Right of Use Lease Accounting:
Challenges & Opportunities of the New Lease Accounting Rules

MIDWEST ASSOCIATION OF RAIL SHIPPERS
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ALLTRANSTEK
knowledge to move ahead

For more information

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AllTranstek | about us

OUR CORE BUSINESS

AllTranstek is one of North America's largest railcar management and consulting companies, managing over 275,000 railcars. Our FLEET MANAGEMENT team serves over 200 unique customers, and manages some of the largest privately owned fleets.

SERVICE & SUPPORT

The TECHNICAL SERVICES group provides a full range of technical and operational support to the rail equipment supply chain. Services include field inspections, engineering, regulatory compliance (StencilWatch® and ShopWatch®), non-destructive testing (NDT), and a variety of training options.

PROVIDING INSIGHT

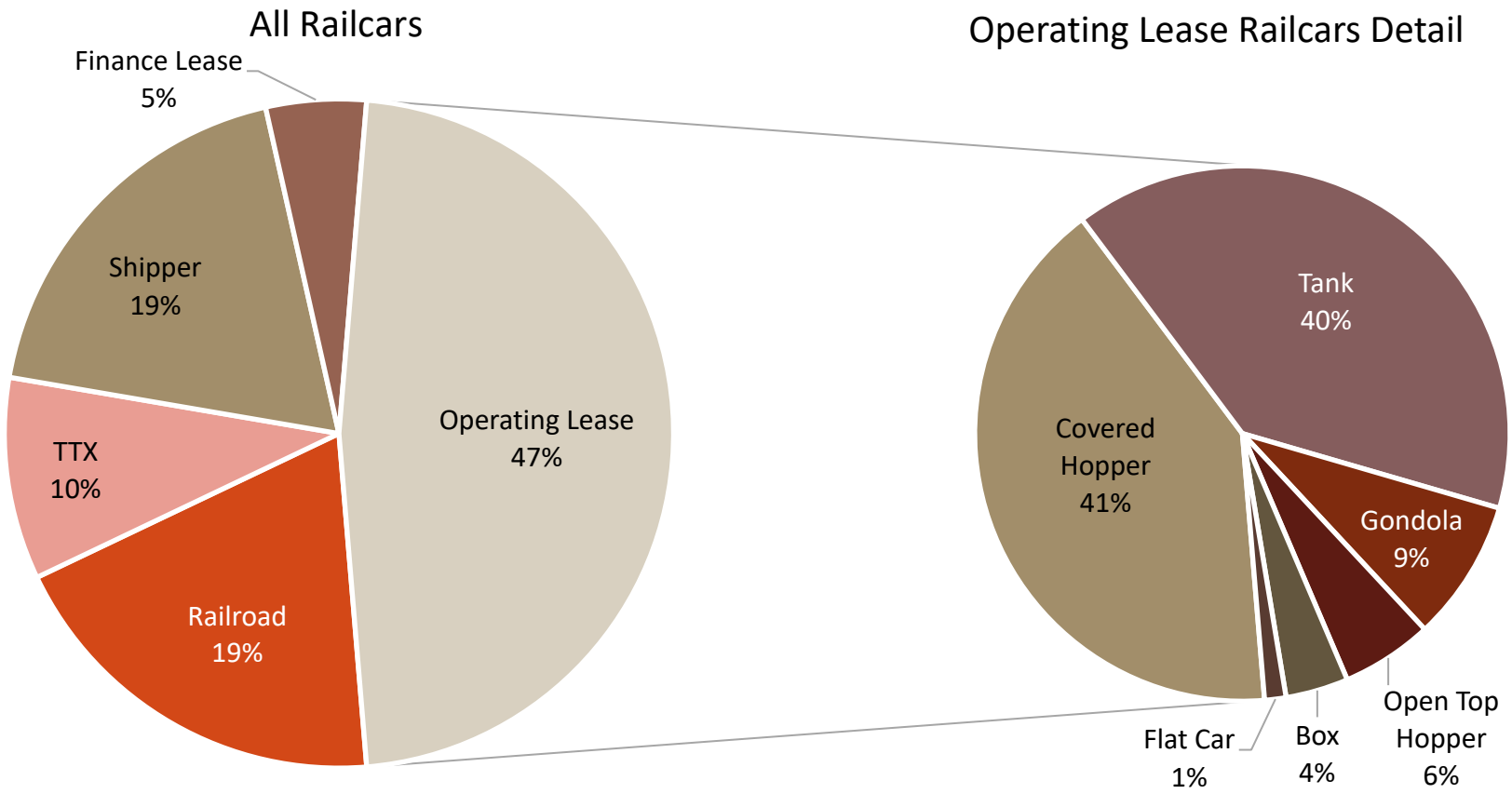
AllTranstek's STRATEGIC SERVICES group offers a 360° view of the rail supply chain in order to broaden our clients' view of the competitive marketplace via market research, analytics, forecasting, and strategic consulting services.

ALLTRANSTEK'S STAFF INCLUDES OVER 100 EMPLOYEES FOCUSED PRIMARILY ON RAILCAR MAINTENANCE AND TECHNICAL CONSULTING, AND HAS COLLECTIVE INDUSTRY EXPERIENCE OVER 1,500 YEARS

Q: What's ROU accounting?
A: All leases go on the balance sheet

- FASB 13 is gone.
- New accounting standard: ASC 842 and IFRS 16
- Adopt at January 1, 2019
  - All IFRS companies
  - Publicly traded US GAAP companies
- The new FASB standard affects all companies and organizations that lease property, plant, or equipment—"that is, land and/or depreciable assets." Leased assets covered by the FASB standard include airplanes, trucks, rail cars not in "car hire" contracts, cruise ships, and manufacturing and construction equipment…
- What's new: All leases with greater than one year term are capitalized on lessee company balance sheets.
  - IFRS: All leases are finance leases.
  - US GAAP: Leases are either finance leases or operating leases.
- What's new: All operating leases become Right of Use liabilities on lessee company balance sheets.
- Why this matters: operating lease liability is there for all to see!

ROU Accounting will impact 47% of N. A. railcar fleet



Source: UMLER, AllTranstek; Total population 1,662,949 railcars

The old accounting looks like this. . . .operating leases disclosed in Footnote 23 on page 123 of a 10K

23. Leases

We have operating leases for certain property and equipment under various noncancelable agreements, the most significant of which are rail car leases and barge tow charters for the distribution of our products. The rail car leases currently have minimum terms ranging from one to eleven years and the barge charter commitments range from approximately one to seven years. We also have terminal and warehouse storage agreements for our distribution system, some of which contain minimum throughput requirements. The storage agreements contain minimum terms generally ranging from one to five years and commonly contain automatic annual renewal provisions thereafter unless canceled by either party.

Future minimum payments under noncancelable operating leases with initial or remaining noncancelable lease terms in excess of one year as of December 31, 2017 are shown below.

	Operating Lease Payments
	(in millions)
2018	$ 83
2019	77
2020	57
2021	47
2022	36
Thereafter	76
	$ 376

Total rent expense for cancelable and noncancelable operating leases was $125 million for 2017, $111 million for 2016 and $100 million for 2015.

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- Leasing is easy
- Perhaps no budget authority required
- Some financial oversight
- No standard analysis of lease- adjusted financials
- Off balance sheet is a selling point!

Balance Sheet Impacts Old v. New

Old Rules

Consolidated Balance Sheets
Years Ended December 31, 2015 and 2014
(amounts in thousands)

ASSETS:	2015	2014
Current assets:		
Cash and cash equivalents	$ 5,500	$ 7,000
Short-term investments	15,000	17,000
Accounts receivable, net	3,500	7,000
Inventories	2,100	2,000
Prepaid expenses and other current assets	4,000	2,000
Total current assets	30,100	35,000
Investments	51,500	52,000
Property, plant, and equipment, net	11,000	14,000
Acquired intangible assets, net	3,400	4,000
Goodwill	5,500	5,500
Other non-current assets	1,050	950
Total assets	$ 102,550	$ 111,450
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current Liabilities:		
Accounts payable	$ 16,500	$ 18,500
Accrued liabilities	11,000	14,000
Deferred revenue	5,000	8,000
Total current liabilites	32,500	40,500
Deferred revenue, non-current	6,100	3,400
Other non-current liabilities	16,500	17,500
Total liabilities	55,100	61,400
Shareholders' equity:		
Common stock and additional paid-in capital	17,000	18,000
Accumulated other comprehensive income	950	1,050
Retained earnings	29,500	31,000
Total shareholders' equity	47,450	50,050
Total liabilities and shareholders' equity	$ 102,550	$ 111,450

See Accompanying Notes to Financial Statements

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New Rules

Consolidated Balance Sheets
Years Ended December 31, 2015 and 2014
(amounts in thousands)

ASSETS:	2015	2014
Current assets:		
Cash and cash equivalents	$ 3,500	$ 5,000
Short-term investments	15,000	17,000
Accounts receivable, net	3,500	7,000
Inventories	2,100	2,000
Prepaid expenses and other current assets	4,000	2,000
Total current assets	28,100	33,000
Investments	51,500	52,000
Property, plant, and equipment, net	11,000	14,000
Right-of-use asset, net	78,500	82,500
Acquired intangible assets, net	3,400	4,000
Goodwill	5,500	5,500
Other non-current assets	1,050	950
Total assets	$ 179,050	$ 191,950
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current Liabilities:		
Accounts payable	$ 16,500	$ 18,500
Accrued liabilities	11,000	14,000
Deferred revenue	5,000	8,000
Total current liabili	32,500	40,500
Lease liability	76,500	80,500
Deferred revenue, non-current	6,100	3,400
Other non-current liabilities	16,500	17,500
Total liabilities	131,600	141,900
Shareholders' equity:		
Common stock and additional paid-in capital	17,000	18,000
Accumulated other comprehensive income	950	1,050
Retained earnings	29,500	31,000
Total shareholders' equity	47,450	50,050
Total liabilities and shareholders' equity	$ 179,050	$ 191,950

Tot Liabilities up 2.38x

Balance Sheet 75% larger

Leases will be visible and have a big financial impact!

Source: GAAPology.com 11/15/16

We can't avoid it. . . here is some jargon used in the ASC 842 standard

- **Lease component** = the financing part of the lease payment
- **Non-lease component** = the maintenance and repair a/k/a service part of the lease payment
- **Observable standalone pricing**
- **Relative standalone pricing**
- **Practical expedient**

New accounting standards change the capitalization and treatment of operating leases

A LEASE IS A CONTRACT WHERIN ONE PARTY GIVES ANOTHER PARTY THE RIGHT TO POSSESS AND USE ITS PROPERTY OR EQUIPMENT FOR A TIME

FINANCE LEASE

- Lessee's purchase option likely to be used
- Transfer of ownership at end of term
- A term equal to major part of remaining economic life of the equipment
- PV of the lease payments equals or exceeds substantially FMV of equipment
- No "bright lines" unlike FASB 13

Very similar to old accounting standard for finance a/k/a capital leases

OPERATING LEASE

- Lease that does not meet any of the criteria for a finance lease
- Operating leases have not appeared on the balance sheet of the lessee; however, lease obligation was required to be disclosed as footnote to financial statements

Changed by new accounting standards

Operating leases with terms 12 months or longer will be reported on the balance sheet

In February 2016, the Financial Accounting Standards Board (FASB) issued ASC 842, a lease accounting standard replacing FASB 13, that takes effect Jan. 1, 2019, for publicly traded companies and Jan. 1, 2020, for private companies.

OPERATING LEASE

- Leases with terms greater than 12 months will be required to be capitalized and appear on balance sheet as right of use (ROU) liability
- FASB has stated that a ROU liability is not to be deemed debt.

"CFOs Fret About Loans on the Eve of New Accounting Rule" –WSJ 10/11/2018

WILL LENDERS WILL ADD ROU LIABILITIES TO THEIR CORPORATE DEBT-TO-EQUITY AND OTHER RISK RATIOS?

The Right of Use Liability and Right of Use Asset, Balance Sheet Impact

- **Required:** Every lease with 12 month + term will be recorded on the lessee's balance sheet as both an asset and a liability.

  Comment: *substance trumps form to determine the term*
  - *No rolling 11 month leases*
  - *If renewal is likely, the term is deemed the base term plus renewal term.*

- A ROU liability for lessee's lease obligation (measured at the present value of the future lease payments over the lease term.)

- An ROU asset for lessee's right to use the underlying asset equal to the lease liability, plus lease payments made at or before lease commencement, lease incentives, and other "initial direct costs."

  Comment: *ROU asset is expected to be greater than the ROU liability*

The Right of Use Liability and Right of Use Asset, P&L and Cash Impact

- No cash impact from new standard for either finance or operating leases.
- Finance Lease: 2 P&L impacts
  - Amortization Expense: annual straight line depreciation of ROU asset over the term reduces balance of ROU asset.
  - Rent Payment: allocated between Interest Expense and reduction in ROU liability.
  - *Comment: Interest Expense determined based on implicit interest rate of the lease.*
- Operating Lease: 1 P&L impact
  - Rental payment plus any initial direct cost (Str/L'ed) is equal to Lease Expense.
  - Rental payment is allocated between a) interest and b) "principal" (= rental payment minus interest). Principal reduces ROU liability over the term.
  - ROU asset is reduced by "amortization" (= Lease Expense minus interest).
  - *Comment: Interest determined based on implicit interest rate or Lessee's incremental borrowing rate (more likely).*

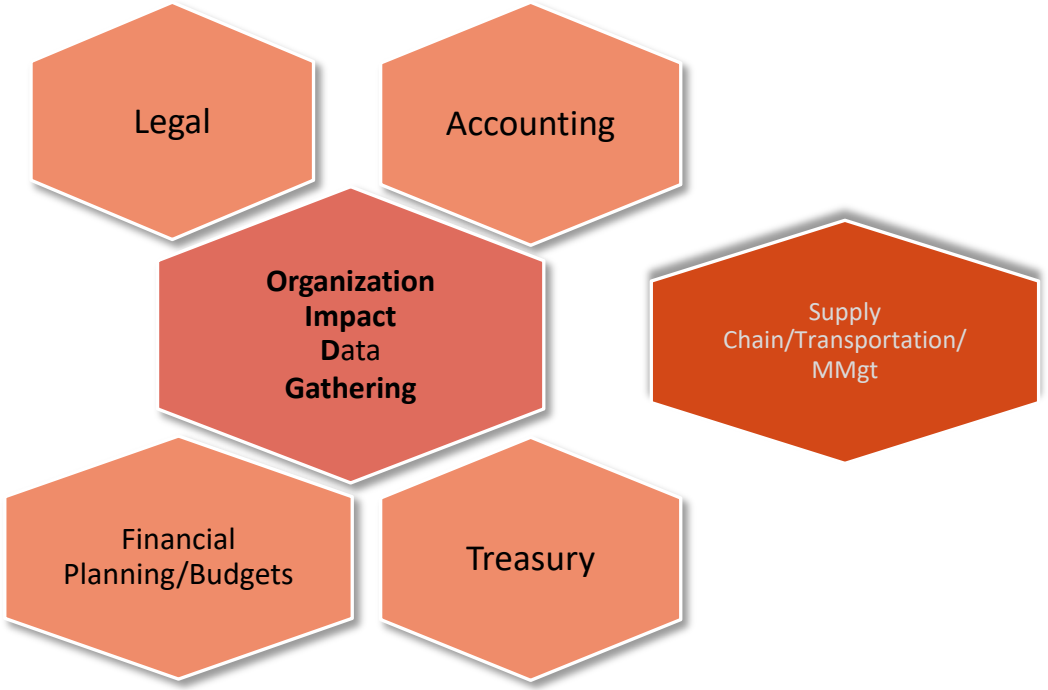
Implementing ROU Accounting. . .the Data Challenge

Data is required to answer these questions:

- Is this agreement a lease?
  - Data required: the agreement document and schedules and amendments and riders
- Who is the lessor?
- If it is a lease, is it a finance lease or an operating lease?
  - Data required: equipment cost at lease inception, remaining useful life of equipment, expected Fair Market Value at lease maturity
- Calculate the Right of Use Asset and Liability
  - Data required:
    - term of the lease; is the lease likely to be renewed?
    - What is the rent? How often is it paid? Advance or arrears?
    - is there a renewal term?
    - If there is a renewal term, is there a specified renewal rent?
    - What is the lessee's incremental borrowing rate? (this is the discount rate for the ROU calculation)

Where does this Data come from?

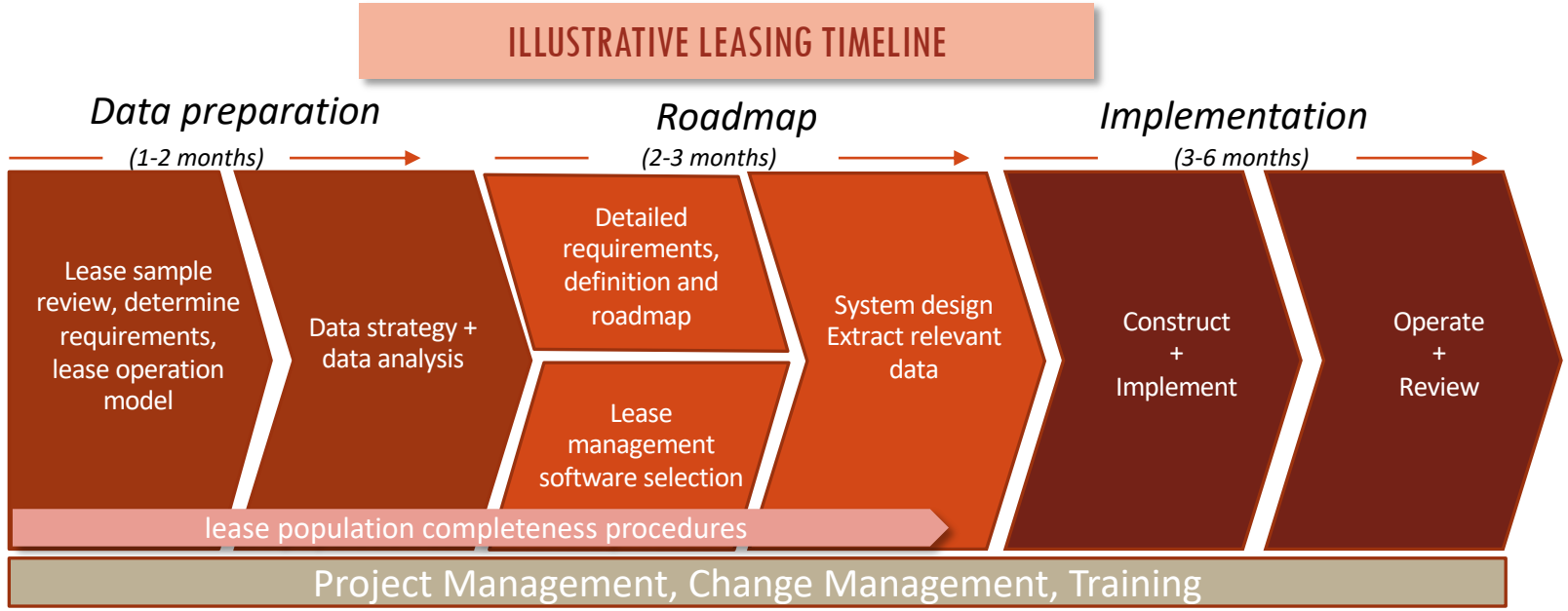
INTERNAL SOURCES



EXTERNAL SOURCES

Implementation Timeline: 6 to 11 months
Prepare, formalize, evaluate

Take action now and prepare	•Impact beyond accounting •Find hidden opportunities
Formalize task force	•Time •Effort
Evaluate	•Lease portfolio •Future system needs



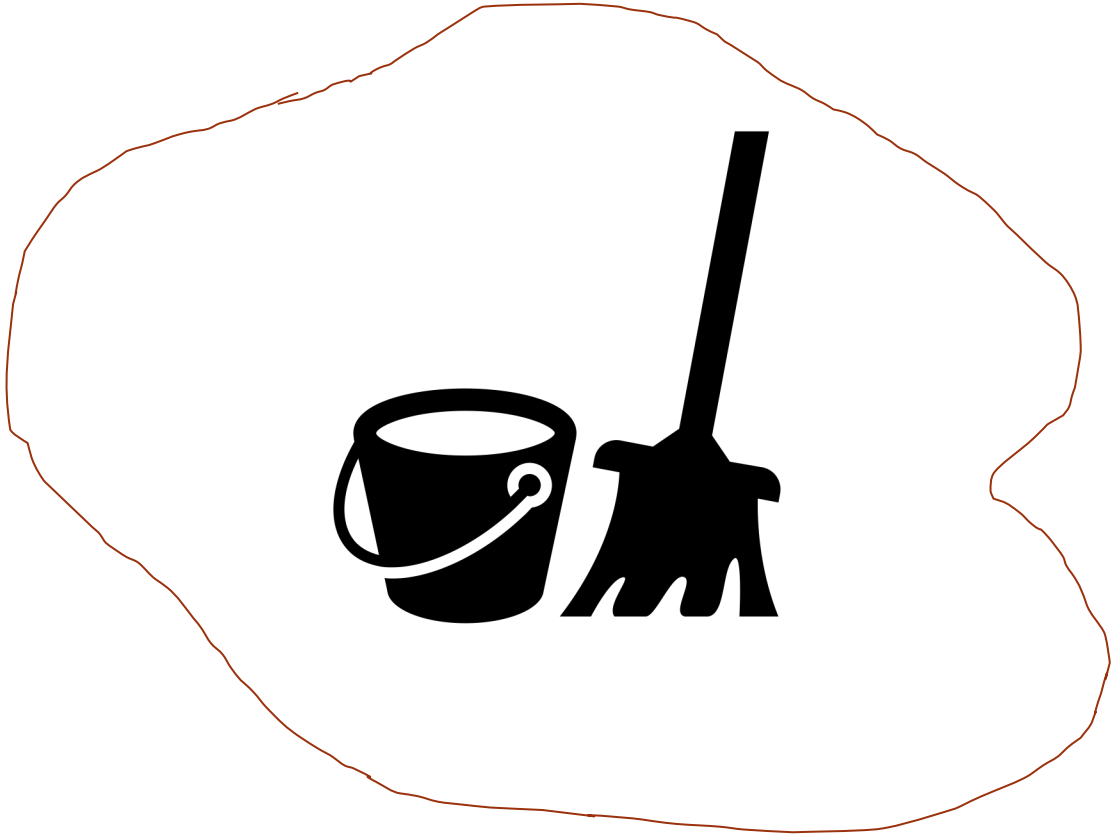
Source: PWC Lease Accounting Implementation

After the Data is gathered, then what?

- Acquire a lease accounting software package (use technology)
  - facilitate data gathering
  - to input the data gathered
  - make the ROU calculations
  - use the software to keep up to date
- Decide whether to use the practical expedient or separate the rent payment into the lease and non-lease component. Is it worth it?
- Be in compliance with the new ROU lease accounting standard

Are you going through and this effort and expense just to be in compliance with ASC 842 or IFRS 16?

- This is data driven drudgery right now (1/2019) or near future (1/2020)

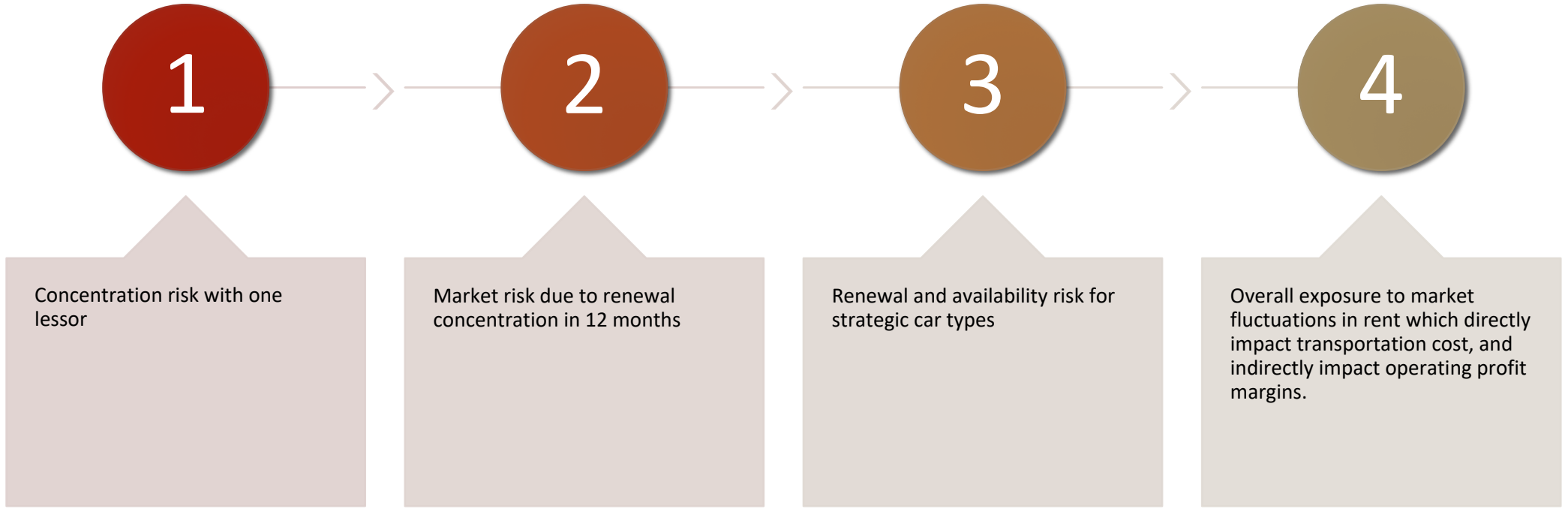


Let's do something with the data now that we've got it.

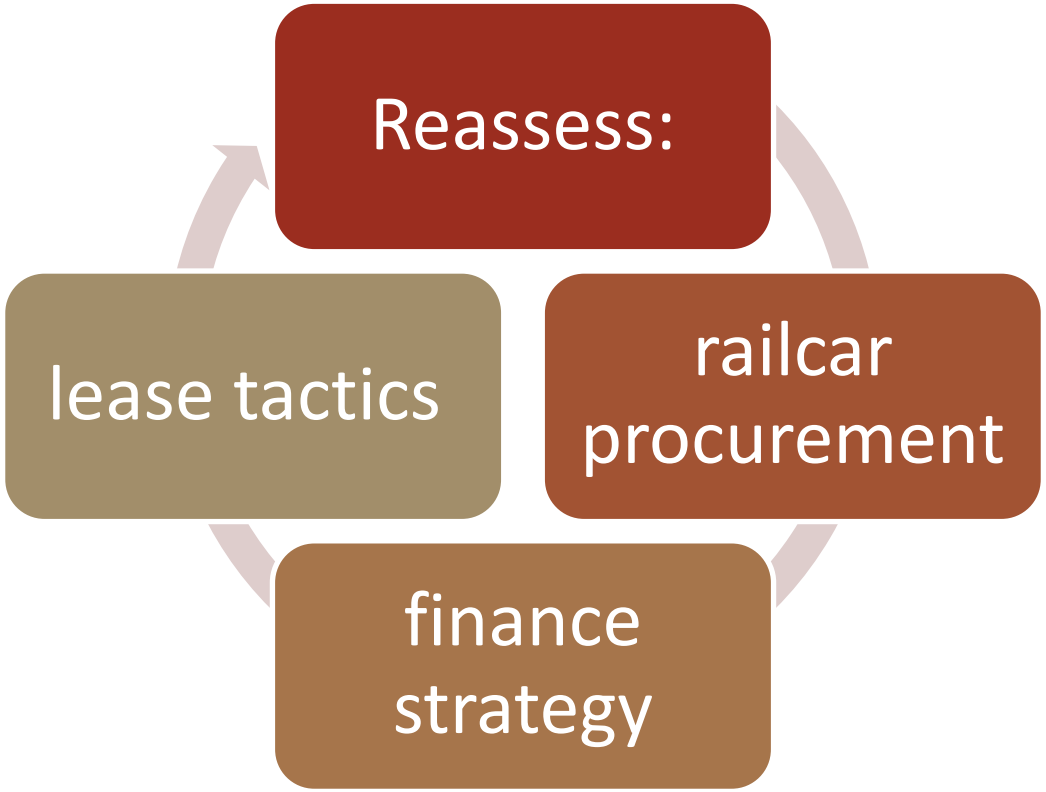
From data-driven drudgery to opportunity and exploitation

- Example:
  - Leased-in railcar fleet for a major shipper
  - Public company-- a statement of risk factors, operations, markets, etc. in the SEC filings
  - Transportation cost is a high percentage of the delivered cost of raw materials and the finished product.

- From the data gathered for the ROU Lease accounting project…risk analysis
  - Observations:
    - More than 50% of the leases with one lessor
    - More than 45% of the railcars' leases renew in the same 12 month period
    - Railcars identified in the SEC filings as strategically important to the company's business are not owned by it. They are leased, and thus not in the company's control.
    - The same railcars have been leased for years under multiple renewals.



So what are the risks?



Opportunity to mitigate risk

Lessee accounting for full service railcar leases. . . a typical full service lease

- Lessor provides railcars to lessee to be used (”controlled”) by lessee for the term of the lease subject to certain terms and conditions.
- Relevant terms and conditions:
  - Lessor pays for maintenance and repair expenses, subject to some exclusions.
  - Lessor can substitute a more or less identical railcar for another if the former is uneconomical to repair.
  - Lessor covers property taxes and insurance
  - Term of the lease is much less than the remaining useful of the railcars.
  - Lessee has no right to buy the railcars at any time.
  - Lessee pays fixed payment to lessor to use the railcars and for the services the lessor provides
- Is this a lease? **YES**
- Is this an operating lease? **MOST LIKELY, YES**

Challenges and opportunities for ROU accounting of full service leases

- **Opportunity:** Reduce the ROU impact on the balance sheet by determining the lease component and non-lease component.
- It is permitted to use only the lease component to calculate the ROU instead of the entire lease payment.

OR…

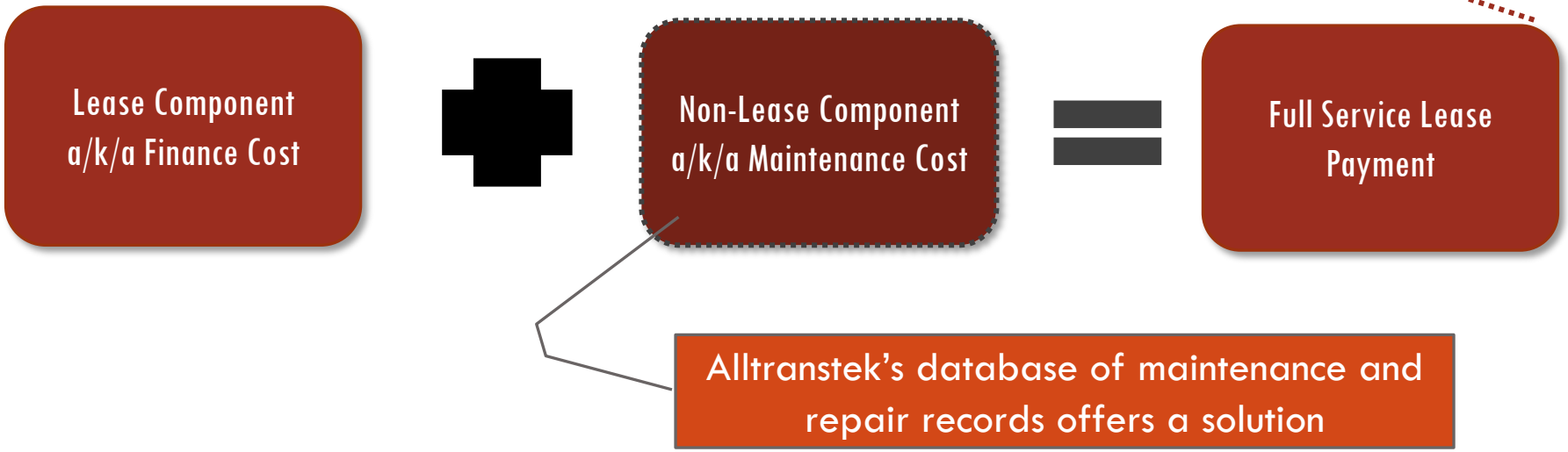
- Use the “practical expedient” and discount the entire lease payment to calculate the ROU.
- Your company’s financial and accounting policy drives the choice….but the choice has to apply to the whole “asset class.”
- In other words, to all your leased-in railcars

Challenges and Opportunities for ROU accounting of full service leases

- Challenge: **Determining the non-lease components**
- Property taxes and insurance paid by lessor are not relevant…this is deemed a cost of ownership independent from any lease. There are no goods or service transferred to the lessee.
- Maintenance and repair costs to keep the railcars in good order are relevant…this is the service component embedded in the full service lease payment. Service component of the rental payment is not a separately identified fee.
- Challenge: How to determine the service component if it is not disclosed?
- A solution?
  - Use the observable standalone selling price for maintenance and repair services for identical railcars.

How AllTranstek can help

FASB EXPECTS LESSEES TO MAKE THE ALLOCATION BETWEEN THE LEASE COMPONENT AND SERVICE COMPONENT OF THE LEASE TO MINIMIZE THE ROU LIABILITY. [Source: ASU 2016-02.BC150]



Sample AllTranstek-defined Car Type Segments

Carefully considered segments based on usage and volume capacity

Boxcar
Plate B Box Car
B, 50', 70t
B, other
Plate C Box Car
C/E, 50', 70t
C/E, 50', 100t
C/E, 60'
C/E, other
Plate F Box Car
F/G, 50'
F/G, 60'
F/G, 86'
Reefer/Insulated Box Car
Mechanical
Non-mechanical

Covered Hopper
Gravity Covered Hopper
Gravity Small (0-3300 cuf)
Gravity Medium (3301-4600 cuf)
Gravity Large (4601-5000 cuf)
Gravity Jumbo (5001-5500 cuf)
Gravity Super (> 5500 cuf)
Pneumatic Covered Hopper
Pneumatic Small (0-5500
Pneumatic Medium (550
Pneumatic Large (> 6000
Pressure Differential Cov
PD3 (0-4999 cuf)
PD5 (>=5000 cuf)
Specialty Covered Hoppe
Gravity-Pneumatic
Fluidized-Gravity
Fluidized-Pneumatic
Other

Flat Car
Flat Car
Bulkhead
Center-Beam
Gen Service & Other
Intermodal
Conventional
Low Profile

Gondola
Coal Gondolas
Aluminum Coal Gon
Steel Coal Gon
Hybrid Coal Gon
Steel Mill Gondolas
Mill Gondola
Coil Steel Gondola
Other Gondolas
Other Gon < 3000 Cuf
Covered Gondola
Other Gon 3001-6000 Cuf
Other Gon > 6000 Cuf
MOW Gondola
70T Gondola

Open Top Hopper
Coal Hopper
Aluminum Coal OTH
Steel Coal OTH
Hybrid Coal OTH
Other OTH
Ore OTH 0-2000 cuf
Aggregate OTH 2000-2400 cuf
Aggregate OTH 2401-3400 cuf
Medium Capacity OTH 3401-5000 cuf
Large Capacity OTH 5001-6000 cuf
High Capacity OTH > 6000 cuf
MOW

Tank Car
General Purpose
GP Small
GP 20k
GP 23.5k
GP 25.5k
GP Large
Pressure
PR Small
PR Medium
PR Large
Specialty
Acid
Rubber Lined
Stainless
Interior Coiled
Multi-Compartment
Aluminum
MOW

Age buckets

Commodity type

Caustic / non-caustic

High / low mileage

Proposed AllTranstek product that assists customers

Customer provides data:

- Car initial & number
- Car Type
- Lessor
- Date Built
- Lease Begin/End "Term"
- Gross Rent PCPM

AllTranstek Output:

- PCPM maintenance and repair expense
- AllTranstek data is based on actual repair events and prices
- *Aggregated* to standard fleet segments

AllTranstek has the maintenance data you need. . . .

AllTranstek can provide maintenance and repair data from its database with a few inputs

Client Input														AllTranstek Input		
Client Car Number	UMLER Car Number	Car Initial	Client Fleet Code	Lessor	Master Lease	Rider	Leased Start	Lease End	Rental Rate $PCPM	Car Type	Date Built	Capacity	Client Fleet Name	Major Car Type	Strategic Segment 1	Strategic Segment 2
AFRX216222	AFRX0000216222	AFRX	ABCD	Key Largo	CLNT00224	CLNT00224-2	1/1/17	12/31/27	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
AFRX216223	AFRX0000216223	AFRX	ABCD	Key Largo	CLNT00225	CLNT00224-3	1/1/17	1/1/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
AFRX216224	AFRX0000216224	AFRX	ABCD	Key Largo	CLNT00226	CLNT00224-4	1/1/17	1/2/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
AFRX216225	AFRX0000216225	AFRX	ABCD	Key Largo	CLNT00227	CLNT00224-5	1/1/17	1/3/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
AFRX216226	AFRX0000216226	AFRX	ABCD	Key Largo	CLNT00228	CLNT00224-6	1/1/17	1/4/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
AFRX216227	AFRX0000216227	AFRX	ABCD	Key Largo	CLNT00229	CLNT00224-7	1/1/17	1/5/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
AFRX216228	AFRX0000216228	AFRX	ABCD	Key Largo	CLNT00230	CLNT00224-8	1/1/17	1/6/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
AFRX216229	AFRX0000216229	AFRX	ABCD	Key Largo	CLNT00231	CLNT00224-9	1/1/17	1/7/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
AFRX216230	AFRX0000216230	AFRX	ABCD	Key Largo	CLNT00232	CLNT00224-10	1/1/17	1/8/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
AFRX216231	AFRX0000216231	AFRX	ABCD	Key Largo	CLNT00233	CLNT00224-11	1/1/17	1/9/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
WFRX116420	AFRX0000216232	AFRX	ABCD	Key Largo	CLNT00234	CLNT00224-12	1/1/17	1/10/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
WFRX116424	WFRX000011642	WFRX	ABCD	Key Largo	CLNT00235	CLNT00224-13	1/1/17	1/11/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
WFRX116450	WFRX000011645	WFRX	ABCD	Key Largo	CLNT00236	CLNT00224-14	1/1/17	1/12/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
WFRX116458	WFRX000011645	WFRX	ABCD	Key Largo	CLNT00237	CLNT00224-15	1/1/17	1/13/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small
WFRX116461	WFRX000011646	WFRX	SVTC	Key Largo	CLNT00238	CLNT00224-16	1/1/17	1/14/28	450	Tank Car	1990		Kryptonite	Tank Car	General Purpo	GP Small

- MAINTENANCE TRENDS AND COSTS
- 10 YEARS OF DATA
- BY CAR TYPE SEGMENT
- MILLIONS OF RECORDS

. . .data that has been assessed using statistical methods and practices

Estimated Maintenance Cost $PCPM (per car per month) — FOR ILLUSTRATIVE PURPOSES ONLY

	Open Top Hopper	Box Car		Tank Car	Covered Hopper										
	Other OTH	Plate C	Plate F	General Purpose	Gravity				Pneumatic		Pressure Differential		Specialty		
Age	Aggregate OTH	C/E, 60'	F/G, 60'	GP Small	Gravity Jumbo (5001-5500 cuf)	Gravity Large (4601-5000 cuf)	Gravity Small (0-3300 cuf)	Gravity Super (>5500 cuf)	Pneumatic Medium (5501-6000 cuf)	Pneumatic Small (0-5500 cuf)	PD3 (0-4999 cuf)	PD5 (>=5000 CUF)	Fluidized-Gravity	Gravity-Pneumatic	Other
0											$ 7.00				
1											$ -				
2											$ 11.00				
3							$ 2.00				$ 13.00				
4							$ 2.00				$ 14.00				
5							$ 3.00				$ 16.00				
6							$ 4.00								
7							$ 3.00								
8							$ 4.00								
9							$ 5.00								
10							$ 9.00								
11							$ 11.00								
12												$ 35.00			
13												$ 37.00			
14												$ 42.00			
15												$ 45.00			
16												$ 48.00			
17												$ 40.00			
18										$ 2.00		$ 40.00			
19										$ 3.00		$ 44.00			
20			$ 13.00	$ 25.00						$ 4.00		$ 43.00			
21			$ 14.00	$ 27.00	$ 49.00					$ 4.00	$ 17.00	$ 38.00			$ -
22			$ 11.00	$ 22.00	$ 41.00				$ 30.00		$ 16.00	$ 33.00			$ 1.00
23			$ 13.00	$ 25.00	$ 45.00	$ 4.00			$ 35.00		$ 21.00	$ 39.00			$ 2.00
24			$ 14.00	$ 27.00	$ 44.00	$ 6.00					$ 19.00	$ 33.00			
25			$ 14.00	$ 27.00		$ 8.00						$ 44.00			
26			$ 15.00	$ 30.00		$ 8.00			$ 34.00			$ 44.00			
27	$ 30.00		$ 14.00	$ 28.00		$ 11.00		$ 54.00	$ 32.00			$ 43.00		$ 25.00	
28	$ 31.00		$ 15.00	$ 29.00					$ 35.00		$ 25.00	$ 53.00			
29	$ 32.00		$ 17.00	$ 33.00					$ 39.00			$ 68.00			
30			$ 17.00	$ 34.00				$ 76.00	$ 41.00		$ 31.00	$ 67.00			$ 3.00
31									$ 42.00		$ 35.00	$ 72.00			$ 3.00
32												$ 90.00			$ 6.00
33									$ 50.00		$ 47.00	$ 97.00	$ 155.00		$ 8.00
34									$ 38.00		$ 34.00	$ 81.00	$ 137.00		
35									$ 48.00		$ 37.00	$ 103.00	$ 171.00		
36						$ 25.00					$ 29.00	$ 94.00	$ 172.00		
37						$ 28.00					$ 35.00	$ 101.00		$ 39.00	
38						$ 30.00				$ 7.00	$ 39.00	$ 103.00		$ 35.00	
39						$ 22.00				$ 4.00	$ 40.00	$ 99.00		$ 40.00	
40						$ 26.00				$ 7.00	$ 36.00	$ 113.00		$ 45.00	
41						$ 48.00				$ 19.00	$ 47.00	$ 89.00		$ 70.00	$ 5.00
42						$ 47.00				$ 17.00	$ 52.00	$ 86.00			$ 6.00
43						$ 58.00				$ 18.00	$ 58.00	$ 58.00			$ 10.00
44					$ 53.00	$ 48.00				$ 15.00	$ 30.00	$ 38.00			$ 7.00
45					$ 54.00					$ 16.00					
46										$ 17.00					
47															
48															
49						#N/A									

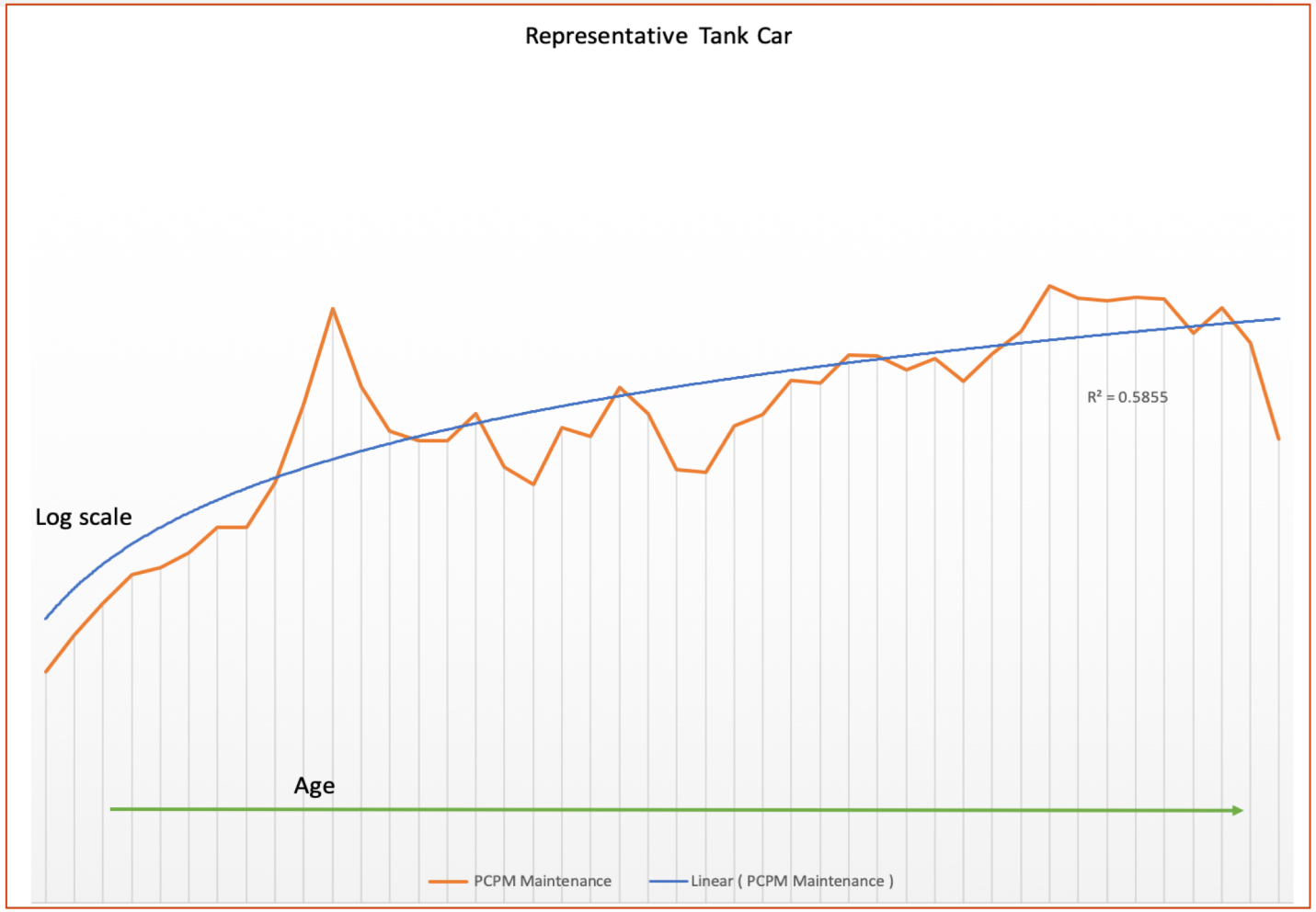
ILLUSTRATIVE

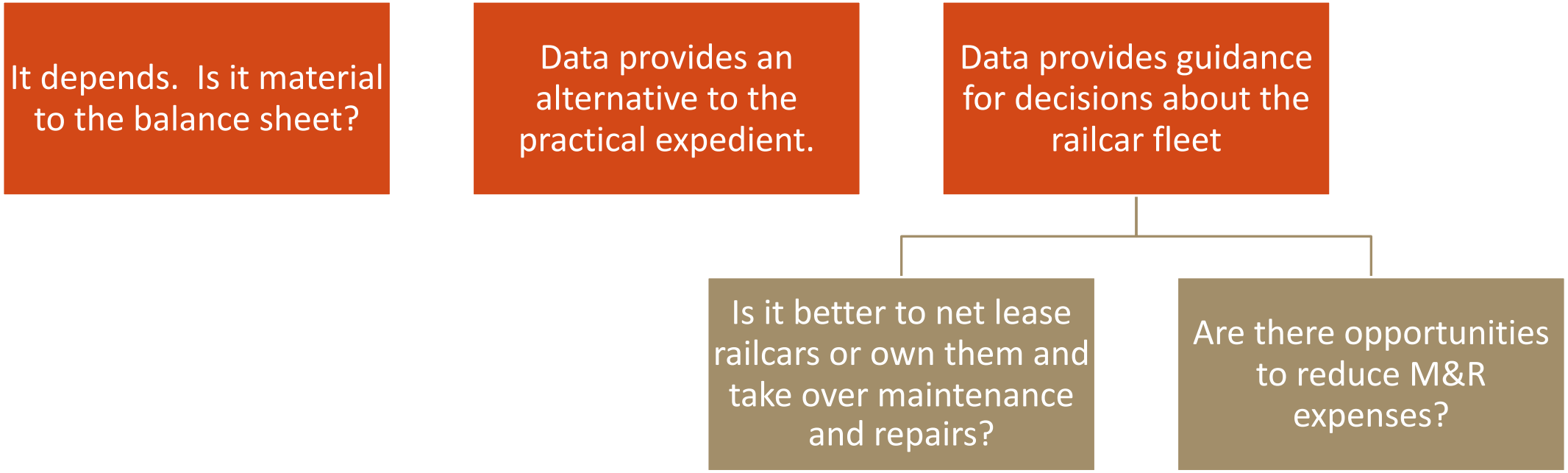
Note. Output report is in its conceptual stage and may vary from the illustration.

POTENTIAL USERS

- Accounting firm
- Lessee administrator
- Treasury department
- Railcar investor

Example: Estimated monthly non-lease component [M&R*] of full service lease





Is it worth the effort to avoid the practical expedient?

Hypothetical Full Service Lease – 500 Railcars

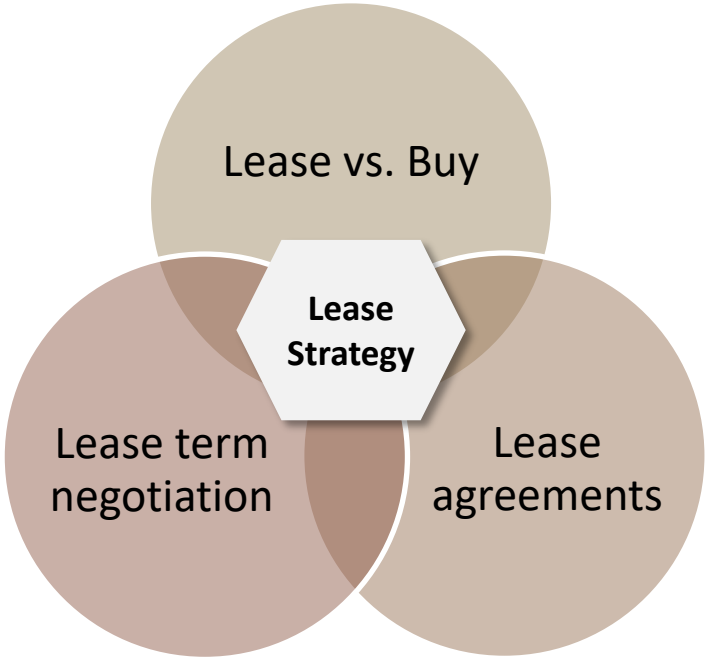
PRACTICAL EXPEDIENT

	Base Term	Renewal Term
Rent (Mo. in Adv.)	$650	$450
Term (Months)	48	36
Lease Component	$650	$450
Full Service Lease Payment/Yr	$ 325,000	
Total Cash Outflow:	$ 15,600,000	$ 8,100,000
Incremental Borrowing Rate/Annum	3.5%	3.5%
Base Term ROU Liability at Base Term Commencement	$14,579,884.65	
Renewal Term ROU Liability at Base Term Commencement	$6,696,319.86	
Total ROU Liability at Commencement	$21,276,204.51	

IDENTIFY NON-LEASE COMPONENTS

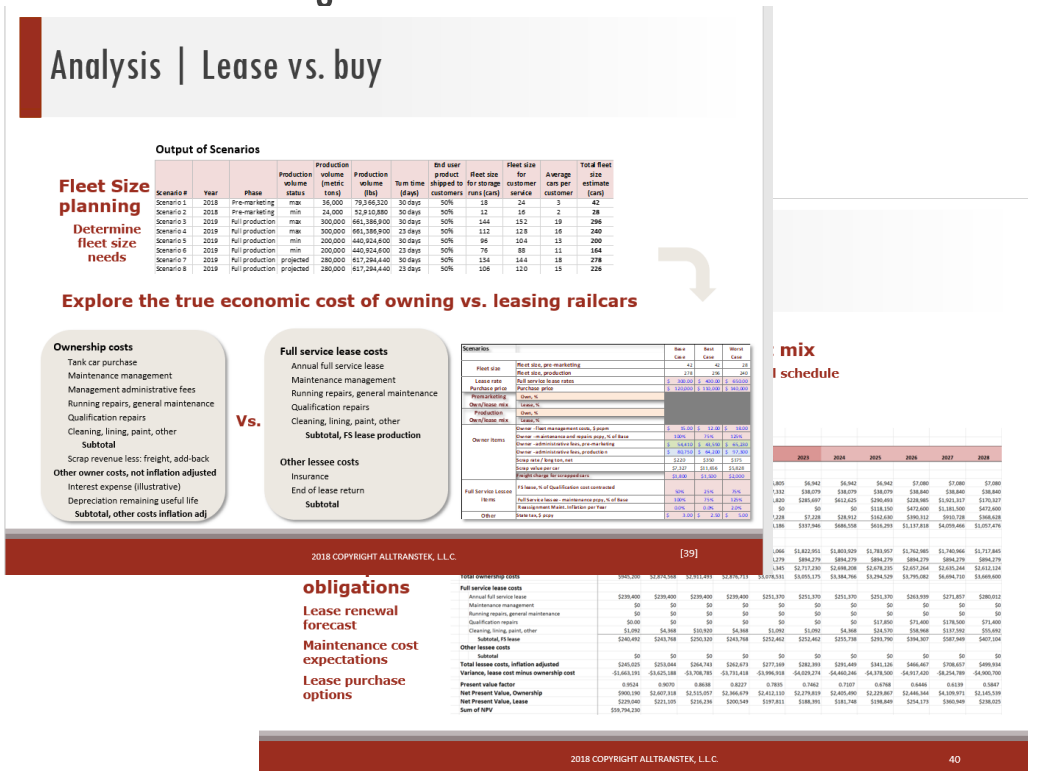
	Base Term	Renewal Term
Rent (Mo. in Adv.)	$650	$450
Term (Months)	48	36
Lease Component	$520	$328
Full Service Lease Payment/Yr	$ 325,000	
Total Cash Outflow:	$ 15,600,000	$ 8,100,000
Incremental Borrowing Rate/Annum	3.5%	3.5%
Base Term ROU Liability at Base Term Commencement	$11,663,907.72	
Renewal Term ROU Liability at Base Term Commencement	$4,882,733.23	
Total ROU Liability at Commencement	$16,546,640.95	

Implications | procurement and finance strategy envision the future



Strategic considerations

- Lease vs. buy evaluation
- Negotiation of contract terms
- Purchasing and divestiture



Some Comments

In My Opinion…

- Go beyond the drudgery of data gathering for accounting compliance purposes.
- ROU accounting data is available to assess and mitigate the risks to the lessee of its historical railcar leasing activity.
- M&R data is available to find opportunities to reduce the costs of the lessee's railcar fleet.
- Data is available to discuss of the number of railcars used and how they are procured.
- ROU accounting is a work in progress. How will the capital market will react? The new rules will change the financial appearance of companies. Will some try to restructure leases into service contracts?
- Leases soon to be visible on the balance sheet as ROU liabilities and assets will attract greater attention.
- Now armed with data that was ignored or not available before ROU, how much will the the behavior of market participants change?

Appendix

RIGHT OF USE LEASE ACCOUNTING:
CHALLENGES & OPPORTUNITIES OF THE NEW LEASE ACCOUNTING RULES

The rating agencies and ROU accounting

CURRENT LEASE ADJUSTMENT

- **S&P:** NPV of future lease commitments @ discount rate of 7% for all rated companies added to debt with P&L & cash flow statement adjustments
- **Moody's:** PV of lease commitment at a discount rate tied to lessee's credit rating, not less than a multiple of 3x–6x rent expense but not to exceed 10x the rent expense, added to debt
- **Fitch:** 8x multiple of total rent expense for companies in North America.

EXPECTED METHODOLOGY POST IFRS 16

- **S&P: IFRS 16** applying a discount rate attached to the cost of the lease or the company's borrowing rate instead of 7%
- **Moody's: IFRS 16** applying a discount rate attached to the cost of the lease or the company's borrowing rate.
- **Fitch:** If the use of long lived assets is core to operations, keeps the 8x multiple used today. For other lessees, Fitch is considering adopting the lease treatment as outlined in IFRS 16.

An example: 10 year operating lease
Lessee's Incremental Borrowing Rate = 6%

	Payment	"Principal"	"Interest"	"Amortization"	Lease Expense	ROU Liability	ROU Asset
	A	B=A-C	C	D=E-C	E	F	G
Initial Direct Costs	$ 10,000.00					$7,360,087.05	$7,370,087.05
Period 1	$ 1,000,000.00	$ 558,394.78	$441,605.22	$ 559,394.78	$ 1,001,000.00	$6,801,692.27	$6,810,692.27
Period 2	$ 1,000,000.00	$ 591,898.46	$408,101.54	$ 592,898.46	$ 1,001,000.00	$6,209,793.81	$6,217,793.81
Period 3	$ 1,000,000.00	$ 627,412.37	$372,587.63	$ 628,412.37	$ 1,001,000.00	$5,582,381.44	$5,589,381.44
Period 4	$ 1,000,000.00	$ 665,057.11	$334,942.89	$ 666,057.11	$ 1,001,000.00	$4,917,324.33	$4,923,324.33
Period 5	$ 1,000,000.00	$ 704,960.54	$295,039.46	$ 705,960.54	$ 1,001,000.00	$4,212,363.79	$4,217,363.79
Period 6	$ 1,000,000.00	$ 747,258.17	$252,741.83	$ 748,258.17	$ 1,001,000.00	$3,465,105.61	$3,469,105.61
Period 7	$ 1,000,000.00	$ 792,093.66	$207,906.34	$ 793,093.66	$ 1,001,000.00	$2,673,011.95	$2,676,011.95
Period 8	$ 1,000,000.00	$ 839,619.28	$160,380.72	$ 840,619.28	$ 1,001,000.00	$1,833,392.67	$1,835,392.67
Period 9	$ 1,000,000.00	$ 889,996.44	$110,003.56	$ 890,996.44	$ 1,001,000.00	$943,396.23	$944,396.23
Period 10	$ 1,000,000.00	$ 943,396.23	$56,603.77	$ 944,396.23	$ 1,001,000.00	$0.00	$0.00
Column F is reduced by periodic principal payment B							
Column G is reduced by periodic amortization accrual D							

An Example: Allocating the Full Service Lease Payment for 500 Railcars

Allocating Lease Components				
	Base Term Allocation:	Base Term Allocation:	Likely Renewal Term	Renewal Term Allocation
Term (Months)	48		36	
Full Service Lease Payment/Mo.	$ 650		$ 450	
Making the Allocation:				
Step I:				
Observable Standalone Selling Prices		Percent of Total		Percent of Total
"Lease Component"	$ 12,480,000	80%	$ 5,906,250	73%
"Service" (Mnt & Repair) Component	$ 3,000,000	19%	$ 2,109,375	26%
Other Expenses Component:	$ 120,000	1%	$ 84,375	1%
Standalone Prices over Term	$ 15,600,000	100.0%	$ 8,100,000	100.0%
Step 2:				
Relative Standalone Selling Prices:				
"Lease Component"	$ 520		$ 328	
"Service" (Mnt & Repair) Component	$ 125		$ 117	
Other Expenses Component:	$ 5		$ 5	
Allocated Full Service Lease Payment	$ 650		$ 450	