CLFP Recertification | 2020

Impact of the New Lease Accounting Standard

n 2/25/2016, Accounting Standards Codification (ASC) 842 was added by the Financial Accounting Standards Board (FASB) via Accounting Standards Update (ASU) 2016-02. This new standard ushered in the long awaited changes in accounting for leases promulgated under Generally Accepted Accounting Principles (GAAP) within the United States. The key change with the new standard is to add operating leases to the balance sheet (i.e. no longer "off balance sheet financing"). Now most leases will be recognized "on balance sheet". The primary rationale for the new standard is to improve transparency and consistency of financial reporting about leasing transactions. Additionally the International Accounting Standards Board (IASB) has adopted a new, but different, standard as well.

The new leasing rules are effective in fiscal years beginning after 12/15/2018 for: public business entities; not-for-profit entities that have issued traded or listed securities; and employee benefit plans that file financial statements with the SEC. For all other entities, the new rules become effective in fiscal years beginning after 12/15/2019. However FASB is considering a one year delay in such implementation for those nonpublic entities from the 12/15/2019 date. Of course early adoption is permitted at any time for all entities while the restatement of prior periods is optional and not required.

The new standard includes all existing and future leases of property, plant, and equipment. No grandfathering is allowed, with the exception of leveraged leases which are still accounted for under ASC 840, since ASC 842 eliminates leveraged leases. Key changes with the new standard include:

- Modified definition of what constitutes a lease.
- Removed "bright-lines" included in prior lease classification tests.
- No longer defined by bargain purchase option; term > 75% of the estimated economic life; or PV of payments > 90% of the FMV (but both remain a reasonable numerical approach to determining the "major part" and "substantially all" new language).
- Present Value (PV) of payments under **Operating leases** will now be capitalized on the balance sheet with an "**Operating Right of Use (ROU) Asset**" and "**Operating Lease Liability**".
- Present Value (PV) of payments under **Finance (fka Capital) leases** will continue to be capitalized but will now be shown as a "**Finance ROU Asset**" (formerly "Capital Equipment") with a corresponding "**Finance Lease Liability**" (formerly "Capital Lease Obligation").
- Increased disclosure requirements.

Lease Classification for Lessees (Operating vs. Finance)

There are 5 criteria used to determine the classification of a lease under the new standard. If "Yes" is answered for ANY of the 5 criteria, the lease is a Finance Lease. If "No" is answered for ALL of the 5 criteria, the lease is an Operating Lease.

- *Does the lease transfer ownership of the underlying asset to the Lessee by the end of term?*
- *Is there an option to purchase the underlying asset that is reasonably certain to be exercised?*
- *Is the lease term for the major part of the remaining economic life of the underlying asset?*
- *Is the present value of lease payments plus any guaranteed residual value greater than or equal to substantially all of the fair market value of the asset?*
- *Is the asset specialized to the extent that it is only useful to the Lessee (does the asset have a highly specialized nature).*

Recognition Characteristics

Operating Lease

- Straight-line/even Operating Rent/Lease Expense payments (no change).
- Asset and Liability have an increasing amortization recognition pattern over the lease term (with decreasing interest expense).
- Lease liability **not** recognized as debt obligation on the balance sheet.
- Treated as operating liability with current and non-current portions presented on balance sheet.

Finance (fka Capital) Lease

- Interest and Amortization expense (no change).
- Front-loaded total expense pattern (no change) – Interest expense decreases during term, amortization expense is level/even.
- Lease liability categorized as debt-like balance sheet item (no change - continues to be Interest Bearing Debt).
- Straight-line ROU asset amortization.

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Adoption of the new lease accounting standard will negatively impact the following financial ratios of the lessee:

- Decrease in Current Ratio (new current portion Operating Lease component)
- Decrease in Quick Ratio (new current portion Operating Lease component)
- Decrease in Return on Assets (higher Total Assets)
- Increase in Total Liabilities/Net Worth (higher TL)

No Impact on other balance sheet and/or income statement items or financial ratios including: Net Worth (Return on Equity), Interest Bearing Debt -- IBD (IBD/Net Worth), Gross Margin, Operating Margin, EBITDA, EBITDAR, or Cash Flow Leverage.

Industry Impact and Expected Default Frequency (EDF)

Adoption of the new lease accounting standard will affect the financial statements of individual firms that engage in leasing activity as well as impact the financial statement profile of firms within whole industries. The most impacted industries would include: retailers, travel & leisure, and transportation. While those least impacted industries would include: non-profits, information technology, and distributors. Since many financial institutions use score models for evaluating credit, deterioration in certain key financial ratios could produce a higher (worse) EDF score. Financial institutions may need to adjust their risk rating score threshold on approvals and update EDF mappings to coincide with such change. Finally there can be impact to loan covenants contained within bank credit agreements. If so financial institutions may need to waive/reset covenants (i.e. balance sheet leverage) as appropriate and exclude the impact of Operating Leases from "Other Indebtedness" restrictions typically found in bank loan agreements.

Fraud: A Current Perspective

The preponderance of fraud is increasing in terms of frequency, number of accounts, and dollars impacted, even during the best of economic times. Fraud comes in many forms and is unfortunately an ongoing part of the equipment finance industry. The intent of the fraudster is to never fully repay its obligations in whatever form it may take with equipment lessors/lenders.

Traditional fraud continues:

- False/manipulated financial statements
- Duplicate financing of one piece of equipment
- Collusion between sales/ vendor and lessee
- No actual equipment
- Inflated equipment values / request for money well over equipment value
- Fake equipment supplier
- Untrustworthy equipment appraisals
- Side agreements / Kickbacks
- And the list goes on and on

Innovated Fraud is underway:

- Person and Business Identity theft
- Email compromise / Spoofing
- Fraudulent wire instructions
- Social engineering/ computer intrusions
- Fake/ doctored bank statements
- Financing secured by fake monetized contracts
- Fake websites
- Phone spoofing (... and the list goes on and on)

Today's fraudsters are cooking up increasingly sophisticated ways to con equipment finance companies. Email addresses can be 'spoofed,' invoices can be stolen or forged, documents can be altered in Photoshop or perfectly reproduced, websites can be invented or misdirected or hacked, and signatures can be precisely reproduced – all with a degree of ease and cunning that was unheard of before criminals became masters of these otherwise wonderful new technologies. Fraud in this era of instant email, mobile apps, automated funding, and remote closings can be very sophisticated and very difficult to detect. Red flags are not always bright red; they may be various shades of pink, or even light yellow. Despite the sophistication and technology of fraud, don't forget the fundamentals like: Know Your Customer (which is the best defense against fraud).

Fraud Prevention and Detection

Know Your Customer!

- Enhanced due diligence on customer
- Check out the people and parties involved
- Make personal contact
- On-site visits of customer/ view of equipment

Valuations by trusted 3rd parties (appraisers chosen by lessor)

- Verbal verifications prior to funding
- UCC searches

Know Your Vendor (if applicable)

- Continually vet your equipment vendors, dealers, and suppliers
- Always follow your company's established procedures and process
- Make fraud awareness and detection a part of your organization's culture
- Maintain a degree of skepticism
- Conduct a gut check

Finding clues pointing to fraud may also require technical expertise you simply don't have on hand – knowledge of the Internet, coding, email, or computer systems and practices, for example, or access to specific methods and resources that may spot indicators of trouble that are naturally overlooked by analysts and underwriters who don't frequently come in contact with them. Using location intelligence, for example, may identify areas where we see a higher concentration of high risk businesses. Business identity theft occurs most often in places like Las Vegas, Los Angeles, Atlanta, and Miami where a larger number of these high risk businesses exist. Tools available from D & B, LexisNexis, Thomson Reuters and others, just to name a few, can assist you in your search to detect and more importantly avoid fraud. Fraudulent accounts are probably already in your current portfolio. A downdraft in the economy will likely expose even more them than you previously detected here to date. In summary fraud is ever present and unfortunately a part of the equipment financing spectrum. Taking active steps by knowing your customer, using "gut" checks, and enlisting new technology may help reduce losses.

In summary, the recent changes to the lease accounting standard has been decades in the making. While appearing radical to many, the new standard reflects more transparency and better financial disclosure than the old one. Credit underwriters have always adjusted for off-balance sheet leases in the final determination of credit worthiness and in the making of credit decisions. Accordingly the adoption of ASC 842 codifies the many practices in assessing the impact of leasing upon individual firms and whole industries. Lease accounting is now simply catching up with the practical approaches employed in the past.