee does not get sale treatment, but keeps the asset and books it as a loan, which misrepresents the transaction. Meanwhile, the lessor doesn't account for the purchase of the asset as an operating or finance leases, but instead has — for accounting purposes — a loan with a residual risk buried inside the reporting. Bober is not happy with this situation. "Lessor accounting should reflect the risks an entity has and the fair reporting of risk should not be a casualty of the push for symmetry in lease accounting," he adds.

Bosco argues that the concept of a failed purchase misrepresents risk. "In a failed purchase, you account for the lease transaction as a loan, and the residual risk you have in the transaction is portrayed as credit risk," he explains. "From our perspective, you're not properly portraying the

risks that the buyer/lessor is taking. This decision reverses the good decision in the leases project that operating lease obligations are not debt."

Hurd questions why this major change is occurring. "Who's benefiting from this?" he asks. "Particularly when the lessor will have to portray what is fundamentally a lease — in terms of all the traditional analysis of shifting of risk and rewards, taking a residual position, putting in significant equity — as a loan." That kind of miscommunication can be problematic in trying to describe the business, according to Hurd. "It makes an apple look like an orange and that going to be an issue," he says.

According to Bosco, the new revenue recognition rules may allow continued sale treatment of certain equipment sale leasebacks, but the rules are not clear. He warns that these transactions will need to be structured very carefully to achieve sale treatment. Bosco lists three potential ways out:

Agent vs. Principal

In sale leasebacks, a question must be asked: Is the lessee acting as merely an agent or as a principal? In a recent *Monitor* article, Bosco argued: "In most sale leasebacks done at or near delivery, the lessee is ordering the asset and seeking competitive bids from lessors, but may actually fund the asset before the lease is finally arranged."

Bosco says a sale leaseback may continue to receive sale treatment if the lessee is merely an agent in a sale leaseback that occurs at or near delivery and there is no profit element for the lessee. To solve this problem, Bosco suggests lessees and lessors should enter into agreements where the lessee agrees to be an agent for the lessor in executing sale leasebacks in advance of the lessee taking any action that might be label the lessee as the owner of the asset.

No Control

The concept of control ushered in by the rules makes sale leasebacks a tricky area. Bosco points out that the rules remain unclear, especially when it comes to assets that need to be constructed, such as corporate jets. "You work with the jet manufacturer. You commit to purchase it. You may put a payment deposit down," Bosco explains. "Then you decide whether you're going to lease it or borrow to buy it and then you contact the leasing company. Under today's rules, that would probably be recognized as a sale leaseback. Is that really a sale if the aircraft hasn't been delivered and all you had was a right to the aircraft? "

According to Bosco, the definition of lessee control needs some fine tuning. Using the corporate aircraft scenario, it is unclear when the lessee is considered to have control of the physical asset or control of a right.

"Momentary" Title Takeover

Bosco contends that if a lessee is merely acting as an agent, with no profit element, there is no sale leaseback. According to the new rules, the lessee does not effectively control an asset due to a "momentary" holding of title. "The lessee is really just putting the lessor in touch with the manufacturer," Bosco explains. "But in form, it might be construed to be an actual sale leaseback."

The word “momentary” needs a better definition, according to Bosco, who suggests the new definition should allow a 90-day period to deal with the final structure of a lease or financing so the lessee is not deemed to control the asset. “If there is a better definition for momentary that is more favorable to the industry, we’d like to see it,” he says.

“The sale leaseback issue is a major issue of concern,” Hurd says. Over time, Hurd believes attorneys will find a solution acceptable to accountants. Until then, he says sale leasebacks will be operationally risky. “If you miss a step along the way where the lessee is deemed to have control of the asset, you’re dead,” Hurd says. “That kind of perfection will be problematic for smaller lenders.”

“Although the ELFA commented on the question of sale leasebacks under the new leasing standard, the board chose not to expand their guidance or provide examples that relate to our specific types of transactions,” Bober says. “The board acknowledged at their December 16 meeting on this issue that judgment will be needed, so the dust hasn’t settled and we will have to see how practice develops.”

In the final installment of this series, our panel will discuss the key takeaways from the ELFA’s 2015 Lease and Finance Accountants Conference, and the important role the ELFA has played throughout the lease accounting project.