

LEASING 101

17 Lancaster Dr.
Suffern, NY 10901
Phone: 914-522-3233
Fax: 845-357-4113
wbleasing101@aol.com

Mr. Robert Herz
Chairman
FASB

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Sir David Tweedie
Chairman
IASB

Dear Sirs:

Thank you for the opportunity to comment on the Lease Exposure Draft (ED). I support the theory that operating lease obligations arising from material operating leases should be capitalized, but I disagree with several major elements in the ED. I agree with the alternative view expressed by Mr. Steve Cooper in the IASB ED with some additions.

I do not believe the proposed approach resolves the stated reasons why the lease accounting model is being re-written. The stated reasons are: "However, those models have been criticized for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions. In particular they omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the boards' conceptual framework. The models also lead to a lack of comparability and undue complexity because of the sharp 'bright-line' distinction between finance leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases."

Specifically, except for lessees capitalizing lease obligations that are true liabilities, the proposed rules distort the economic effect for both lessors and lessees, rather than faithfully presenting the effects of leases in financial statements. The estimated payments from renewals and contingent rents do not meet the definition of liabilities, resulting in far too much being capitalized. The requirement for both lessees and lessors to estimate payments will lead to a lack of symmetry between lessors and lessees in the same lease and a lack of comparability among lessors, as well as among lessees due to the lack of objective, reliable measures. The cited complexity in the existing rules is merely the one-time classification of a lease whereas the proposed rules make complexity a monthly event as estimates are made, and then adjusted, month

after month for large companies that report earnings monthly. For example, one company I worked with said that virtually all its estimates in its 13,000 real estate leases will be wrong one month after inception. Retaining risks-and-rewards-type classification criteria for lessor accounting seems to be retaining the complexity that is cited as a problem. Most users do adjust financials for the off-balance sheet operating lease obligations, but to a far lesser degree than the proposed rules. In many cases the proposed rules are a step backward regarding fair value. They create assets, liabilities, non cash front-ended lease costs, deferred tax assets and deferred revenue that will be confusing for users, and certainly do not reflect the economic bargain struck by a lessor and a lessee in the lease contract. This standard will create an extremely large charge to earnings by companies worldwide, especially when one looks at the cumulative effects of front ending costs for lessees.

The following is a summary of my main issues with the ED, and my detailed comments about lesser issues follow below.

Major Issue	Suggested Change to ED	Reason(s) for Change
Lessee lease cost pattern is front ended	Amortize the right of use (ROU) asset at the same rate as the debt amortization. Accrue rent payable at the average of cash paid for rent. Link the lease costs on the profit and loss statement (P&L). Label the cost as rent expense.	My proposed approach more faithfully presents the periodic costs for the usage of the leased asset; ROU asset and liability are inextricably linked; Unit of account is the contract, not its components; Proposed approach creates large, permanent charges to capital and deferred tax assets for going concerns. Elimination of rent expense creates cost reimbursement issues with regulations and contracts in effect based on existing GAAP.
Estimated renewals and contingent rents are not liabilities of the lessee at lease inception	Keep the current GAAP definition of the lease term and minimum lease payments and supplement with new principles that deal with contingent rents that are disguised minimum lease payments	Estimated renewals and contingent rents do not meet definitions of liabilities; Estimates are not reliable due to uncertainty and the long time between inception and the triggering contingent event date; P&L volatility is created due to frequent adjustments; Adds complexity, inflates balance sheets, exacerbates the front-end cost pattern, and creates comparability and

		symmetry issues; Current GAAP is more objective.
Lessee cash flow statement presentation	Rent payments should be operating cash outflows	Reflects the economic substance of an ROU lease.
Performance obligation (PO) method inconsistent with lessee ROU model	Discard the method except where the lessor performance risk is so great that it is likely the lessee will withhold rent payment	Derecognition is the only method that is symmetrical with the lessee ROU model in reflecting that the value of the ROU is transferred to the lessee.
Lessor classification criteria are not consistent with choosing which leases have significant lessor performance obligation risks	Use only the criterion “does the lessor have a PO that has a real risk that the lessor may not perform and the lessee will withhold rent payment”	Risks and rewards analysis is inappropriate since retaining risks does not mean that a lessor performance obligation exists; The criteria and decision processes are not crisp. If the value of the ROU has been transferred, and the lessor has delivered the asset, then the lessee controls the asset, and the ROU value should be derecognized.
Derecognition method does not allow residual asset to be accreted to its fair value	Use implicit rate in the lease to present value (PV) expected residual value and accrete residual over the term	Residual is an expected cash flow from the investment in the lease; It is not property, plant and equipment (PP&E); Fair value gives users best information

Specifically, I believe:

LESSEE ISSUES:

- Estimated renewal options, other than those that are bargains, create compulsion to exercise or create a penalty for failure to renew are not liabilities of the lessee at lease inception. They should not be capitalized because they do not meet the definition of a liability since the lessee controls the obligating event—that is the exercise of the option. This principle is used in the application of FAS 13 in the United States. The obligating event of a non-bargain renewal may occur in the future but it has not occurred at inception. The proposed front-ended lease cost model causes the current month reported lease cost to increase if a renewal is assumed, even if the renewal is assumed to occur years in the future. The revenues generated from the use of the leased asset in renewal periods are not reported in the same periods as the lease costs.

- Estimated contingent rents based on usage do not meet the definition of a liability because the lessee controls the obligating event—that is, the additional usage of the leased asset. The obligating event may occur in the future but it has not occurred at inception. The contingent rents based on usage in most equipment leases are not financial engineering tactics, but rather they are designed to protect the lessor’s residual. The proposed front-ended lease cost model causes the current month lease cost to increase if a usage based contingent rent is assumed, even if it is estimated to occur years in the future. The revenues generated from the use of the leased asset related to the contingency are not reported in the same periods as the lease costs.
- Contingent rents based on indexes such as the consumer price index (CPI), and contingent rents based on lessee performance such as sales, should be expensed when the contingent event occurs because estimates of these elements are not reliable. The longer the lease term, the less reliable are the estimates. The revenues generated from the use of the leased asset related to the contingency (like inflation from increases in CPI or sales increases) are not reported in the same periods as the lease costs.
- Contingent rents based on an interest rate index like LIBOR-based floating leases, in which the rent has a portion based on the prevailing LIBOR plus a spread, should not be subject to estimating future payments based on estimated forward rates. This is an unnecessary complication. The amounts capitalized using the spot rate method of calculation or the forward rates method of calculation would be the same. It is virtually assured that there will be changes in actual spot rates and estimates of the forward rates throughout the lease term. Additionally, the forward rates in a normal or steep yield curve environment will create an effective incremental borrowing rate that is likely to be artificially high. This will create more imputed interest expense than the likely actual amounts in the early portion of the lease term, exacerbating the front ending of lease costs. This standard is overly complex and the use of forward rates adds to the complexity. If this is not changed I suggest that detailed examples be included in the standard to guide lessees in to how to estimate interest rate-indexed lease payments and how to calculate and apply the floating incremental borrowing rate, both at inception and when estimates change. Floating rate leases are fairly common.
- Estimated contingent rents that are disguised minimum lease payments should be capitalized, as in the example of a retail real estate lease where the entire rent the lessee is obligated to pay during the base lease term is contingent based on a percentage of sales calculation. This is the driver for the proposed rule of capitalizing all contingent rents, that is, the fear that many leases would be structured with entirely contingent rents. Entirely contingent rents are extremely rare in my experience. I have only heard of their existence (again rare) in the retail real estate leasing industry. Third-party equipment lessors would never write an entirely contingent rent lease as it would create intolerable residual risk. Rather than writing a rule capitalizing all contingent rents, I suggest using a principle of only capitalizing base term

contingent rents that are disguised minimum lease rents. That is how current GAAP is applied in practice in the United States.

- Estimating renewals and contingent rents will create lack of symmetry between lessees and lessors in accounting for the same contract, as well as lack of comparability among lessors and lessees. Using the definitions in current GAAP that are based on objective and reliable measurements that would be consistently applied by all would result in comparability. For instance, determining whether a renewal is a bargain is often done by professional appraisers during the process of documenting the tax treatment of a lease. The estimation of possible renewals and contingent rents also becomes less reliable the longer the period of time involved. Also, the longer the lease term, the more exaggerated the front-end lease cost pattern. IAS 37 principles are not being followed in the capitalizing of estimated renewals and contingent rents. BC125 cites financial engineering as a reason for not following IAS 37, but writing a rule to subvert financial engineering versus developing principles creates the unintended consequence of capitalizing all contingent rents.
- Replacing rent expense with amortization and imputed interest expense will create issues with cost reimbursement in existing contracts and with existing government regulations. As an example, in the United States Medicare will reimburse hospitals for non-medical equipment rent expense but there is no reimbursement for amortization and imputed interest expense.
- The Boards concluded that a lessee is buying an intangible ROU and incurring a liability through the terms in the lease contract, But I think that a lease contract is unique in that the asset and liability are linked. In other transactions such as the acquisition of a building, the buyer negotiates the purchase with the seller and then separately borrows funds from a lender. The loan can be paid off separately while keeping the asset. When the loan is paid off the owner of the asset still has use of the asset. These facts support separate accounting for the asset and the liability whereas in a lease the asset and liability are linked hence the need for linked accounting to reflect that. The ROU asset should be amortized at the same rate as the capitalized lease liability, except for impairment and initial direct costs. This would recognize the accounting for the lease contract and not its components. Using straight line amortization of the ROU asset makes the lease contract appear to be “under water” immediately, since the book value of the asset amortizes more quickly than the liability. The Boards have decided that the unit of account is the contract, not its components. The asset and liability in a lease contract are inextricably linked. The Boards’ view at lease inception is that the best proxy for fair value of the asset and liability is the same (the PV of the lease payments). That relationship should hold true in subsequent accounting periods, absent impairment and initial direct costs, and would give the user of financials better information regarding the value of the lease contract on the balance sheet and costs in the P&L statement. The Boards’ decision to straight line amortize the leased asset distorts the balance sheet values and creates a front-ended cost pattern that increases in severity

the longer the lease term. I realize the IASB allows for revaluing of the ROU asset even if there is no observable market, but the FASB does not allow revaluing the ROU asset. This will allow IFRS lessee preparers to show 'better' accounting results for the same transaction than FAS preparers. The following table shows the front-ending effect of the proposed P&L pattern by lease term:

The Effect of Front Ending Lease Costs	
Lease Term	First Year Increase in Lease Cost – proposed rules vs. current GAAP
3 Years	7%
5 Years	11%
7 Years	16%
10 Years	21%
17 Years	26%

The proposed P&L pattern is a timing difference compared to current GAAP. Using footnoted operating lease payments from recent 10Ks for several selected large U.S. companies in business segments that tend to lease real estate and long lived equipment, the following table shows the cumulative front ending of lease expense, the year the timing difference turns around, the first-year increase in lease expense and the first year's percentage increase in lease cost over current GAAP:

Impact of Front-Ended Lease Cost for Selected Large US Companies (in \$ Millions)				
Company	Cumulative increase in lease cost vs. SL to turn around point	Year of turn around	1st yr increase in cost vs. SL	% in excess of SL cash expense in 1 st year
Walgreen's	<u>2,664</u>	10	<u>456</u>	<u>23</u>
CVS	1,500	9	330	19
Wal-Mart	838	8	194	17
Home Depot	581	9	125	16
Target	487	<u>15</u>	50	21
Sears	374	6	118	14
Kroger	323	6	112	14
Best Buy	275	6	127	12
Delta A/L	298	7	110	10
United A/L	303	7	149	11
Cont A/L	777	7	223	16
American A/L	498	7	146	15
US Air	624	7	285	11
FEDEX	632	7	211	12
BNSF	437	7	117	19
Bank America	913	6	305	13
JP Morgan	891	7	269	16
Citigroup	319	4	157	11
Exelon	98	9	21	16
AEP	178	7	55	18

The above table is based on footnoted operating lease payments under current GAAP and does not include estimates of renewals and contingent rents. The amounts, as is, are material but the actual numbers will be significantly higher. One bank on the list said they expected the number for expense increase to be twice as high as I calculated due to the proposed requirement to include likely renewals and contingent rents. The front-ended lease cost pattern will be exacerbated as new leases are added and will normalize only when the half life of the total portfolio of leases is reached. The twenty U.S. companies displayed above show a combined first-year pretax earnings reduction of \$3.6 billion and a cumulative reduction of \$13 billion, calculated on a conservative basis.

The impact of the combination of including estimated renewals and contingent rents, as well as front ending the cost pattern, has a particularly severe impact on common U.S. retail space leases. I calculated a typical example of a 10-year retail lease with four five-year renewal options, contingent rents based on increases in sales and CPI, and rent increases of 10 percent every five years. I made modest estimates of CPI (added 2 percent to CPI every five years) and sales increases (assumed sales increased 15 percent every five years). I assumed the location was strategic to the business so that it was likely, but not a compulsion issue, that the lease would be renewed for the full possible term of 30 years. The impact is displayed in the table below. First-year lease cost is 213 percent of current GAAP lease cost. The pattern is so distorted that there is negative amortization (imputed interest exceeds cash paid for rent) for the first 10 years. The cost timing difference turns around in year 17, at which point the cumulative reported lease cost is 153 percent of what current GAAP cost would be for the first 17 years of the lease. The estimates of contingent rents based on CPI and sales for year 30 increase reported costs in year one. Since the book cost is higher than the cash paid for rent there will be a very large deferred tax asset on the balance sheet that builds up in the first 17 years of the lease. All of this combined should be very confusing to a reader of financial statements.

Retail Lease Example					
		Total Current	ROU Accounting	Difference	ROU Cost as a %
year	total cash rents	GAAP rents	Lease Cost	Proposed vs. Current GAAP	Of Curr GAAP
1	\$30,000	\$31,500	\$67,234	(\$35,734)	213%
2	\$30,000	\$31,500	\$67,937	(\$36,437)	216%
3	\$30,000	\$31,500	\$68,683	(\$37,183)	218%
4	\$30,000	\$31,500	\$69,473	(\$37,973)	221%
5	\$30,000	\$31,500	\$70,311	(\$38,811)	223%
6	\$43,099	\$41,599	\$71,199	(\$29,600)	171%
7	\$43,099	\$41,599	\$71,534	(\$29,935)	172%
8	\$43,099	\$41,599	\$71,889	(\$30,290)	173%
9	\$43,099	\$41,599	\$72,266	(\$30,667)	174%
10	\$43,099	\$41,599	\$72,665	(\$31,066)	175%
11	\$56,227	\$56,227	\$73,089	(\$16,862)	130%
12	\$56,227	\$56,227	\$72,660	(\$16,433)	129%
13	\$56,227	\$56,227	\$72,205	(\$15,978)	128%
14	\$56,227	\$56,227	\$71,723	(\$15,496)	128%
15	\$56,227	\$56,227	\$71,212	(\$14,985)	127%
16	\$69,387	\$69,387	\$70,670	(\$1,283)	102%
17	\$69,387	\$69,387	\$69,306	\$81	100%
18	\$69,387	\$69,387	\$67,861	\$1,527	98%
19	\$69,387	\$69,387	\$66,328	\$3,059	96%
20	\$69,387	\$69,387	\$64,704	\$4,683	93%
21	\$82,585	\$82,585	\$62,982	\$19,602	76%
22	\$82,585	\$82,585	\$60,366	\$22,219	73%
23	\$82,585	\$82,585	\$57,592	\$24,993	70%
24	\$82,585	\$82,585	\$54,651	\$27,933	66%
25	\$82,585	\$82,585	\$51,535	\$31,050	62%
26	\$95,824	\$95,824	\$48,231	\$47,593	50%
27	\$95,824	\$95,824	\$43,935	\$51,890	46%
28	\$95,824	\$95,824	\$39,381	\$56,444	41%
29	\$95,824	\$95,824	\$34,553	\$61,271	36%
30	\$95,824	\$95,824	\$29,436	\$66,388	31%
total	\$1,885,610	\$1,885,610	\$1,885,610	\$0	
	cum thru turnaround	\$785,404	\$1,204,055	(\$418,652)	153%

Lessees do not mind the increases in rents caused by CPI and sales based contingent rents because they assume they will have increased cash and earnings from inflation-based price increases and increases in their sales at the point when their cash rent payment increases due to contingent rents. Under

current GAAP their cash receipts and sales revenue match the cash paid for rent and reported rent expense. That will no longer be the case due to the proposed front-ending P&L pattern of lease costs. In my opinion readers of financials expect to see rent expense in the P&L of lessees as an operating expense and expect the reported cost pattern to be straight-line. The reported cost of using a leased asset should not be different in the first month of a lease versus the last month of a lease as long as the asset is able to produce the same benefits.

If the lease in the above example is terminated after the first renewal in 15 years the lessee would have an "income event" of \$417,450 caused by reversing the cumulative front-ended lease cost. If the ROU asset had been amortized at the same rate as the capitalized lease obligation, the adjustment would have been lower. In addition, if contingent rents and renewals were accounted for when they became liabilities there would be no P&L impact on termination. This is a consequence of de-linking the accounting for the lease asset and liability in the lease contract (unit of account) and ignoring the legal realities and the economics of the transaction.

- Regarding short-term (ST) leases, in order to relieve lessees of the burden of accounting for short-term leases by capitalizing the undiscounted payments, I would preserve the operating lease method and only require accrual of an asset and liability for estimated undiscounted lease payments under ST leases whenever balance sheets are presented. Perhaps this is what the Boards intended, but it is not clear to me.
- The statement of cash flows treatment under the ED proposes to treat lease payments as financing activity. This is a major change since readers of financials are used to seeing rent paid as an operating cash outflow. Readers will have to search the footnotes to find out the amount of cash paid for rent.

LESSOR ISSUES:

- The PO method does not comply with the basic premise that an ROU has been transferred and the lessee is obligated to pay rent for the estimated term of the lease. If there is a lessor performance obligation that remains unfulfilled and its risk of performance is so high that it precludes the lessor from derecognizing the value of the asset transferred, then no receivable should be recorded by the lessor. Likewise the lessee should not capitalize the lease. The proposed method seems to be merely deferring revenue recognition without basis.
- The lessor PO versus derecognition lease classification criteria as proposed are not the indicators of when a lessor has a performance obligation. I recommend changing the criteria to one criterion: does the lessor have a performance obligation whose risk of non-performance is high so that it precludes derecognition of the value of the right to use the asset that has been transferred to the lessee? Paragraph BC14 does not explain why the Boards think a risks and rewards analysis is superior to a determination based on the presence of significant and risky performance obligations. I do

not think a relatively short lease term or relatively high residual indicates the lessor has a performance obligation. The classification indicators are not crisp and the unknown is how the accounting firms will interpret them and apply them. BC27 says “in most cases” the business model of the lessor will indicate whether the PO or derecognition method is appropriate. I suggest it should say “in all cases”, and I suggest moving the statement to the body of the ED as it seems to be the clearest and most logical classification guidance. There is a need for clarity.

- The derecognition or a modified derecognition method is appropriate for all leases. This is based on the basic premise that a lease transfers the value of the right to use an asset from the lessor to the lessee. The derecognition method as proposed is a step backward from the current direct finance method in that it does not account for the residual asset’s economic effects. The residual asset should be accreted. I agree with the idea that only part of the “sales-type” profit should be recognized up front in proportion to the value of the ROU transferred. I would defer recognition of the portion of the sales-type profit associated with the residual until the residual asset is sold or the leased asset is leased again.
- The residual asset is not PP&E, since it is not an asset the lessor uses or intends to use in its business; rather it is more like a financial asset. It is the expected cash flow from sale of the asset at lease expiry. In equipment leases, more often than not at the end of the lease, the asset is sold or leased again to the lessee or a third party.
- If leveraged lease (LL) accounting is eliminated it will mean assets and liabilities will be double counted in the financial system as the lessor will show a receivable as will the leveraged debt lender (the same receivable). An asset should be the asset of only one entity—the entity that enjoys the economic benefits of the asset. In the case of a leveraged lease that is the lender. In substance, the discounting of lease payments via a non-recourse loan is the same as the sale of a receivable as the lender controls the economic resource of the right to receive payments.
- Subleases should be accounted for under the derecognition method to avoid double counting of assets, and to record income where the value of the sublease rent receivable exceeds the value of the ROU asset. The principle is that the sublessor transferred something of value and the sublessee is obligated to pay rent for the term.

LESSOR/LESSEE ISSUES:

- Transition will be a huge undertaking for both lessees and lessors. For lessors it means re-booking every lease since none of the existing models survived from current GAAP, despite no evidence that there was a deficiency in financial reporting of lessor activities. The ED does not explain how existing leases should be tested for classification between PO or derecognition methods in transition. If the classification criteria are applied at the date of transition the remaining lease term is shorter versus the remaining life, and the residual is much larger as a percentage of the current book

value. This means that more leases may be classified as PO leases. This dilemma would be solved if the classification criteria were limited to just whether a performance obligation exists that has a high risk of failure to perform. I suggest that existing leveraged leases be allowed to be grandfathered. The leases were structured in good faith under current GAAP and grossing them up will distort returns, require additional capital and put assets on balance sheet that are not assets from which the lessor can get any economic benefit. I also suggest that current capital and finance leases be grandfathered for lessors and lessees if the reported results would not be materially different.

My Recommended Lease Accounting Model

I suggest a simpler standard that will accomplish capitalization of lease obligations, but will provide reliable measures and comparability among lessors and lessees and symmetry between the lessee and lessor. It will also provide users of financials with better, more useful information since it will portray the economic effects of lease transactions in the financials of lessors and lessees. My suggested lease accounting model, in keeping with many ideas included in Mr. Cooper's alternative view, is as follows:

Short Version of Lease Accounting Project:

Amend FAS 13 as follows:

Lessee Accounting:

- Scope out leases that are, in substance, financed purchases using the criteria the boards have developed
- Eliminate lease classification.
- All leases, except short term leases, are capitalized using the ROU concepts with exceptions detailed below. Short-term leases should continue to use the current operating lease accounting method with accrual of lease obligations outstanding when balance sheets are presented.
- Maintain definitions of minimum lease payments and lease term but add a principle as follows: "If the lease contains base term contingent rents that are disguised minimum lease payments, an estimate should be capitalized."
- Account for contingent rents only when the contingency occurs.
- Bifurcate the executory costs and capitalize only the lease portion of the payments.
- For subsequent accounting, amortize the asset and liability at the same rate and charge or credit rent expense. Accrue rent at the average of the minimum lease payments and charge cash rent paid to accrued expenses.
- For transactions in transition, grandfather existing finance/capital leases.

Lessor Accounting

- Eliminate lease classification.
- All but short-term leases are derecognized with a PV receivable and a PV residual recorded. Recognize interest income as the rents are collected.

Accrete the residual to its expected fair value at lease expiry. Record any gross profit and cost of sales on the portion of the ROU value transferred. Defer any gross profit on the residual portion of the leased asset retained by the lessor until the asset is sold or re-leased at expiry. Amortize initial direct costs.

- Leases where, at inception, the lease term is one year or less use the operating lease method. Leases with significant continuing performance obligations are short-term leases.
- Consider keeping leveraged lease accounting since the net rent is an asset of the lessor, not the gross rent. Control of the rent has been transferred to the lender.
- Use the same definitions of minimum lease payments as for lessees (see above).
- Use the implicit rate in the lease to PV rents and residuals in finance lease accounting. Where the implicit rate is not applicable (as in most real estate leases) use the lessee's incremental borrowing rate.
- For transactions in transition, grandfather existing finance and leveraged leases.

Sub Lease Accounting

- Use the derecognition method for the sublease, which will derecognize the ROU asset and book a receivable and residual. Where the sublessee assumes the sublessor's obligation to pay rent, remove the assets and liabilities from the sublessor's balance sheet.

Sale leaseback accounting

- Use the decisions made to date. That is, if there is no sale, account for the transaction as a financing; if there is a sale, derecognize the asset and use capital lease accounting recognizing a gain or loss. If the terms of the transaction are not market, adjust the gain or loss.

CONCLUSION:

In conclusion I would like to present my views regarding the impacts of the proposed rules change. I know the Boards' view historically has been that if the accounting is correct, the market impacts should not change the decisions. Unfortunately, accounting is not an exact science as is evidenced by the difficult deliberation process for this standard. I do think that there are many views, many principles and many methods the Boards have discussed and can apply and that all have logic. Mr. Cooper's alternative view or my alternative view would lessen the market impacts since in my opinion they more faithfully portray the effects of leases in financial statements. The following are my views on likely impacts:

- Banks
 - The lessee accounting rules will create capital needs as non-cash front-ended expenses erode retained earnings permanently with far too much being capitalized. Large deferred tax assets will be created that

attract 100 percent capital if the amounts exceed certain regulatory limits (I am told they will exceed regulatory limits due to the large deferred tax assets that exist from the current banking crisis) and intangible ROU assets will attract 100 percent capital.

- The lessor rules changes will gross up balance sheets for leveraged leases creating a capital need. The earnings patterns of derecognition, PO and leveraged leases will likely be back ended compared to current GAAP for direct finance and leveraged leases. Returns on assets (ROA) will deteriorate.
- Banks, as lessors, will likely raise lease rates to compensate for the poor pattern of revenues and ROAs in all leases, especially those that were formerly structured as leveraged leases. They will likely reduce their leasing activities resulting in tightening of available credit.
- Banks are still trying to build capital bases from the current crisis and this proposal will be further damaging.
- Captive finance companies and dealers
 - Much depends on the interpretation and implementation, but I see a risk that there will be many leases offered with lease terms shorter than the economic life of the underlying asset and with large residuals that will be classified as PO leases. This will occur even if there are no lessor performance obligations in the lease, or there is no undue risk in the lessor's performance obligations in the lease. This means no sales-type profit recognition.
 - Sales-type lease accounting allowed for a better pattern of revenue and tax deferrals on profits in the United States. This meant that lower lease rates could be charged by captives and dealers than third-party lessors. Lessees benefitted but that will not be the case under the proposed rules as there will be fewer sales-type lease profit opportunities.
 - Captives will be motivated to sell PO leases to third-party lessors who will charge higher rates.
- Gross real estate leases and bundled full service leases
 - Lessees will want to renegotiate leases to disclose or bifurcate the service portion of the payment, incurring legal expenses and staff time spent.
- Real estate leases
 - Lessees will be motivated to shorten lease terms creating business risk for them.
 - Lessors will be reluctant to shorten terms rent obligations are collateral for real estate project loans. The real estate lending market is in crisis and the proposed rules will drive collateral values down.
 - The compliance burden will require large staff expense to extract lease terms from existing leases, obtain estimates of renewal and contingent rents, make the calculations for transition and deal with the ongoing process for new leases. In most cases this will necessitate an IT project to build a system or the purchase of a system. Lease terms are

not standard so the system must be complex and the inputs will be extensive.

- Large ticket leases
 - The demise of the leveraged lease model will increase lessee costs.
 - Tax benefits that are part of new world-wide green energy asset initiatives and fiscal stimuli, such as accelerating tax write-offs, have traditionally been handled most efficiently through leveraged leases. Not only are the tax benefits transferred to a lessor who values them more efficiently than the lessee, but the reporting of the net investment at risk allows for a very price-effective product. That will be lost, and energy project and large ticket financing costs will be higher than under current GAAP.
- Financial impact
 - The reduced profit for lessees caused by increased lease costs will be large and confusing to readers. For Walgreen's, the largest U.S. lessee of operating leases, their 2009 pretax earnings were \$3.2 billion and using only their footnoted lease obligations, they will report a decline of \$456 million due to front ended non-cash lease costs. If you include the impact of renewals and contingent rent it is likely to triple that number and the result could be a decline in pretax earnings of close to 50 percent.
 - The changes in the balance sheet and earnings and cash flows statement are extensive, and measures and comparative analyses will need to be adjusted. Although the credit and equity ratings of companies should not change because of an accounting rules change that does not change cash flows, the extensive nature of the proposed changes will cause market confusion.

Lease contracts are unique and I would hope that the Boards redeliberate and move away from anti-financial engineering rules, complexity and delinking and move toward reflecting the economic effects of leases.

Sincerely,



William Bosco
Leasing 101
17 Lancaster Dr.
Suffern, NY 10901
Wbleasing101@aol.com
914-522-3233

Question 1: Lessees

(a) Yes, but I would use current GAAP definitions to define minimum lease payments. The proposed definition of lease payments to be capitalized includes payments that are not liabilities at inception of the lease. The current GAAP model with Big 4 accounting firm interpretations accomplishes the anti-financial engineering rules proposed in the ED.

(b) No. The ROU asset and lease liability are linked and the unit of account is the lease contract. The lessee should amortize the ROU asset at the same pace as the lease liability and the rent expense account should be charged and credited. Rent expense should be accrued at the average rent to be paid over the contract and actual cash paid for rent should be credited to accrued rent payable. This method would reflect the best estimate of the value of the lease contract on the balance sheet and show the cash and economic effects of the contract in the P&L. The asset and liability are inextricably linked and can't be settled separately. The choice of straight line amortization of the ROU asset causes the value of the lease to be "under water" immediately and that does not give users useful information about the balance sheet effects of a lease.

Question 2: Lessors

(a) No. The PO method should only be applied to leases where the lessor has a performance obligation where the risk that the lessor will not perform rises to a high level such that it is likely the lessee will withhold rent payment. Additionally, I believe that if that is the case, the lessee has an executory contract and should not capitalize payments it is not likely to make due to significant lessor performance risks. I think there should be lessor/lessee symmetry. The ED does not explain why it is appropriate that there is a lack of symmetry in PO leases.

(b) No. The PO method does not recognize that the value of the ROU has been transferred. Some believe there will be immediate impairment issues regarding the book value of the leased asset unless the prescribed depreciation method is straight line over the lease term to a salvage value equal to the expected residual value. As I and others read the ED, it requires depreciation of the leased asset to be over the useful life presumably to a zero salvage. The derecognition approach should include recording the residual at its present value using the implicit rate in the lease and accretion should be allowed. Most equipment leases are priced as an investment and the expected cash flows are from rent and the residual proceeds. Failing to recognize the fair value of a residual is a step backward from today's GAAP accounting for finance leases. The decision to present the net PO position on the balance sheet mitigates the problem of over reporting assets. The Boards should both agree that the P&L components of the PO method should be reported net since depreciation of the leased asset is a component of lease revenue, not an expense of PP&E as the leased asset is an investment not a use asset. The finance lease method is the only method that is consistent with the lessee ROU model.

Question 3: Short-term leases

a) I agree with the lessor accounting method but don't agree with the lessee method. I propose that the lessee use the current operating lease method but accrue any lease asset and obligation that exists on the balance sheet date and reverse it to open the new accounting period. This is much simpler than booking an ROU asset and a loan at inception for every short-term lease, yet it achieves the goal of reporting lease assets and liabilities when a balance sheet is presented. Perhaps this is what is intended, but it was not clear to me.

Definition of a lease**Question 4**

(a) Yes

(b) Yes. I think the reference to trivial should be dropped as it needs a definition and will be judgmental if not defined. All you need are the two criteria: bargain purchase option or automatic title transfer. This is simple and clear and certainly will cause leases that are in substance financed purchases to be accounted for as such.

(c) Yes.

Scope**Question 5: Scope exclusions**

All leases, regardless of the type of asset leased, should be in the scope.

Question 6: Contracts that contain service components and lease components

The front-ended lease cost pattern makes this a big issue. Also, bundled lease payments are a big issue in real estate leasing and full service equipment leases. If you revise the P&L lease cost pattern as I have suggested above, the bifurcation of executory costs becomes a non-issue as they would all be straight lined. I understand there are a large amount of real estate leases in the United States that are billed gross of executory costs. Lessees will be motivated to renegotiate them with landlords to avoid over-capitalizing and front-ended expense recognition. This will be a burden upon transition that could be alleviated if the P&L cost pattern for leases is reconsidered. I do agree that executory costs should be bifurcated using the ratio of the relative fair values of the components of the lease payment.

Question 7: Purchase options

Both lessees and lessors should account for purchase options when they are bargains or the lessee is compelled to buy.

Measurement**Question 8: Lease term**

Current GAAP and its interpretations by the Big 4 accounting firms should be left in place. The concept of including renewal terms that include periods where failure to renew would impose a penalty captures the financial engineering issues. "Likely" renewal payments do not meet the definition of a liability. Retaining the current GAAP definitions will promote symmetry and consistency since they are objectively measurable. The proposed model creates comparability and symmetry problems. It also exacerbates the front-ended cost pattern since the longer the lease, the more exaggerated the difference between cash paid for rent is compared to accounting lease cost. When lessees shorten their estimates of renewals it will create large income events, which is an indication that the accounting is not reflecting contractual or economic reality. The chosen straight line pattern of ROU asset amortization creates much of the distortion. Straight line amortization is far from the amortization pattern of the lease liability, yet the two are linked as part of the lease contract. If one must chose an amortization method, why not chose one that limits the accounting distortions and volatility when estimates change?

Question 9: Lease payments

I suggest that the current U.S. GAAP definition of minimum lease payments should be retained with the addition of the capitalization of contingent rents that are disguised minimum lease payments. Likely renewals and estimated contingent rents do not meet the definition of a liability.

Question 10: Reassessment

The current GAAP definition of lease term and lease payments should be retained. When a renewal is exercised, a contingent rent is triggered, or when a residual payment is likely under a residual guarantee, then and only then, should the amounts be accounted for.

Sale and leaseback

Question 11

Yes.

Presentation

Question 12: Statement of financial position

(a) I agree with lessee presentation. For subleases I think the derecognition method should be employed since the lessee has transferred a portion of its ROU asset.

(b) For lessor accounting I think the PO method is not compatible with the lessee ROU model. The only way to make up for its deficiencies is to present the components net on the asset side of the balance sheet and net in the P&L. Gross presentation distorts the effects of the lease in the lessor's financial statements.

(c) For the derecognition method I think the residual should be accreted and presented with the lease receivable as an investment in a lease. Residual assets are not PP&E.

(d) In my opinion the derecognition method should be used. In addition, if the sublessee relieves the sublessor of its obligations under the head lease, the lease obligation should be derecognized.

Question 13: Statement of comprehensive income

I think lessees should report rent expense in a linked presentation where the ROU asset and liability amortization are offsets to rent expense, and the average rent is accrued and cash paid for rent is charged to accrued rent. This reflects the economic effects of a lease.

In sublease transactions the income from the sublease should be netted against rent expense.

Lessors should use the derecognition method with accretion of the residual with sales-type revenue recognized in proportion to the value of the ROU transferred compared to the total value of the underlying asset. Any sale-type gain on the residual asset should be deferred.

Question 14: Statement of cash flows

Yes. I think rent paid is an operating cash outflow for lessees.

Disclosure

Question 15

Yes, except that the uncertainties and lack of reliability caused by estimating payments that do not meet the definitions of assets and liabilities create the need for huge amounts of numeric and verbal explanation. The longer the lease term, the less reliable and more uncertain the estimates.

Transition

Question 16

(a) The transition undertaking is huge for many lessees and all lessors. I suggest that lessee capital leases and lessor direct finance leases be grandfathered since the difference in recognition would be minor. I believe leveraged leases should be grandfathered since there are few companies that have them on the books, they were structured in good faith assuming current GAAP rules and they do faithfully reflect the economics to the lessor. If the front ending of lease costs was not an issue, the proposed approach is fine for lessees. Otherwise the proposed approach will cause a huge hit to P&L that grows until the half life of the portfolio is reached. Even a full restatement would not solve the front-ending issues for lessees since that would cause a permanent charge to retained earnings and a permanent deferred tax asset for going concerns.

(b) Yes, since it would lessen the charge to earnings but unfortunately would make the charge to retained earnings—that is just as onerous and does not reflect the economic effects of ROU leases. The charge to retained earnings is permanent for a going concern that continues to lease. The phenomenon also creates a large permanent deferred tax asset, further distorting the amount of assets of a lessee. Why should the reported cost of a lease be different in the first month of the lease than the last? The only reason I see is the choice of amortization method for the ROU asset that does not reflect the fact that the asset and liability are linked and the value of the contract should not be under water except for impairment. Straight line is an arbitrary mathematical formula. All amortization methods are imperfect, but I suggest you choose the method that results in the most faithful representation of the value of the lease contract and the logical reported costs pattern.

(c) See my answers above.

Benefits and costs

Question 17

No, the costs of compliance are too great. The small changes the Boards made to the Discussion Paper approach will not materially reduce the administrative burden imposed by the proposed rules. The idea that a lessee can determine the materiality of the result of changing estimates without doing all the work to calculate the impact of changed estimates is wrong. Once they have done the work to determine the size of the adjustment they might as well book it. I understand that the bank branch and retail real estate leasing community will have the toughest time in complying.

As far as the benefits, the only benefit I see is that lease obligations are capitalized. The amount capitalized is too great since non-liabilities are capitalized. The front ending of lease costs do not portray the economic effects of leases for lessees. The lessor models are not an improvement versus current GAAP.

Other comments

Question 18

None