WHITE PAPER

New Lease Accounting Rules

wheels

Introduction

New lease accounting rules (FASB Topic 842) will be required for all public companies beginning in 2019. The primary goal of the new standard is to improve transparency for committed long-term leases by requiring lessees to show most leases on their balance sheets. The existing lease accounting rules (“Topic 840”) do not require assets and liabilities for operating leases to be shown on lessee balance sheets. The new accounting will be a big change for lessees, particularly those with large, long-term leases of assets like real estate, aircraft, and specialized equipment.

The Financial Accounting Standards Board (“the Board”) considered feedback received on three separate papers addressing lease accounting and throughout many years of deliberations. The Board introduced several simplifications to make the new lease accounting requirements similar to those in previous leases’ guidance and to reduce the cost and complexity of transition to the new guidance.[1] One such simplification was allowing lessees to elect not to recognize lease assets and lease liabilities for leases with a term of 12 months or less.[2]

We followed the Board’s process leading up to issuance of the new lease accounting standard (“Topic 842”) and share our views of what the standard means for the lessees of our unique leases of automobiles and trucks.

Unique Vehicle Leases

We are lessors of vehicles that are used for business purposes (sales and service) as part of a corporate fleet. Each vehicle is under a separate lease and a typical corporate client/lessee may have tens, hundreds, or thousands of vehicle leases at one time. A critical objective inherent in our lease is flexibility for lessees to terminate, renew, or redeploy vehicles as required to manage business needs.

The contractual lease term is 12 months followed by monthly renewal options. Our vehicle lease contains a Terminal Rental Adjustment Clause (TRAC) so that

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[1] Differences between new GAAP and current GAAP, **Section A—Page 2**

[2] The Board agreed that applying the full standard on all leases was not cost justified for short-term leases. The lessee election to not recognize leases on the balance sheet was described as “simplified” accounting to “offer more relief” from cost and complexity. **Section C—BC375-BC379**

when the lease is terminated, the lessee and lessor have a final settlement calculation. The settlement calculation compares the sum of rent and disposal proceeds to the initial vehicle value. Any difference (rental adjustment) is paid by or to the lessee and is recognized as a variable lease payment.

The vehicle TRAC lease includes a lessor guarantee that the disposal value of the vehicle will not be less than a specific percentage of initial capitalized cost. This structure limits lessee exposure and results in the lease meeting the 90% test under Topic 840 and complies with all operating lease classification requirements. The lease meets the requirements of a true lease under the federal tax code and the lessor is the owner for tax and legal purposes.

New Lease Accounting — Lease Term

Topic 842 requires a lessee to record a Right of Use Asset and Lease Liability on the balance sheet that is calculated based on the specifics of each lease. The **Lease Term** is the critical factor for calculating the amount to be recorded on the balance sheet and for determining whether a lessee can elect short-term treatment. Lease Term is defined as "the noncancellable period for which a lessee has the right to use an underlying asset, together with…periods covered by an option to extend the lease if the lessee is ***reasonably certain*** to exercise that option"[3] Evaluating whether the lessee is reasonably certain to exercise or not exercise an option is the most important step for determining the lease term for a vehicle TRAC lease.

The term "reasonably certain" can be misleading because it is not meant, by the Board, to have the lay meaning that one might intuitively assume. The Board provided a detailed discussion of their rationale for using the words "reasonably certain," along with guidance regarding the initial measurement (and subsequent re-measurement) of lease term for leases with renewal options. The discussion is found in Topic 842's Basis for Conclusions paragraphs BC 189 to BC197.

The Board acknowledged the difficulty in determining when to include renewal options in the lease term and "that either including or not including renewal options in the measure of assets and liabilities will be inconsistent in one way or another with the conceptual definitions of assets and liabilities."[4] **The Board concluded that they "view the approach in Topic 842 as a practical way, consistent with that in previous GAAP, to account for renewal options where the form is optional, but it is clear that there is economically little or no choice but to extend or not to terminate the lease."[5]**

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[3] Glossary definition for 'Lease Term' including criteria a; criteria b and c not relevant to the vehicle TRAC lease, **Section A—Pages 24-25**
[4] Lease Term: Options to Extend (Conclusion), **Section C—BC 197**
[5] Lease Term: Options to Extend (Conclusion), **Section C—BC 197**

If Operating leases for committed long-term assets like real estate, aircraft, heavy equipment, and specialized equipment, often provide little or no choice but for lessees to extend renewal options. We will address the Board's option extension question for vehicle TRAC leases:

"For vehicle TRAC leases — do lessees have an economic choice or must they extend the lease?"

Reasonably Certain and Economic Factors

For at least six decades and before Topic 840 was published, the vehicle TRAC lease had a contractual term of 12 months followed by monthly renewal options. The vehicle TRAC lease was meant to provide flexibility for lessees with the substance of the arrangement being short term in nature. Lessees have almost always, since Topic 840 was published, determined that renewal is NOT reasonably assured after 12 months.

Updated definitions now in Topic 842 will require accountants to re-assess lease term for the vehicle TRAC lease, though significant changes are not expected. As noted above, the definition of reasonably certain is the crucial concept for evaluating lease term and renewal options. The meaning of reasonably certain: "At commencement date, an entity assesses whether the lessee is reasonably certain to exercise or not exercise an option by considering all economic factors relevant to that assessment—contract-based, asset-based, market-based, and entity-based. An entity's assessment will often require the consideration of a combination of those factors because they are interrelated."[6] The Board meant for the evaluation of reasonable certainty to be comprehensive and clear; so, the "basis of that expectation (reasonable certainty) was linked to a lessee having a "significant economic incentive" to exercise an option."[7]

Economic factors[8] identified by the Board are either not relevant or do not result in significant economic incentives when evaluating renewal options for the majority of vehicle TRAC leases. There are no termination penalties included in the contractual lease terms. Leased vehicles are generic, not specialized, and easily replaced. Vehicles do not include leasehold improvements but can include vehicle upfitting that (like the vehicles) is also usually immaterial, generic (ladders, racks, hoists), and easily replaced. There are no significant economic incentives to exercise renewal options, and lessees do not keep vehicles on lease if the vehicles are not needed.

Despite an absence of significant economic incentives to renew leases, our experience is that lessees keep vehicles on lease for varying periods that can average 3 to 4 years. In our discussions with personnel at large corporations and Big 4 accounting firms, we are sometimes asked or told "that it is significant that lessees consistently exercise renewal options, so the lease term must be more than one year."

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[6] Reasonably Certain, **Section A—842-10-55-26**
[7] Lease Term: Options to Extend (Significant Economic Incentive), **Section C—BC 193**
[8] Reasonably Certain / Economic Factors (also see in appendix with commentary), **Section A—842-10-55-26**

In response, there are some reasons that lessees keep vehicles on lease for longer than the non-cancellable contractual period of a year:

- Avoid a final settlement payment
- Optimize the average monthly cost of vehicle by prolonging lease
- Convenience for the fleet office and driver
- Lack of meaningful benefit to upgrade vehicles

These are all good reasons to keep vehicles on lease when they are needed for business purposes, but none are significant from an economic standpoint.

Usually the entire vehicle fleets are not material to lessees. Individually leased vehicles and associated renewal decisions are immaterial to lessees; so, manipulating the final settlement amount or optimizing the monthly cost on leases is simply not economically significant. Large fleet lessees obtain substantial volume discounts and often receive cash credits regardless of when they terminate leases. In situations where a lessee must pay a final settlement, their alternative is to continue paying rent, maintenance, insurance, and other costs on a depreciating asset; consequently, lessees will terminate leases if the vehicle is no longer needed for their business.

Additionally, costs to purchase, transport, and sell vehicles are very low utilizing a national network of dealers, transportation companies, and auctions. Vehicles are acquired at wholesale prices and lease depreciation rates are generally set conservatively. Fleet office and driver time required for vehicle replacement is minimal, and AALA companies can manage the logistics of lease termination and vehicle replacement.

Our experience contradicts the assumption that lessees have little choice but to exercise renewal options as lessees regularly dispose of vehicles when they are no longer needed, and without regard to the final settlement amount or the age of the lease. We have examples of thousands of leases that were terminated early, even before a year, with final settlement credits and also with final settlement payments. Regardless of whether the final settlement is a receipt or a payment, amounts are rarely considered significant; and settlement economics are just not determinative of whether lessees exercise renewal options at a year or other periods.

We also observe situations where lessees will replace a lease or multiple leases early to upgrade safety technology, improve fuel economy, or change branding on vehicles. The bottom line is that lessees choose the vehicle TRAC lease for month-to-month flexibility that allows for lease termination at will.

Reasonably Certain and Other Considerations

Some see a conflict with a conclusion that the lessee is NOT reasonably certain when, in fact, management expects, estimates, or intends to lease vehicles under a vehicle TRAC lease for longer than a year. The Board understood this complexity and explained that "An expectation of exercise alone (and without a significant economic incentive to do so) would not be sufficient. The Board concluded that requiring an economic incentive would provide a threshold that could be applied more objectively than a threshold based solely on management's estimates or intent."[9]

Early on, the Board vetoed a proposal for "determining the lease term based on the basis of a most likely measurement approach; that is, the lease term would be the longest possible term that is more likely than not occur...(and reflective of) an entity's reasonable expectation of what the term would be."[10] Financial statement users and other respondents to the early proposals "did not like the uncertainty of management estimates based only on a 'more likely than not' threshold that could change frequently, understood [the Board's objective] that 'significant economic incentive' was a **high threshold** and said that [this approach was] an improvement"[11] to earlier proposals.

Ultimately, "it was the Board's intention that 'significant economic incentive' should result in similar lease term conclusions as the "reasonably assured" guidance in previous GAAP," [12] which is a year for the vehicle TRAC lease.

While it is possible that differing facts and circumstances may change the analysis of economic factors, it is RARELY the case with vehicle TRAC leases that lessees do not have an economic choice regarding renewal options. We expect the vast majority of vehicle TRAC leases will continue to have a one-year lease term.

Other Considerations — Short Term Lease Classification

The Board provided an exception to recording a lease asset and liability on the balance sheet when the lease term is 12 months or less. The exception was provided as a practical cost benefit in recognition of the recordkeeping for such short leases. Lessees can take advantage of this exception.

Given the 12 month term in our leases, we expect that lessees will have an option under Topic 842 to make an accounting policy election (by class of underlying assets) not to recognize lease assets and liabilities, similar to existing operating leases under Topic 840. We expect some lessees will make this election and others may not.

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[9] Lease Term: Options to Extend (Significant Economic Incentive), **Section C—BC 193**
[10] Lease Term: Options to Extend (explanation of rejected ideas), **Section C—BC 191**
[11] Lease Term: Options to Extend (Significant Economic Incentive), **Section C—BC 194**
[12] Lease Term: Options to Extend (Significant Economic Incentive), **Section C—BC 194**

Other Considerations — Final Settlement Calculation (Variable Lease Payment)

A final settlement calculation is made at termination of the vehicle TRAC lease to determine the final rental adjustment. This final rent adjustment is a rent payment (or credit) that reflects actual usage of the vehicle while under lease. This final amount is not known at lease commencement.

The rental adjustment amount depends upon known factors such as monthly depreciation and initial acquisition cost, and several unknown factors at lease commencement, such as mileage, condition of the vehicle, wear and tear, damage, geography of operation, disposal channel, and other factors. Together, these factors generally represent "use" of the vehicle.

Variable lease payments are "payments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time."[13] Payments that vary due to use of the underlying asset and vehicle mileage specifically are variable lease payments.[14]

The final rental adjustment is not a residual value guarantee as the Board narrowly defined as "a guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount."[15] The rental adjustment is not a specified amount, it is different amounts at different times, based on many factors, not reliably determined in advance, and can be a credit returned to lessee. This adjustment is much more akin to rent based on use of a vehicle.

The final rental adjustment under Topic 840 is recognized as revenue or expense when realized. Similarly, variable lease payments (except those that depend on an index or a rate) are excluded from current recognition as an asset or liability at commencement of the lease.[16] The Board excluded variable lease payments to reduce cost and complexity involved in estimating and measuring such payments.[17] The Board acknowledged that payments contingent on future events do not represent present obligations.

Neither the direction nor the amount of these rental adjustments can be estimated at lease commencement. Thus, the lessee generally does not know whether the rental adjustment will result in an asset or a liability. The rental adjustment resulting from the final settlement calculation is a variable lease payment that will be recognized when it becomes probable, and generally when realized.[18]

To learn more or if you have questions regarding the new Lease Accounting rules, please contact a member of your Wheels Account Team or e-mail us at info@wheels.com.

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[13] Glossary (p. 30) **Section A**
[14] Variable payments, **Section C—BC 205**
[15] Glossary (p. 28), **Section A**
[16] Excluding variable payments, **Section A—842-10-30-6**
[17] Variable lease payments, **Section C—BC209-210**
[18] Recognizing variable lease payments, **Section A—842-20-55-1**

Appendix A:

Excerpts and definitions from Topic 842 and relevant discussions from Basis for Conclusions.

Lease Term
Topic 842 Glossary

The non-cancellable period for which a **lessee** has the right to use an **underlying asset**, together with all of the following:

a. Periods covered by an option to extend the lease if the lessee is ***reasonably certain*** to exercise that option

Reasonably Certain
842-10-55-26 At the **commencement date**, an entity assesses whether the **lessee is** reasonably certain to exercise or not to exercise an option by considering all economic factors relevant to that assessment—contract-based, asset-based, market-based, and entity-based factors. An entity's assessment often will require the consideration of a combination of those factors because they are interrelated.

FASB	AALA COMMENTARY
"Examples of economic factors to consider include, but are not limited to, any of the following:	
a. Contractual terms and conditions for the optional periods compared with current market rates, such as:	
1. The amount of **lease payments** in any optional period	• All at market rate
2. The amount of any **variable lease payments** (VLP) or other contingent payments, such as payments under termination penalties and **residual value guarantees**	• Final settlement is a VLP—revenue or cost to lessee • No termination penalties • No expected residual guarantee
3. The terms and conditions of any options that are exercisable after initial optional periods (for example, the terms and conditions of a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).	• No purchase options • All renewal options: - Arms-length - At market
b. Significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the underlying asset becomes exercisable.	• No significant improvements • No lessee purchase options • Assets generic and marketable
c. Costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.	• No termination cost • No renegotiation cost • Cost to sell vehicles very low • Cost for signing new vehicle lease very low
d. The importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset."	• Vehicles are not specialized • Vehicles are easily replaced • Transportation is low cost

Significant Economic Incentive

BC197. Board members view the approach in Topic 842 as a practical way, consistent with that in previous GAAP, to account for renewal options where the form is optional, but it is clear that there is economically little or no choice but to extend or not to terminate the lease.

BC195. It was the Board's intention that "significant economic incentive" should result in similar lease term conclusions as the "reasonably assured" guidance in previous GAAP, the Board decided that the lease term should include only optional periods to extend the lease if either (a) the lessee is reasonably certain to exercise that option or (b) exercise of the option is controlled by the lessor.

BC194. [Board] understood that "significant economic incentive" was a high threshold.

BC193. The Board considered that applying the concept of significant economic incentive would provide a threshold similar to the concepts of "reasonably assured" in previous GAAP and "reasonably certain" in IFRS. However, the proposals would have emphasized that there needed to be a significant economic incentive for the lessee to exercise the option to include optional periods in the lease term. An expectation of exercise alone (and without a significant economic incentive to do so) would not be sufficient. The Board concluded that requiring an economic incentive would provide a threshold that could be applied more objectively than a threshold based solely on management's estimates or intent.

Short-Term Lease

A **lease** that, at the **commencement date**, has a **lease term** of 12 months or less and does not include an option to purchase the underlying asset that the **lessee** is reasonably certain to exercise.

BC379. The Board affirmed the short-term lease threshold of 12 months or less that was previously proposed but decided to permit the recognition and measurement exemption to apply to any lease for which the lease term (as defined in Topic 842) is 12 months or less, rather than only to a lease with a maximum possible term of 12 months or less. That decision was largely a consequence of feedback on the 2013 Exposure Draft that suggested that use of a "maximum possible lease term" would not permit the exemption to be applied to "evergreen" leases that may typically only be for a matter of only weeks or even days, because there is no stated maximum lease term (that is, the lease may contain terms that permit the lessee to continue to extend the lease on a day-to-day, week-to-week, or month-to-month basis).

Variable payments

BC205. Some or all of the lease payments for the right to use an asset can be variable. That variability can arise because lease payments are linked to (a and b not relevant):

c. The use of the underlying asset. For example, a car lease may require the lessee to make additional lease payments if the lessee exceeds a specified mileage.

Excluding variable payments

842-10-30-6 Lease payments do not include any of the following:

a. Variable lease payments other than those in paragraph 842-10-30-5(b)

Variable lease payments

BC209. On the basis of that feedback, the Board agreed that the cost and complexity of estimating and measuring all variable lease payments could not be justified by the benefit.