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G00302829

The Demise of the Operating Lease Requires Close Collaboration to Minimize Transition Risk

Published: 16 June 2016

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The recently announced FASB and IASB lease accounting standards will eliminate off-balance-sheet operating lease financing by YE18 for terms greater than 12 months. Technology procurement leaders must collaborate closely with finance and IT to evaluate and manage the material impact.

Impacts

- The demise of off-balance-sheet operating leases means that, for IT and technology procurement leaders, cloud computing and SaaS will grow more attractive as off-balance-sheet replacements for operating lease financing of IT infrastructure.
- IT and procurement executives should be aware that the shift to capital assets is likely to lengthen the relatively short refresh cycles associated with operating leases, and drive higher asset disposition costs for older equipment.
- Although the operating lease's off-balance-sheet accounting benefit will be eliminated by YE18, finance and procurement leaders must understand that the residual value benefits of FMV financing will remain for shorter-term leases, requiring a revised "lease versus buy" strategy.

Recommendations

Technology procurement leaders must work closely with their finance and IT colleagues to:

- Assess the impact of the demise of off-balance-sheet lease financing on the opex/capex balance and specifically, on financial ratios.
- Update their "make or buy" decision for hosting software application systems.
- Evaluate asset disposition implications, and beware of extending their asset portfolio's useful life beyond its economic life.
- Evaluate the continued use of FMV lease financing to leverage the lessor's equity investment even after the proposed new leasing standards force capitalization.

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Analysis

This research is aimed at IT, finance, and procurement executives responsible for the financing or operation of IT infrastructure (see Figure 1). This includes not only those in the IT asset management and procurement office, but also IT executives and corporate CFOs.[1]

After several false starts over the past five or more years (see "Beware the Effect of the Operating Lease's Demise on Finance and Real Estate"), International Accounting Standards Board (IASB) and the U.S.-based Financial Accounting Standards Board (FASB), which manage the world's accounting standards, have introduced the final versions of new lease accounting standards that will take effect for public companies on 15 December 2018 (FASB) and 1 January 2019 (IASB).[2]

These new standards are designed to improve the transparency and comparability of public, private and not-for-profit organizations that use lease financing. Their bottom-line objective is to ensure that all assets and liabilities resulting from lease transactions are easily recognized on a lessee's balance sheet.

Lease financing, in general — and off-balance-sheet operating lease financing, in particular — is often an important component of corporate (and IT) financing. It is used as an alternative financing source that can minimize the user's risk of asset ownership.

IT, procurement and finance executives should take note that these changes effectively do away with traditional off-balance-sheet operating leases for terms longer than 12 months. To give a sense of the impact of such a significant change, estimates of off-balance-sheet-leased assets range from well more than $1 trillion in the U.S. to just less than $1 trillion in Europe, to the most recent estimate of the IASB, which estimated that, as of 2014, listed companies using International Financial Reporting Standards (IFRS) or generally accepted accounting principles (GAAP) standards had around $3.3 trillion in lease commitments.[3]

Specific IT assets that will be affected by these accounting changes include hardware assets such as enterprise servers and storage, networking kits (for example, switches and routers), PCs (for example, desktops and laptops), mobile devices (for example, tablets and smartphones), as well as an array of Internet of Things (IoT)-related devices that are often financed via an off-balance-sheet operating lease.

Under the new standards, all new and existing leases (that is, there will be no "grandfathering") with terms greater than 12 months will be capitalized on the balance sheet.

Technology procurement, IT and finance leaders are cautioned to avoid the risk of complacency with such a long-term effective date. When such material changes in accounting standards are issued, statutory rules require comparative figures for prior periods. In this context, we urge users to analyze any potential budget and long-term capital expenditure (capex)/operating expenditure (opex) impact sooner rather than later, especially given that all then *current* leases will have to be capitalized — that is, no existing leases will be "grandfathered."

Users interested in a more detailed explanation of the new standards are encouraged to review the announcements from the FASB and the IASB.[2]

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Figure 1. Impacts and Top Recommendations for Finance, IT and Technology Procurement Leaders

Impacts	Top Recommendations
Cloud computing will grow more attractive as a viable off-balance-sheet replacement for operating-lease financing of on-premises IT infrastructure.	▪ Evaluate the effect of the demise of off-balance-sheet lease financing on the opex/capex balance and on financial ratios. ▪ Re-evaluate your "make or buy" decision for hosting software application systems.
The shift to owned, capital assets is likely to lengthen the relatively short refresh cycles associated with operating leases and drive higher asset disposition costs for older equipment.	▪ Evaluate asset disposition implications and beware of extending your asset portfolio's useful life beyond its economic life. ▪ Exercise caution in determining the appropriate financing life (depreciation term) for purchased or leased IT assets.
Although the operating lease's off-balance-sheet accounting benefit will be eliminated by YE18, the benefits of FMV financing will remain for shorter-term leases.	▪ Evaluate the continued use of FMV lease financing to leverage the lessor's equity investment, even after the new leasing standards force capitalization.

capex = capital expenditure; FMV = fair market value; opex = operating expenditure

Source: Gartner (June 2016)

Please note that, although Gartner research may discuss legal and accounting issues related to IT, Gartner does not provide legal or accounting advice or services, and the information provided hereunder should not be construed as such. Instead, professional legal and accounting counsel should be sought. Technology procurement professionals are encouraged to collaborate with IT finance and corporate finance to ensure their internal finance and accounting policies are being met.

Impacts and Recommendations

The demise of off-balance-sheet operating leases means that, for IT and technology procurement leaders, cloud computing and SaaS will grow more attractive as off-balance-sheet replacements for operating lease financing of IT infrastructure

As Figure 2 shows, opex has remained relatively steady during the past five years, at 70% to 74% of total IT expenditure.

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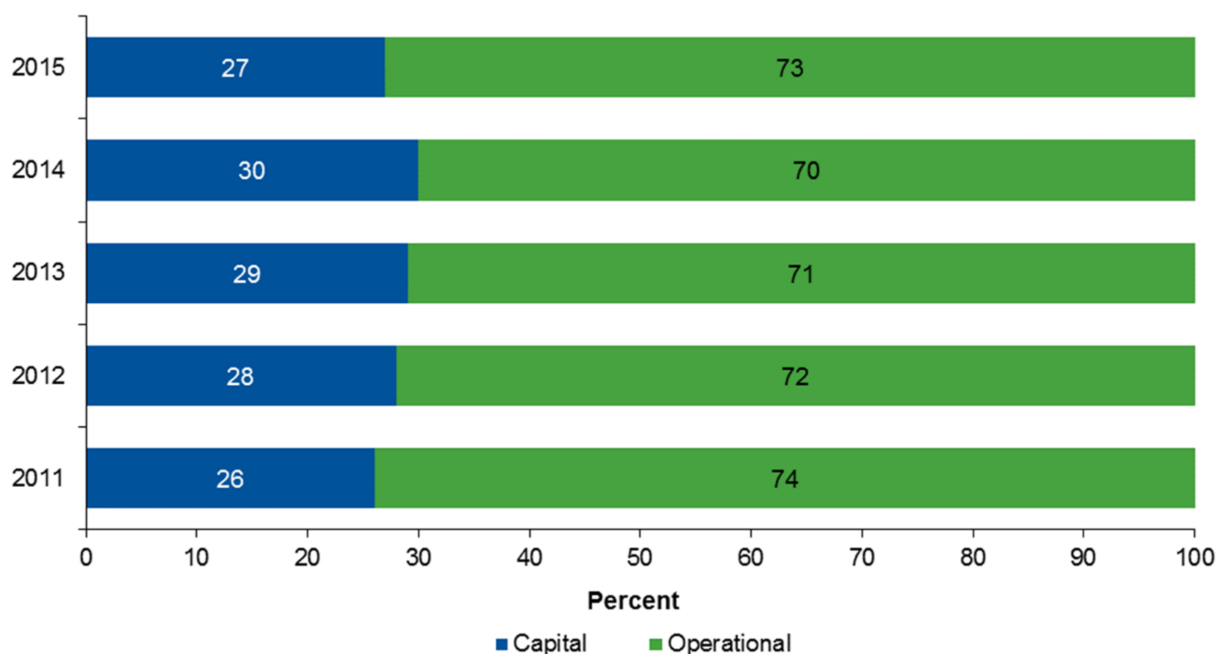
Figure 2. The Cross-Industry IT Operating vs. Capital Spending Ratio Has Been Relatively Stable Over Time



Note: Data is from 2016.

Source: Gartner IT Key Metrics Data

The demise of the ability to keep the financing of IT equipment off the balance sheet poses a challenge to this relatively steady opex/capex ratio. Indeed, a likely derivative effect of the new accounting standards will be a re-evaluation of outsourcing and cloud computing solutions, which are usually treated as off-balance-sheet operating expenses. This is also likely to impact IT service providers the most, as their core business involves acquiring assets with which to deliver services. Unlike end-user organizations, they will not have the option to buy assets as a service.

Financing infrastructure assets through off-balance-sheet operating leases has traditionally been the path of least funding resistance for many IT procurements. With the demise of the operating lease, we expect organizations to re-evaluate the "make or buy" hosting decision — that is, whether to deploy in-house computing solutions or use outsourcing services and the cloud — for both new and existing application deployments.

To be sure, this hosting decision has many important strategic implications with complex variables. While the need to replace the operating lease's ease of funding will be real for many organizations, users should be aware that the decision to outsource via cloud computing has many more and significant operational, logistical, security and financial implications (see "2016 Planning Guide for Cloud Computing and Virtualization") than the relatively simple accounting decision to enter into an operating or capital lease. Although we believe these accounting rule changes will not prove to be a major long-term catalyst for cloud computing, the shift to all-capitalized IT infrastructure may well shift the balance in certain "close call" hosting decisions.

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Moreover, the greater transparency and visibility into true infrastructure costs afforded by the transition to an all-capital budget also risk diminishing the economic and political motivation to retain application systems in-house. Indeed, this may be a catalyst to improve capital planning to a similar level of focus as expense forecasting.

Bottom line: While cloud/SaaS is a potential off-balance-sheet alternative to capitalizing assets, there are of course many other factors to consider when making a cloud decision, of which the accounting implications are only one.

Recommendations:

- Technology procurement leaders, in collaboration with business and finance executives, should re-evaluate their financial analysis/approach to the "make or buy" decision for hosting software application systems, as the demise of the operating lease's off-balance-sheet benefits may make outsourcing and cloud alternatives somewhat more financially attractive.
- The finance organizations (IT and corporate) should collaborate with IT procurement to evaluate the projected effect of the demise of off-balance-sheet lease financing on the opex/capex balance in general and on financial ratios specifically — for example, return on assets and return on equity.

IT and procurement executives should be aware that the shift to capital assets is likely to lengthen the relatively short refresh cycles associated with operating leases, and drive higher asset disposition costs for older equipment

Interesting potential derivative effects of the end of the operating lease will be the longer refresh cycles typically associated with purchased assets, and a consequent rise in net IT asset disposition (ITAD)/end-of-life costs. For users who currently lease a significant portion of their IT infrastructure portfolio, the new accounting standards will likely shift that leased portfolio toward purchased assets, with their concomitant ITAD responsibilities, costs, and data security and environmental risks. Also, the extended refresh cycles typical of a purchased kit will yield lower remarketing revenue and greater recycling costs.

Recommendations:

Technology procurement leaders, in collaboration with asset and financial managers in organizations with a significant operating lease portfolio should:

- Evaluate the ITAD implications as their organizations plan for the transition away from the operating lease. Specifically, they should beware of the risky temptation to extend the useful life of an IT asset portfolio beyond its economic life, resulting in lower (or no) remarketing revenue.
- Exercise caution in determining the appropriate financing life (depreciation term) for purchased IT assets. To avoid costly book value write-offs, conservative best practice is to ensure the IT asset's ultimate useful life within the enterprise is at least as long as its financing term (see "Minimize IT Financing Risk and Exploit Cost Optimization Opportunities Through Gartner's IT Financing Framework").

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Although the operating lease's off-balance-sheet accounting benefit will be eliminated by YE18, finance and procurement leaders must understand that the residual value benefits of FMV financing will remain for shorter-term leases, requiring a revised "lease versus buy" strategy

Off-balance-sheet operating leases for IT equipment currently require an equity investment of at least 10% by the lessor.[4] To profit from such an FMV lease transaction, the lessor depends on the asset's FMV at the end of the lease term to recoup that equity investment.

Just because the off-balance-sheet accounting advantage of the short-term (for example, 36 months or shorter) FMV lease is likely to be eliminated does not mean that the FMV lease itself will no longer be offered by lessors. On the contrary, our research indicates that many lessors — especially the captive OEMs (such as IBM Global Financing and HP and HPE Financial Services) — intend to continue investing in and offering leases that entail some back-end residual value risk. The lessor's profit model entails betting that its equity investment (typically 10% to 20% of the asset's original value, depending on the lease term/period and equipment type, for example) will be more than repaid during the (often extended) life of the FMV lease, plus the asset's residual value at lease end. This investment profit motive of the lessor will not materially change under the new accounting standards. Moreover, many of lease financing's other benefits (such as portfolio refresh discipline, matching asset benefit to cost over time and elimination of residual value risk) will also remain under the new accounting standards.

Recommendations:

- If your organization has benefited from the lessor's equity investment in FMV leases, consider continuing such financing after the proposed new leasing standards take effect, despite having to capitalize the lease payments.
- Re-evaluate/update your financial "lease versus buy" models to accommodate the new accounting requirements and enable accurate, informed financing decisions.

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Acronym Key and Glossary Terms

capex	capital expenditure
FASB	Financial Accounting Standards Board
FMV	fair market value
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
ITAD	IT asset disposition
opex	operating expenditure
SaaS	software as a service
SEC	U.S. Securities and Exchange Commission
SOX	Sarbanes-Oxley Act

Gartner Recommended Reading

Some documents may not be available as part of your current Gartner subscription.

"2016 Planning Guide for Cloud Computing and Virtualization"

"Magic Quadrant for IT Asset Disposition, Worldwide"

"Minimize IT Financing Risk and Exploit Cost Optimization Opportunities Through Gartner's IT Financing "Framework"

"Reduce Costs and Extend the Life of Data Centers Using Server Refresh"

Evidence

[1] During the past 12 months, Gartner has received over 400 inquiries about lease financing.

[2] **International Accounting Standards Board (IASB):** IFRS 16: 13 January 2016:

- IASB Announcement of IFRS 16 (press release)
- IFRS 16: Project Summary and Feedback Statement
- IFRS 16: Fact Sheet
- IFRS 16: Effects Analysis

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Financial Accounting Standards Board (FASB): Accounting Standards Update (ASU): 25 February 2016:

- FASB Announcement of ASU (press release)
- FASB In Focus: Accounting Standards Update No. 2016-02, Leases (Topic 842)
- FASB ASU: Leases (Topic 842): Understanding Costs and Benefits

[3] The following are examples of industry estimates of global off-balance-sheet lease financing obligations:

- The most recent estimate came from International Accounting Standards Board's 13 January 2016 announcement of IFRS 16, in which it stated that "Listed companies using IFRS Standards or U.S. GAAP are estimated to have around US$3.3 trillion of lease commitments; over 85% of which do not appear on their balance sheets. Based on a sample of 30,000 listed companies using IFRS or U.S. GAAP, over 14,000 companies disclose information about off balance sheet leases in their 2014 annual reports. The future payments for off balance sheet leases for those companies totaled $2.9 trillion (on an undiscounted basis)."
- According to the Voice of Leasing and Automotive Rental in Europe, Annual Survey Leaseurope, April 2014, the total outstanding leasing market: €729.5 billion ($792.8 billion).
- The Economic Impact of the Current IASB and FASB Exposure Draft on Leases, February 2012, U.S. Chamber of Commerce, page 16: "… we estimate that IASB/FASB's proposed standard would increase the recognized liabilities of U.S. publicly traded companies by $1.5 trillion, or 1.2%. Real estate makes up $1.1 trillion of that figure."
- SEC SOX Off-Balance-Sheet Reporting, 2005, page 4: "… approximately $1.25 trillion in noncancelable future cash obligations committed under operating leases that are not recognized on issuer balance sheets, but are instead disclosed in the notes to the financial statements."

[4] Paragraph 7 of the FASB's Statement of Financial Accounting Standards No. 13 details four criteria for classifying a lease as operating (off-balance-sheet) or capital. If the lease meets any of the four criteria, it must be classified as a capital lease by the lessee.

For most IT equipment leases, the most problematic of the four criteria (7d) requires that the present value of the minimum lease payments be less than 90% of the asset's original value (typically, its purchase price). This means that the lessor typically must inject at least 10% of the asset's initial value — that is, its net purchase price — as its equity investment. This investment (plus any profit) must be extracted from the FMV resale of that asset at the end of the lease term (as well as from any intraterm changes to the original lease).

While this requirement will cease to exist under the new lease accounting standards, we believe IT equipment lessors (especially the financing arms of the original equipment manufacturers [OEMs]) will likely still invest equity into FMV lease financing.

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