IASB/FASB LEASE ACCOUNTING PROJECT EXPOSURE DRAFT: ISSUES AND IMPLICATIONS

The FASB and IASB issued the Exposure Draft ("ED") for the proposed Lease Accounting rule on August 17, 2010. The leasing industry has been following this project since 1995 when the G4+1 first proposed capitalisation of operating leases in a discussion paper.

At the time most leasing "experts" expected lessees to be capitalising operating leases using a rating agency capitalisation model. Capitalising lessee operating lease obligations was a stated objective of the new approach to lease accounting. The adjustments made by rating agencies and other users to the balance sheets of companies rating agencies was cited as a financial reporting deficiency. The basis of the new approach is the capitalisation of the rights and obligations in a lease rather than capitalising the leased asset contract itself as under current GAAP.

At the same time most leasing "experts" thought that lessor accounting would be symmetrical and follow the same concepts so that all but short-term leases would be accounting for as direct finance leases. This expected change in lessor accounting was viewed as an improvement by the equipment finance industry as operating lease accounting for lessors did not reflect the economics of most equipment leases. In summary there was some concern regarding the overall approach to lessee accounting but most stakeholders in the industry were accepting of the balance-sheet changes for the lessee and were looking forward to the possible lessor changes.

Bill Bosco, author of this article.

Over the past few years the project and the proposed lease accounting model have evolved in ways that I did not expect. For lessees the proposed rules capitalise far more than what the rating agencies currently consider and will also completely change the P&L and cash flow treatment of leases.

For lessors the proposed rules create several models that are not as transparent as the current GAAP direct finance method, or as straight-forward as the operating lease model, and create uncertainty as to which model to use. The proposed lessor accounting is not in many cases symmetrical with lessee accounting. In the process it appears the benefits of sales-type lease accounting will be reduced and leveraged lease accounting will be eliminated.

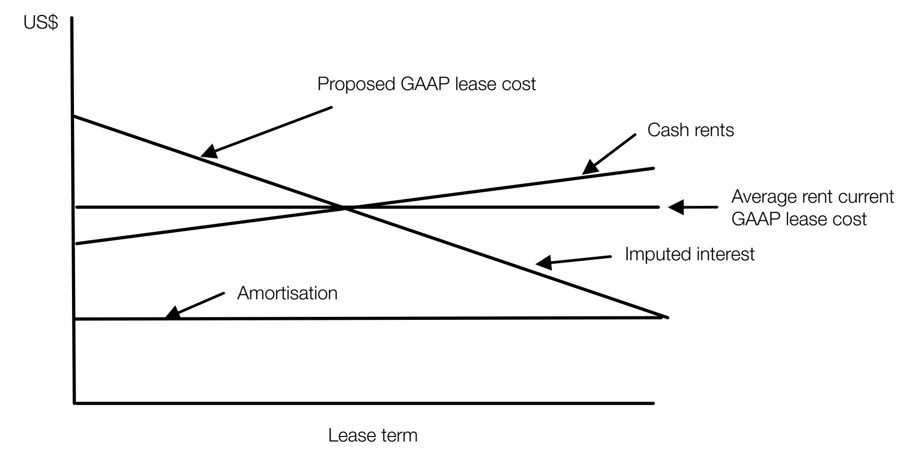
This article will explain the proposed lessee and lessor accounting rules and prognosticate as to the impacts based on what I have observed and heard and what I expect to happen.

Overview of proposed lease accounting rules. *Timing*. The Exposure Draft (ED) was issued with a four-month comment period. The comment period to the

Table 1: Expected timing of proposed lease accounting rules

Event	Expected timing
Issue Exposure Draft	August 17, 2010
End of comment period	December 15, 2010
Redeliberation of issues	First half 2011
Issue final new rule	Mid 2011
Implementation	No earlier than 2013

Table 2: Front-ended pattern



Exposure Draft ends on December 15, 2010. The FASB/IASB plan is to review comment letters and then redeliberate any changes to the ED in the first quarter of 2011.

If there are significant changes it is possible that a second exposure draft could be issued, but that rarely happens. If changes are not viewed as significant the actual final rule will be completed, voted on and issued by midyear 2011 without further solicitation of public comments. This is the normal track.

The effective date is likely to be no earlier than 2013 but it has not been decided at this point. Companies with calendar year ends will begin accounting for leases under the new rules in January of the year of the effective date.

Scope. The proposed lease accounting rule covers leases of property, plant and equipment (same as FAS 13). Leases that are the equivalent to financed purchases are excluded from the scope and are treated as a purchase and a loan obligation by the lessee and as a sale and loan receivable by the lessor.

The criteria to determine which leases are financing are limited to two factors – automatic transfer of title to the leased asset and the presence of a bargain purchase option. The project defines a lease as:

> A contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration and the contract conveys the right to control the use of the underlying asset.

Lessee accounting. The lessee accounting method is called the Right-Of-Use ("ROU") approach. The theory is that the lessee should account for its rights and obligations arising from the lease contract. So, we are accounting for the contract not the leased item. The contract is the unit of account, not its components (components of a lease contract being contractual rents, renewal and purchase options, contingent rents and residual guarantees).

For all leases, lessees will initially recognise an asset representing its right to use the leased item for the lease term (the right-of-use asset) and a liability for its obligation to pay rentals. The amount they will record will be the present value of the *estimated* lease payments discounted using the lessee's incremental borrowing rate, plus any initial direct costs incurred (the interest rate implicit in the lease can be used if it can be readily determinable).

The lessee will determine the most likely lease term considering any options to renew, and include the renewal payments in the estimated lease payments to be capitalised. Past behaviour in renewing leases, such as month-to-month renewals, is an indication that the lessee is more likely than not to renew for some period and will require including an estimate of month-to-month renewals in the payments to be capitalised.

It is important to note that the "most likely" threshold is low, being a likelihood of only more than 50%. This is a big change from the current definition of the lease term in GAAP.

Current US GAAP defines the lease term as the contractual lease term plus periods that include bargain renewals, renewals that precede a bargain purchase option or where the lessee is compelled to renew such as in cases where failure to renew imposes an economic penalty on the lessee.

Leasing services

Compass Capital Corporation
750 Battery Street, Suite 430, San Francisco, CA 94111-1523, US. Tel: +1 (415) 392 4900; Fax: +1 (415) 392 9142. President: Stephen C. Bieneman; Email: sbieneman@compasscapitalcorp.com; Executive Vice Presidents: Mark S. Maymar; Email: mmaymar@compasscapitalcorp.com; Ben J. Assaf; Email: bassaf@compasscapitalcorp.com.
Activities: International asset finance and management company specialising in the acquisition of capital equipment portfolios.

Connext Financial Ltd fka MTC Equipment Finance
101 W. Washington Street, Suite 1140 East, Indianapolis, IN 46204, US. Tel: +1 (317) 781 4682; Fax: +1 (317) 781 5698. President: Ken D. Wuethrich.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Constellation Financing Systems Corp.
5959 Central Avenue, Suite 103, St Petersburg, FL 33710, US. Tel: +1 (727) 381 7855; Fax: +1 (727) 381 6937; Email: sales@constellationfs.com; Website: www.constellationfs.com. Marketing, Account Manager: Jean Swantish.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Constellation Financing Systems Corp.
10701b Roosevelt Boulevard, Suite 600, Saint Petersburg, FL 33716, US. Tel: +1 (289) 291 4999; Fax: +1 (289) 291 4998. Business Development: Cha Loh.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Continental Bank
15 W. South Temple, Suite 420, Salt Lake City, UT 84101-1531, US. Tel: +1 (801) 595 7041; Fax: +1 (801) 595 7053. Chief Executive Officer: Nathan J. Morgan.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Cooley Godward Kronish LLP
101 California Street, 5th Floor, San Francisco, CA 94111-5800, US. Tel: +1 (415) 693 2136; Fax: +1 (415) 693 2222. Special Counsel: Barry A. Graynor.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Cooper, White & Cooper LLP
201 California Street, 17th Floor, San Francisco, CA 94111-5002, US. Tel: +1 (415) 433 1900; Fax: +1 (415) 433 5530. Partner: Barry A. Dubin, Esq.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Copernicus-USA, LLC
3522 Haldeman Creek Drive, Suite 114, Naples, FL 34112, US. Tel: +1 (239) 774 1419; Email: info@copernicus-usa.com; Website: www.copernicus-usa.com. President: Allen Jones; Email: allen.jones@copernicus-usa.com.
Activities: Authors of the Solar family of software products providing global instalment finance functionality, utilising latest web native technology throughout with integrated cell phone processing.

Copier Remarketing, LLC
540 Barnum Avenue, Bridgeport, CT 6608, US. Tel: +1 (203) 345 0250; Fax: +1 (203) 345 0252. Owner: Christopher J. Shay.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

CoreTech Leasing, Inc.
415 29th Street, Newport Beach, CA 92663, US. Tel: +1 (949) 723 2305; Fax: +1 (949) 723 2335; Email: smcfetters@coretechleasing.com. President: Scott McFetters.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Cornerstone Financial Advisors L.P.
Three Parkway North, Deerfield, IL 60015-2537, US. Tel: +1 (847) 444 1000; Fax: +1 (847) 444 1100. Managing Director: Mark Detrempe.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Corporate Leasing Associates, Inc.
100 N. Centre Ave, Suite 500, New York, NY 10038-3805, US. Tel: +1 (212) 732 5571; Fax: +1 (516) 596 6777; Email: elesnick@corplease.com. CEO: Eileen H. Lesnick.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Corporate Turnaround
95 Rt. 17 South Paramus, NJ 7652, US. Tel: +1 (201) 845 5400; Fax: +1 (201) 843 1240. VP, Business Development: Patrick McGahren.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

United States

Table 3: The effect of front-ending lease costs

Lease term	First-year increase in lease cost – proposed vs. current GAAP
5 years	12%
10 years	21%
15 years	26%
20 years	28%

The reason for the change is to combat financial engineering as the Boards imagine that lessors will offer short-term leases with renewal options but no penalty for termination. If one understands lessor risk positions and risk tolerance, this would be a rare occurrence. The requirement to estimate the lease term will be a compliance burden as every lease must be reviewed.

The lessee will also include in estimated lease payments any interim rents, estimated payments under contingent rent and residual guarantee provisions in the lease. It should be noted that the method for estimating contingent payments and residual guarantees is the probability-based weighted average method.

This measurement method is based on the theory that when the amount or timing of outflows of resources is uncertain, an entity should estimate their expected value, that is, estimate the probability-weighted average of the outflows for the range of possible outcomes.

The IASB, in other similar circumstances, has said that the expected value calculations need not be complex and that a limited number of discrete outcomes and probabilities can often provide a reasonable estimate. Although the expected value is unlikely to be equal to the amount that is ultimately paid, the IASB believes that it is a relevant measure for capital providers when assessing the effect of a liability on the value of their claims to the entity's resources.

The practical implications of this are enormous in real estate and vehicle leasing where many large companies will have to do thousands of these calculations as in many cases the need will be to do a lease-by-lease calculation (this is true for vehicle lease excess mileage charges and retail real estate contingent rents based on sales for the leased location).

Purchase options will be ignored unless they are bargains in which case the lease is a financed purchase and out of the scope. Disregarding non-bargain purchase options is an important new development and will reduce the amount capitalised for some leases with purchase options.

Current GAAP generally defines lease payments as the payments that the lessee is obligated to make, is compelled to make or can be required to make including the full amount of any residual guarantee, bargain renewal rents and bargain purchase options. This definition is drastically changed.

Estimated contingent rents and estimated non-bargain renewals would

Table 4: Impact of front-ended lease cost for selected large US companies (US$m)

Company	Cumulative increase in lease cost vs. SL to turn around point	Year of turn around	First-year increase in cost vs. SL	% in excess of SL cash expense in first year
Walgreen's	***2,664***	10	***456***	***23***
CVS	1,500	9	330	19
Wal-Mart	838	8	194	17
Home Depot	581	9	125	16
Target	487	***15***	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

Leasing services

Credential Leasing Corporation
PO Box 5967, Suite 2801, Harrisburg, PA 17110-0967, US. Tel: +1 (717) 255 7870; Fax: +1 (717) 255 7879; Email: info@credentialleasing.com. Controller: Alan C. Messner.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Creek View Consulting Group, LLC
597 Riverside Drive, Pasadena, MD 21122, US. Tel: +1 (410) 437 6168. Principal: John A. Hurt.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Creekridge Capital LLC
7808 Creekridge Circle, Suite 250, Edina, MN 55439-2611, US. Tel: +1 (952) 826 7890; Fax: +1 (952) 996 0271; Email: glarson@creekridgecapital.com. President: Mr Gregory E. Larson; Direct Tel: +1 (952) 826 7890.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Crossroads Equipment Lease & Finance LLC
9121 Haven Avenue, Suite 270, Rancho Cucamonga, CA 91730, US. Tel: +1 (909) 786 3040; Fax: +1 (909) 945 0279. VPO: John W. Wales.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Crowe & Dunlevy, P.C. - Aviation Law Group
20 North Broadway, Suite 1800, Oklahoma City, OK 73102-8273, US. Tel: +1 (405) 235 7700; Fax: +1 (405) 239 6651; Email: avlaw@crowedunlevy.com. Directors: Preston G. Gaddis II; J. Robert Kalsu; Will E. Van Egmond; Jeffrey T. Hills; Julia S. Dittberner.
Activities: Providing legal advice since 1960 on matters involving the FAA and the International Registry established under the Cape Town Treaty.

CSA Financial Corp
343 Commercial Street, #109 Union Wharf, Boston, MA 02109, US. Tel: +1 (617) 357 1700; Fax: +1 (617) 357 1720. President: J. Frank Keohane; Vice President: Mark M. McGovern.
Activities: CSA is one of the largest independent equipment lessors for financing new and used capital equipment. Offices also in London and Dublin. Has acquired large portfolios from banks, lessors and other investors.

CSI Leasing, Inc.
9990 Old Olive Street Road, Saint Louis, MO 63141-5904, US. Tel: +1 (314) 810 8830; Fax: +1 (314) 997 7844. President & COO: Stephen G. Hamilton.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

CT Lien Solutions
111 8th Avenue, 13th Floor, New York, NY 10011, US. Tel: +1 (212) 894 8602; Fax: +1 (713) 831 9891. Director of Marketing: Michelle Rowley.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

CTR Executive Search
PO Box 80512, Rancho Santa Margarita, CA 92688, US. Tel: +1 (949) 858 5400; Fax: +1 (949) 858 5401. Principal: William H. Rowe.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Cypress Financial Corporation
Bayside Plaza, 188 The Embarcadero, Suite 420, San Francisco, CA 94105, US. Tel: +1 (415) 281 3024; Fax: +1 (415) 281 3021. President: Stephen R. Harwood.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Daimler Financial Services
36455 Corporate Dr., Farmington Hills, MI 48331, US. Tel: +1 (248) 991 6638; Fax: +1 (248) 991 9459; Email: kenneth.casper@daimler.com. President & CEO: Kenneth Casper.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Daimler Financial Services
1011 Warrenville Road, Lisle, IL 60532-0903, US. Tel: +1 (630) 435 6615; Fax: +1 (630) 434 2982. Operations Manager: David B. Kohout.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Daimler Financial Services
PO Box 901, Rosston, TX 76263-0901, US. Tel: +1 (630) 435 6615; Fax: +1 (630) 434 2982. Vice President: Richard Howard.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Table 5: Derecognition method

Years lease	0	1	2	3	4	5
Lease receivable	932	773	602	416	216	0
Residual	68	68	68	68	68	–
Total assets	**1,000**	**841**	**670**	**484**	**284**	**0**
Lease revenue		75	62	48	33	17
Residual gain						32
Lease income		75	62	48	33	49
Interest expense		35	29	23	17	10
Pre-tax income		40	32	25	16	39
Taxes		16	13	10	7	16
After-tax income		24	19	15	10	24
Return on assets		2.37%	2.31%	2.21%	2.03%	8.29%

increase the amounts included while only considering the likely amount due under a residual guarantee would reduce the amount included.

As a result of the change to the definition of lease payments the amount of lease liability the lessee will record may be significantly greater than their fixed liability to the lessor and the lessee will be capitalising far more than the rating agencies do when they evaluate the credit rating of companies. In cases where there are interim rents and a history of renewing leases, lessees may find the capitalised amount is equal to or even greater than the cost of the equipment.

The real issue here is that contingent rents and non-bargain renewals do not meet the IASB/FASB definition of a liability at inception. A liability must result from a past event and must be legally enforceable.

For leases with services like full service leases, the lessee should bifurcate the service portion and account for the services as an executory contract (recognise the costs in P&L as the services are performed – generally straight-line expensing). If the lessee cannot determine the breakdown of lease payment vs. service payment the *full* payment must be capitalised.

Of course it will be in the best interest of the lessee for the lessor to disclose the service portion if the lessee cannot make that determination from other sources. If the cost of services is not bifurcated the amount capitalised is likely to exceed the cost of the leased asset.

Under current GAAP this is not an issue as most full service leases would meet the definition of an operating lease for the "lease" component of the payment. In that case the payments are treated as executory and generally would have a straight-line expense pattern as typical for any executory contract.

For subsequent accounting, lessees will amortise the ROU asset as they would an intangible asset. That method will be straight-line over the lease term. The expense will be labelled in the P&L statement as amortisation rather than as rental expense.

Subsequent accounting for the lessee's obligation to pay rentals would be to amortise the obligation using the effective interest method (mortgage or sinking fund amortisation). The rent payment will be accounted for as if it was a loan payment with an interest and an amortisation of "principal" component.

Rent expense under FAS 13 is straight lined (the average of the minimum lease payments) in the P&L statement while the proposed method front ends lease expense as the reported lease cost will be the sum of the asset amortisation and the imputed interest on the lease obligation. This will cause lessees to report higher costs in the first half of the lease term followed by lower costs in the last half of the lease term, which is generally contrary to the economic flows in a lease contract.

Since the IRS tax accounting policy of allowing deduction of the cash paid for rent will not change, the lessee will have to record a large deferred tax asset, further ballooning the assets on the balance sheet. The deferred tax accounting adds to the complexity.

The front-ended pattern is best illustrated as in Table 2.

The increase in lease costs is exacerbated the longer the lease term. The effect of increased first-year lease costs by lease term can be seen in Table 3.

Given the reporting impacts of the proposal and that it does not reflect the

Table 6: Performance obligation method

Years	0	1	2	3	4	5
Leased asset	1,000	820	640	460	280	–
Lease receivable	932	773	602	416	216	0
Perf. obligation	(932)	(746)	(559)	(373)	(186)	–
Total assets	**1,000**	**847**	**683**	**503**	**310**	**0**
Lease revenue		186	186	186	186	186
Interest income		75	62	48	33	17
Residual gain						100
Lease income		261	248	235	220	304
Interest expense		35	30	24	18	11
Depreciation expense		180	180	180	180	280
Pre-tax income		46	39	31	22	13
Taxes		18	15	12	9	5
After-tax income		28	23	18	13	8
Return on assets		2.76%	2.73%	2.69%	2.63%	2.49%

economics of lease contracts, it is surprising that few lessees commented to the FASB/IASB on the Lease Project Discussion Paper issued in March 2009. By my count there were only 10 retail company comment letters among the 302 comment letters received.

Among the reasons for lack of response are: they feel the proposal is a *fait accompli*, they do not fully understand the implications and they have no staff to follow and comment on new proposals. There are strong arguments for a different approach to the amortisation of the leased asset and against the proposed definition of lease payments; unfortunately, a few comment letters gave the FASB/IASB an implied confirmation of their proposed accounting.

The ELFA (US Equipment Leasing and Finance Association) has tried to raise lessee awareness through articles, direct mail contact, organised lessee and trade association meetings and webinars. The reaction has been slow but is growing as more companies delve into the details of the accounting using examples of specific leases.

Table 4 provides an analysis of the impact on reported lease cost for some of the largest companies in the US.

Table 4 is based on footnoted operating lease payments under current GAAP and does not include estimates of renewals and contingent rents. The amounts as they stand 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 normalise only when the half life of the total portfolio of leases is reached. The 20 US companies displayed in Table 4 show a combined first-year pretax earnings "hit" of US$3.6bn and a cumulative "hit" of US$13bn calculated on a conservative basis.

The lease term would be reassessed at each reporting date as well as estimated payments regarding contingent rents and residual guarantees. This will be a significant burden for lessees. The FASB/IASB believe they gave lessees relief by stating that detailed examination of every lease would not be required unless there is a change in facts or circumstances that indicates that the lease term or estimated rents may need to be revised. In practice a company with significant amounts of leases will not be able to make this materiality determination unless they review all leases and accumulate the impact of the adjustment. Once this detail is accumulated, they will frequently book the adjustment.

Any change to the obligation to pay rentals resulting from a reassessment of the lease term would be recorded as an adjustment to the right-of-use asset. Changes to contingent rents and residual guarantees will be split between current expense for the current period portion of the adjustment and the right-of-use asset for the future period portion of the adjustment. The lessee's discount rate should not be revised when there are subsequent changes in the estimated lease payments.

In the statement of cash flows, the imputed interest expense on the capitalised lease obligation will be a deduction from operating cash flows and the imputed principal repayments will be a

Table 7: Direct finance lease (DFL) method

Years	0	1	2	3	4	5
Lease receivable	1,167	934	700	467	233	–
Residual	100	100	100	100	100	–
Unearned income	(267)	(187)	(119)	(65)	(25)	(0)
Total assets	**1,000**	**847**	**681**	**502**	**308**	**0**
Lease revenue		80	68	54	40	25
Residual gain						0
Lease income		80	68	54	40	25
Interest expense		35	30	24	18	11
Pre-tax income		45	38	31	23	14
Taxes		18	15	12	9	6
After-tax income		27	23	18	14	8
Return on assets		2.70%	2.70%	2.70%	2.70%	2.70%

deduction in financing activities cash flows. The cash paid for rent will not appear in the cash flows statement or elsewhere on the face of the financial statements.

Since that information would be only disclosed in the notes to the financial statements analysts will have to continue to search in the footnotes to find out the amount of cash paid for rents. It will also mean that certain measures of cash flows from operations will now improve as rent expense will not be considered an operating cash outflow.

In other cases, particularly for certain long-term leases, there will be a negative amortisation as imputed interest may exceed the amount of cash paid for rent, further confusing analysts and readers of financial statements when they try to determine the impact of leasing activities.

I have interviewed analysts, and their general position is they need to understand the accounting so that they can make adjustments for purposes of their analysis. In my opinion they will still have to make adjustments for leases despite the accounting changes in the ED.

The proposed treatment of leases also means that leases will be capital budget items as opposed to operating budget items.

Lessee disclosures will include much of the same information as under FAS 13 but will necessarily include breakdowns and explanations of the estimated amounts of contingent rents, renewals and residual guarantees that have been capitalised but may in fact not be paid. This is necessary because the proposal drastically increases the amounts capitalised by including estimates that are not actual liabilities.

In my opinion it would be better to disclose in the footnotes the possible future payments under options and contingent rent provisions in a lease rather than include them in the amounts capitalised on the balance sheet.

To transition to the new rules, lessees will have to book all leases that are outstanding on the date of initial application of the proposed new leases guidance, except for capital/finance leases with no options, contingent rents or residual guarantees.

Table 8: Operating lease method

Years	0	1	2	3	4	5
Leased asset	1,000	820	640	460	280	–
Total assets	**1,000**	**820**	**640**	**460**	**280**	**–**
Rent income		233	233	233	233	233
Residual gain						100
Lease income		233	233	233	233	333
Depreciation		180	180	180	180	280
Interest expense		35	29	22	16	10
Pre-tax income		18	25	31	37	44
Taxes		7	10	12	15	17
After-tax income		11	15	19	22	26
Return on assets		0.30%	0.51%	0.85%	1.51%	4.67%

Leasing services

Dougherty Equipment Finance LLC
90 A. Seventh Street, Suite 4300, Minneapolis, MN 55402-3903, US. Tel: +1 (612) 376 4005; Fax: +1 (612) 317 2045; Email: aweingart@doughertymarkets.com. Senior Vice President: Alan R. Weingart.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Dover Management Group, Inc.
PO Box 238, Dover, MA 02030-0238, US. Tel: +1 (508) 785 1277; Fax: +1 (508) 785 3008. President: Christopher J. Condon.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Doyle & Bachman LLP
4350 N. Fairfax Drive, Suite 420, Arlington, VA 22203-1637, US. Tel: +1 (703) 248 3386; Fax: +1 (703) 465 5593. Partner: James D. Bachman.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Dressler & Peters, LLC
111 W. Washington, Suite 1900, Chicago, IL 60602, US. Tel: +1 (312) 602 7362.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Dykema & Gossett Plc
1300 Eye Street NW, Suite 300, West Tower, Washington, DC 20005-3306, US. Tel: +1 (202) 906 8656; Fax: +1 (202) 906 8669; Email: egroobert@dykema.com. Partner & Secretary for ELFA: Edward A. Groobert.

Dynamic Funding, Inc.
1 Inverness Drive East, Englewood, CO 80112, US. Tel: +1 (303) 754 2038; Fax: +1 (303) 754 2007; Website: www.dynamicfundinginc.com. Contact: James T. Tarbell; Email: tarbell@dynamicfundinginc.com.
Activities: Leasing services. Member of the NAELB, NEFA.

Eckert Seamens Cherin & Mellott LLC
1717 Pennsylvania Avenue, NW., 12th Floor, Washington DC 20006, US. Tel: +1 (202) 659 6600; Fax: +1 (202) 659 6699; Email: twhalen@eckertseamens.com. Partners: Thomas J. Whalen; Direct Tel: +1 (202) 659 6621; Email: twhalen@eckertseamans.com; Evelyn D. Sahr; Email: esahr@eckertseamens.com.
Activities: Provide legal advice to airlines and other sellers, lessors and purchasers of aircraft in financing, sales or leasing transactions and export trade matters.

Ecologic Leasing Services
726 Forest Park Road, Suite 100, Great Falls, VA 22066, US. Tel: +1 (703) 791 1930; Fax: +1 (703) 562 6991; Email: sales@ecologicleasing.com; Website: www.ecologicleasing.com. CEO & President: Michael J. Keeler; Direct Tel: +1 (703) 791 1931; Email: keeler@ecologicleasing.com; CFO: Angela Sabella; Direct Tel: +1 (703) 791 1936; Email: asabella@ecologicleasing.com.
Activities: Provider of outsourcing services and software services to equipment lessees.

ECS Financial Services, Inc
18108 Poplar Grove Road, Poplar Grove, IL 61065, US. Tel: +1 (847) 291 1333; Fax: +1 (847) 291 1190; Website: www.ecsfinancial.com. Principal: Shari L. Lipski, CLP.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

ECS Financial Services, Inc.
3400 Dundee Road, Suite 180, Northbrook, IL 60062, US. Tel: +1 (847) 291 1333; Fax: +1 (847) 291 1190; Website: www.ecsfinancial.com. Partners: Nancy A. Geary, CPA, CLP; Jay W. Dahl, CPA, CLP.
Activities: Member of the IEF, AICPA, NAELB and ELFA.

Edson Financial Inc
2701 E. Imperial Highway, Brea, CA 92821-6713, US. Tel: +1 (714) 986 3980; Email: nrocco@edsonfinancial.com. President: Nicholas Rocco.

Edwards Angell Palmer & Dodge, LLP
2800 Financial Plaza, Providence, RI, 02903-2407, US. Tel: +1 (401) 276 6452; Fax: +1 (888) 325 9038. Associate: John J. Rogers.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Edwin E Huddleson, III, Esq.
1250 Connecticut Avenue, NW. Suite #200, Washington, DC 20036, US. Tel: +1 (202) 543 2233; Fax: +1 (202) 783 7678; Email: huddlesone@aol.com; Website: www.edwinhuddleson.com. Chief Executive: Edwin E. Huddleson, III.
Activities: Wide-ranging legal experience structuring equipment leases and leasing programs, including TRAC vehicle lease for commercial motor vehicle fleet lessors.

Table 9: Reasons for leasing after new rules are implemented

Reason for leasing	Details	Status after new rules implemented
Raise capital	Additional capital source, 100% financing, fixed rate, level payments	Still a major benefit especially for small and medium-sized non-investment-grade lessees
Low-cost capital	Low payments/rate due to tax benefits, residual and lessor cost of funds	Still a benefit versus a bank loan
Tax benefits	Lessee cannot use tax benefits and lease vs. buy shows lease option has lowest PV cost	Still a benefit
Residual risk transfer	Lessee has flexibility to return asset	Still a benefit
Service and convenience	Outsource servicing of the leased assets Quick and easy financing process often tied in with the sales process	Still a benefit
Regulatory	Capital issues	Still a partial benefit if the PV is less than the cost of the asset
Accounting	Off balance sheet	Still a partial benefit if the PV is less than the cost of the asset

Lessees would apply the proposed new leases requirements by booking an obligation to pay rentals and a right-of-use asset measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate on the transition date. Additional adjustments for prepaid or accrued rentals should be made when lease payments are uneven over the lease term.

The transition process will also require that all financial periods presented (usually at least two years are presented) must be adjusted so lessees should be working on this project now if the implementation year is 2013. This will be a daunting task for most large companies due to the number of, mostly smaller dollar, leases they may have and to other companies with significant real estate leases because of scale and the complex terms of many of these lease transactions.

Lessor accounting. There likely will be multiple accounting models for lessors. The four models proposed are the Derecognition Method, Performance Obligation Method, Short-Term Lease Method and Investment Property Method. The existing lessor models, including leveraged leases, will no longer exist.

The determining factors for the choice of what method to use are not precisely clear at this juncture. The short-term model applies to leases that have terms of 12 months or less with no renewal options. The investment property model applies to real estate leases only. Most ELFA member equipment lessors will use either the Derecognition Method or Performance Obligation Method.

The model to be followed will be determined via an analysis of whether the lessor retains exposure to significant risks or benefits associated with the underlying asset, i.e. the residual. If the lessor has significant risks or benefits associated with the following factors (notice that there are no bright lines) the lessor will be required to use the performance obligation method:

- Significant contingent rentals during the expected lease term that are based on the use or performance of the underlying asset.
- Options to extend or terminate the current lease term.
- Material non-distinct services provided under the current lease contract.
- Whether the lease term is short in relation to the useful life of the asset.
- Whether a significant change in the value of the underlying asset at the end of the lease term is expected. In making this assessment the lessor should consider the present value of the underlying asset at the end of the lease term and the effect that any residual value guarantees may have on the lessor's exposure to risks and benefits.

These are subjective criteria and it will be interesting to see the final wording and guidance. The interpretations adopted by the "Big Four" accounting firms will also have a significant impact on how these factors are interpreted in practice. Lessors may have a difficult time getting accounting that reflects the business deal and economics.

I believe the performance obligation method is not an appropriate method of accounting for most equipment leases as they do not include services that are non-distinct. The performance obligation method leaves the leased asset on the books which fails to recognise that the lessor has transferred the value of the right of use to the lessee. Full service

Leasing services

El Camino Resources, LLC
21300 Superior Street, Chatsworth, CA 91311-4312, US. Tel: +1 (818) 226 6625; Fax: +1 (818) 226 6656. President & CEO: David E. Harmon; Direct Tel: +1 (818) 226 6661; Email: dharmon@elcamino.com; Also Contact: Andrew Martinez.
Activities: Disaster recovery company. Replacing computer equipment in the event of breakdown.

Elephant Leasing, Inc.
1221 3rd St., Oakland, CA 94602, US. Tel: +1 (415) 717 6346; Fax: +1 (415) 388 4910. Vice President: Susan L. Shumway.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Emigrant Business Credit Corporation
101 Executive Blvd, Elmsford, NY 10523-1316, US. Tel: +1 (914) 789 5138; Fax: +1 (914) 789 5125. Vice President: Sondra Rowland.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Emkay, Inc
805 West Thorndale Avenue, Itasca, IL 60143, US. Tel: +1 (630) 250 7400; Fax: +1 (630) 250 7077; Website: www.emkaynet.com. President & CEO: Greg Tepas; Email: gregtepas@emkay.com; EVP, Client Services & Marketing: Chris Tepas; Email: ctepas@emkay.com.
Activities: Member of the American Automotive Leasing Association (AALA).

Empire Financial Funding, Inc.
415 State Route 10, Suite 3, Randolph, NJ 07869-2100, US. Tel: +1 (973) 366 7300; Fax: +1 (973) 366 7301; Email: slevy@empirefinancialfunding.com. Contact: Saul Levy.

Encore Leasing Group, LLC
815 Mission Avenue, Suite 202, Oceanside, CA 92054-2856, US. Tel: +1 (760) 721 9090; Fax: +1 (760) 721 9084. Co-Managing Member: John F. Dow.
Activities: Member of the Equipment Leasing and Finance Foundation (ELFA).

Enterprise Fleet Management
600 Corporate Park Drive, St. Louis, MO 63105, US. Tel: +1 (314) 512 5000; Fax: +1 (314) 512 5220; Website: www.enterprise.com/fleet. Sr. Vice President: Steve Bloom; Direct Tel: +1 (314) 512 3930; Email: sbloom@erac.com; Vice President of Finance & Administration: Steve Usselmann; Direct Tel: +1 (314) 512 2332; Email: susselmann@erac.com.
Activities: Member of the American Automotive Leasing Association (AALA).

Enterprise Funding Group
4308 Three Mile Road NW, Suite A, Grand Rapids, MI 49534-1297, US. Tel: +1 (616) 774 9090; Fax: +1 (616) 774 8740; Email: mcoon@enterprisefundinggroup.com. Contact: Michael Coon.

eOriginal, Inc.
The Warehouse at Camden Yards, 351 W. Camden St. Suite 800, Baltimore, MD 21201-2479, US. Tel: +1 (410) 625 5141; Fax: +1 (410) 625 2479. President & CEO: Stephen F. Bisbee; Email: sfbisbee@eoriginal.com.
Activities: Member of the Equipment Leasing and Finance Foundation (ELFA).

ePlus Group, Inc
13595 Dulles Technology Dr, Herndon, VA 20171-3413, US. Tel: +1 (703) 984 8084; Fax: +1 (703) 984 8684; Email: gfox@eplus.com; Website: www.eplus.com. President: Bruce M. Bowen; Direct Tel: +1 (703) 984 8020; Email: bbowen@eplus.com.
Activities: General equipment leasing company.

Equifax, Inc.
1550 Peachtree Street, N.W., Atlanta, GA 30309, US. Tel: +1 (404) 885 8000; Fax: +1 (404) 885 8762. Director, Business Unit Communications: Christie Toelkes.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Equilease Financial Services, Inc.
50 Washington Street, 10th Floor, Norwalk, CT 06854-2710, US. Tel: +1 (203) 354 6010; Fax: +1 (203) 354 3655. Executive Vice President: Michael D. Zwick.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Equipment Data Associates, LLC
1509 Orchard Lake Drive, Suite E, Charlotte, NC 28270-1496, US. Tel: +1 (704) 845 5666; Fax: +1 (704) 845 5670. VP, Sales & Marketing: Dave Schwartz.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

equipment leases have distinct services that are bifurcated and accounted for separately.

The Exposure Draft includes an alternative view that the classification criteria as to when the performance obligation model should be used should be limited to just one – is there an ongoing performance obligation that has significant risk of non-performance? That is a view that I believe is most appropriate and I urge equipment lessors who comment on the exposure draft to consider this in their responses.

The Exposure Draft includes the best criteria for lessor classification "buried" in its basis for conclusions as follows: *"BC27 In most cases an entity's business model will indicate when a derecognition or a performance obligation approach would be appropriate as follows:*

"(a) The derecognition approach is likely to be appropriate when the entity's business model is primarily the provision of finance, because the profit of that business is derived from interest income and the principal risk associated with the business is credit risk.

"(b) The performance obligation approach is likely to be appropriate when the entity's business model is primarily to generate a return from the active management of the underlying assets either from leasing these assets to multiple lessees during their life or from use or sale of the asset at the end of the lease. The lessor may also generate a variable return during the term of the lease by accepting payments that are contingent on the usage or performance of the underlying asset. In that business model the principal risk is asset risk."

In my opinion the FASB/IASB should change the name of the Performance Obligation model to the Operating Lease model and use the "business model" criteria above as the sole criteria for classification.

Derecognition method. Of the two methods proposed, I believe the derecognition model is the one most ELFA members will find closest to their business model and to the economics of lease transactions. The derecognition model is a step back from today's direct finance lease model due to its handling of residuals, but it is better than the alternative.

In the derecognition model, the lessor books the PV of estimated rents (lessors will estimate the lease term and lease payments in the same manner as the lessee) at a rate like the implicit rate (they call it "the rate the lessor is charging the lessee") and "plugs" the residual asset (no longer called residual value) which is essentially the PV of the expected residual.

Lease revenue is finance revenue on the lease receivable and sales-type revenue and gross profit, if any. The residual asset is left on the balance sheet unchanged except for impairment (this is the major weakness as it should be treated as an estimated lease cash flow and accreted).

The ELFA will challenge the residual accounting in its comment letter as it is a step backwards from today's DFL accounting, which treats the residual as a lease cash flow to be measured at fair value. The residual is an estimated cash flow that is part of the lease investment cash flow analysis when pricing a lease. Revenue will be somewhat back ended compared to current direct finance lease accounting because of cash basis accounting for the residual.

Performance obligation method. In general, the performance obligation approach does not reflect the legal and economic framework associated with equipment leasing. Because of these issues, ELFA is likely to challenge any potential widespread utilisation of this model in the ELFA comment letter.

In the performance obligation model, the lessor leaves the leased asset on its books, books a receivable at the PV of the estimated payments (lessors will estimate the lease term and lease payments in the same manner as the lessee) using the implicit rate or similar rate as the discount rate and books a performance obligation liability. The "performance obligation" is not a real liability but rather it is more like a deferred income.

The three components (undepreciated leased asset, present valued lease receivable and the unamortised performance obligation) are netted for balance sheet presentation. The residual is ignored so it is accounted for on a cash basis by default. Lease revenue has a finance component and straight-line amortisation of the deferred liability and there is also depreciation on the leased asset.

Currently the FASB thinks depreciation should be netted with the lease revenue but the IASB thinks depreciation should be shown as an expense. The ELFA thinks depreciation should be netted and this is an important issue for banks or any lessor that uses operating leverage as a key performance measure. Depreciation of a leased asset should not be considered an operating expense but

Leasing services

Equipment Finance Corp.
219 Roswell Street, Suite 125, Alpharetta, GA 30004-7930, US. Tel: +1 (678) 319 0333; Fax: +1 (678) 319 0334. Credit/Syndication Manager: Christy L. Pruitt.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Equipment Placement Services, Inc.
107 Fm 3059, Streetman, TX 75859-4003, US. Tel: +1 (903) 599 2077; Fax: +1 (903) 599 2079. Director, Remarketing/Client Services: Mark J. Crabtree.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Ernst & Young LLP
1101 New York Avenue, N.W., Washington DC, 20005-4213, US. Tel: +1 (202) 327 6000; Fax: +1 (866) 461 9914.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Ervin Leasing Company
3893 Research Park Drive, PO Box 1689, Ann Arbor, MI 48108-2217, US. Tel: +1 (734) 332-5400; Fax: +1 (734) 332 5296. CFO: Thomas J. Conzelmann.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Essex Capital, Inc.
201 West Passaic Street, Rochelle Park, NJ 7662, US. Tel: +1 (201) 291 5113; Fax: +1 (201) 712 1790; Email: dburke@essextec.com. Contact: Dennis Burke.

Evans Feldman & Ainsworth, LLC
261 Bradley Street, PO Box 1694, New Haven, CT 6507, US. Tel: +1 (203) 772 4900; Fax: +1 (203) 782 1356; Email: rcfeldman@snet.net. Contact: Richard Feldman.

Evans National Leasing
One Grimsby Drive, Hamburg, NY-14075, US. Tel: +1 (800) 416 9080; Fax: +1 (866) 619 4738; Email: bgallo@evansnational.com. Contact: Brian Gallo.

Executive Solutions for Leasing and Finance, Inc.
181 New Providence Road, Mountainside, NJ 07092-2516, US. Tel: +1 (908) 654 1550; Fax: +1 (908) 654 1553. President & CEO: Teri Gerson.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Experian Business Information Solutions
5 Sylvan Way, Suite 300, Parsippany, NJ 07054-3818, US. Tel: +1 (973) 285 4844. Contact: Dan Meder.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Farleigh Wada Witt
121 SW Morrison Street, Suite 600, Portland, OR 97204-3117, US. Tel: +1 (503) 228 6044; Fax: +1 (503) 228 1741. Shareholder: Mark R. Wada.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Farm Credit Leasing Services Corporation
600 Highway 169 South, Suite 300, Minneapolis, MN 55416-1241, US. Tel: +1 (952) 417 7844; Fax: +1 (303) 796 1460.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Farm Credit Services of Mid America
1601 UPS Drive, Louisville, KY 40223-4023, US. Tel: +1 (502) 420 3789; Fax: +1 (502) 420 3489. VP of Agribusiness: Jay L. Carter: Email: jcarter@e-farmcredit.com.
Activities: Member of the Equipment Leasing and Finance Foundation (ELFA).

Felsberg, Pedretti, Mannrich e Aidar, Advogados e Consultores Legais
1725 I Street, N.W., Suite 300, Washington D.C., 20006, US. Tel: +1 (202) 331 2492; Fax: +1 (202) 331 2493; Email: thomasfelsberg@felsberg.com.br; Website: www.felsberg.com.br. Managing Partner: Thomas Benes Felsberg; Partners: Maria da Graça de Brito Vianna Pedretti; Nelson Mannrich; Carlos Miguel Castex Aidar; Guilherme Fiorini Filho; Cláudia Haidamus Perri; Ricardo Wanderley Mano Sanches; Roberto Wilson Renault Pinto; Antonio Ivo Aidar; Paulo Sigaud Cardozo; David Leining Meiler; Joel Luis Thomaz Bastos; (Thiago) Vallandro Flores; Neil Montgomery.
Activities: Full service law firm with significant experience in complex business transactions, such as international lease, project finance, corporate restructuring, mergers and acquisitions, privatisations and legal consulting in domestic and international transaction, and tradition of exceptional quality and personal service.

rather it is a component of the return on the lease investment.

Revenue may be more front-ended under the performance obligation model than under the operating lease model as the depreciation expense, net of the performance obligation amortisation, is lower. The proposed deprecation model for leased assets is straight line over the economic life to a zero salvage resulting in depreciation expense that may be too low.

Since the lease term is typically less than the economic useful life the salvage value at the end of the lease term usually is different than the expected residual. This will likely result in impairment issues. This method will confuse readers of lessors' financial statements.

Tables 5 to 8 provide comparisons of the returns from the proposed lessor models versus current GAAP. I assume in the PO example that the depreciation calculations will be straight line over the lease term to a salvage value equal to the residual value (the ED proposes that the term is the useful life and presumably the salvage value is zero, but this approach creates impairment issues and matching of revenue and expense). Note that although the lease would not be classified as an operating lease under current GAAP I used the same assumptions to create a *pro forma* operating lease for illustrative purposes only.

Assumptions:

- Lease yield 8.00%
- Equipment cost US$1,000
- Residual US$100
- Annual rent payment US$233
- PV of rent payments US$932
- Term in years 5
- Cost of funds 3.50%
- Tax rate 40.00%

You will note that the returns under the derecognition method are back-ended compared to the direct finance method (DFL) due to back ending of the residual income. Returns under the performance obligation method are front-ended compared to all the methods. This is a strange result as the basis for developing that method was to account for leases with more inherent risk than leases that qualify for derecognition. One would think that the resulting earnings pattern for "riskier" leases would be flatter or back ended.

Other lessor models. The short-term lease method, for leases with terms of less than one year, is the current GAAP operating lease model. The investment property method is for actively managed real property leases. The method essentially involves current GAAP operating lease accounting but the residual can be fair valued with gains or losses flowing through P&L.

Sales-type lease accounting will be negatively impacted by the proposed new rules. Any lease that is deemed a financed sale will result in gross profit recognition. Leases that are classified as derecognition leases will result in partial gross profit recognition based on the ratio of the PV of the rents vs. the fair value of the asset. This is less than what FAS 13 allows under its sales-type lease approach. No gross profit recognition will be allowed for performance obligation or short-term leases.

Leveraged lease accounting will be eliminated. I do not agree that the rent in a leveraged lease that is transferred to the lender at inception is an asset of the lessor. It is an asset of the lender and only one entity should record the asset. In transition leveraged leases will be booked gross and the MISF yield income amortisation method will not be used. The total gross rents remaining will be present valued and the leveraging debt principal balance will be recorded as a liability.

Leveraged leases may be classified and either performance obligation leases or partial derecognition leases. This means the existing residual asset will be removed and rebooked according to the applicable lessor accounting method. The deferred tax liability account will also be adjusted. The net balance in the adjustment will be charged or credited to retained earnings.

Transition. For transition lessors would be required to rebook all leases going forward under the new rules. If the transition year is 2013 work should begin now as all periods presented in financials will need to be adjusted. This will be a major undertaking for lessors and it is likely the ELFA will push for grandfathering of existing direct finance leases and leveraged leases.

Lessee impacts. Many reasons for leasing will still exist for lessees if the present value of the rents in the lease is less than the cost of the asset.

Undoubtedly some lessee behaviour will change:

- The cost of a lease will be more evident. Interim rent and month-to-month renewals historically have been a source of profit to lessors at the expense of lessees who may not have been conscious of the true cost.
- Although the lease vs. buy economic

Leasing services

Ferns, Adams & Associates, A Professional Corporation
2815 Mitchell Drive, Suite 210, Walnut Creek, CA 94598-1623, US. Tel: +1 (925) 927 3401; Fax: +1 (925) 927 3419. Attorney: Barry W. Ferns.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Fifth Third Leasing Company
38 Fountain Square Plaza, Md 10904A, Cincinnati, OH 45263-0001, US. Tel: +1 (513) 579 4139; Fax: +1 (513) 534 6706; Email: david.merrill@53.com. President: David A. Merrill.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Financial Federation Corporation
733 3rd Avenue, 24th Floor, Ney York, NY-10017-3204, US. Tel: +1 (212) 599 8000; Fax: +1 (212) 286 5885; Email: sgroth@financialfederal.com. Contact: Mr Steven F. Groth.

Financial Pacific Leasing, LLC
PO Box 4568, Federal Way, WA 98063-4568, US. Tel: +1 (800) 447 7107; Fax: +1 (800) 447 7106; Email: tereyj@finpac.com; Website: www.finpac.com. President & CEO: Dale A. Winter; Email: dwinter@finpac.com; Senior Vice President: Terey Jennings.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Finley, Alt, Smith, Scharnberg, Craig, Hilmes & Gaffney, P.C.
699 Walnut, 1900 Hub Tower, Des Moines, IA 50309, US. Tel: +1 (515) 288 0145; Fax: +1 (515) 288 2724. Attorney/Shareholder: Stacie M. Codr.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First American Equipment Finance
780 5th Avenue South, Suite 200, Naples, FL 34102 6632, US. Tel: +1 (239) 349 2332; Fax: +1 (312) 896 9127; Email: bill.verhelle@faef.com. Contact: Mr. William H. Verhelle.
Activities: Immediate past Chairman of the Equipment Leasing and Finance Association (ELFA). Monitor 100 equipment finance company serving large corporate borrowers, hospitals, private colleges and universities and large law firms throughout the US.

First Bank of Highland Park
633 Skokie Boulevard, Northbrook IL 60062, US. Tel: +1 (847) 562 1090; Fax: +1 (847) 272 8298; Email: rgreen@firstbankhp.com. President: Randy L. Green.
Activities: Member of the Equipment Leasing and Finance Foundation (ELFA).

First Business Equipment Finance
N53 W14403 Aberdeen Drive, Menomonee Falls, WI 53051, US. Tel: +1 (262) 792 7151; Fax: +1 (262) 792 7105; Email: trude@firstbusiness.com. VP/Territory Manager: Thomas Rude.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First Citizens Bank & Trust Commercial Leasing
PO Box 29519, Raleigh NC 27626, US. Tel: +1 (252) 985 6377; Fax: +1 (800) 292 6288. Senior Vice President: Thomas Harris.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First Data Gobal Leasing
1307 Walt Whitman Road, 3rd Floor, Melville, NY 11747-3011, US. Tel: +1 (631) 683 6353; Fax: +1 (631) 683 6366; Email: bob.neagle@firstdata.com. SVP & General Manager: Robert C. Neagle; VP: Daniel O'Connell; Direct Tel: +1 (631) 683 6352; Email: daniel.oconnell@firstdata.com.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First Eagle Bank
1201 W. Madison, Chicago, IL 60607-1907, US. Tel: +1 (312) 850 1405; Fax: +1 (312) 850 1416; Email: asalk@febank.com. President: Andy Salk; Senior Vice President: Richard A. Burns.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First Financial Bank
201 E. Fourth Street, Suite 1900, Cincinnati, OH 45202, US. Tel: +1 (513) 979 5739. Contact: John V. Handelsman.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First Financial Corporate Services, Inc.
711 West Kimberly Avenue, Suite 160,Placentia, CA 92870, US. Tel: +1 (714) 646 1600; Fax: +1 (847) 663 6704; Email: rstebbins@ffcsi.com. President: Richard Stebbins; CFO: Brad Wheatley.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

The basis of the new approach to lease accounting is the capitalisation of the rights and obligations in a lease rather than capitalising the leased asset itself as under current GAAP.

answer will be the same, non-economic accounting issues may influence the decision to a buy choice despite the economics.

- Capital budget constraints were a reason for leasing that will go away. A lease will be viewed as a capital budget item and this will raise the level of attention and change the approval process to a centralised or higher-level decision. This will at the very least slow the approval process down if not change the decision to buy.
- The sales cycle for equipment may be extended if lessees choose to buy. I have heard this comment from one truck lessor who had customers that normally do full service leases choosing to buy the trucks and buy a service contract. Historically, leased trucks were returned with significant useful life remaining.
- A computer lessor reported that one customer has already announced that they will no longer lease due to the accounting changes.
- A bank that did significant real estate sale leasebacks to reduce assets and raise capital is considering buying back the properties. They will come back on the books under the proposed new rules at higher amounts than prior to the sale leaseback and the unamortised gain on sale will be credited to retained earnings rather than flowing through operating earnings.
- Level payments that fit the operating budget will not do so any longer. Rent expense will no longer exist, replaced by front-ended lease cost.
- Trade-ups negotiated with a line manager, swapping one off-balance-sheet operating lease for another, will be more difficult. The operations manager will have to get finance/accounting involved as the existing lease will have to be closed out on the books and replaced by a new lease booking. Ironically the front-ended cost pattern will likely result in a gain being recorded when the new lease is closed out. In any case the trade-up will be on the radar screen of the accounting, finance and treasury departments.

Unintended consequences. Many contracts and regulations are based on accounting treatment and definitions in current GAAP. Cost reimbursement for rent expense will be an issue. As an example, hospitals in the US get reimbursement from government health programmes (Medicare/Medicaid) for rent expense of non-medical equipment but they do not get reimbursed for amortisation and imputed interest expense. How will this be resolved given the proposed rule to eliminate rent expense? Debt covenants define debt as debt under current GAAP. I suppose the covenants will have to be negotiated, but the task will be enormous.

Conclusion. In conclusion I would like to present my views as to the impacts of

Leasing services

First Franchise Capital Corporation
One Maynard Drive, Suite 2104, Park Ridge, NJ 7656, US. Tel: +1 (201) 326 4001. President: John Rinaldi.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First Hawaiian Leasing, Inc.
PO Box 1240, Honolulu, HI 96807, US. Tel: +1 (808) 943 4947; Fax: +1 (808) 943 4975; Email: kkoyanagi@fhb.com. President: Keethe T. Koyanagi.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First Litchfield Leasing Corporation
1057 Torringford Street, Torrington, CT 6790, US. Tel: +1 (860) 626 7714; Fax: +1 (860) 626 7719; Email: gmason@fnbl.com. President: Glenn Mason.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First National Bank of Hutchinson
One N. Main, PO Box 913, Hutchinson, KS 67504-0913, US. Tel: +1 (620) 694 2351; Fax: +1 (620) 694 2353; Email: mike.chapin@fnbhutch.com. SVP & Manager, Leasing Services: Michael K. Chapin.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First National Capital Corporation
26050 Towne Centre Drive, Foothill Ranch, CA 92610-3441, US. Tel: +1 (949) 707 2070; Email: kduggan@firstncc.com. President: Keith Duggan.

First National Medical Leasing Corporation
120 Mountfort Street, Suite 107, Boston, MA 2215, US. Tel: +1 (617) 776 1940; Fax: +1 (866) 577 2007; Email: rnobe@firstnatleasing.com. Contact: Robert Nobe.

First Niagara Leasing Inc.
726 Exchange, Suite 900, Buffalo, NY 14210, US. Tel: +1 (716) 625 7657; Fax: +1 (800) 745 5822; Email: traci.stadler@fnfg.com. Senior Vice President: Dan Dintino; Email dan.dintino@fnfg.com; Leasing Portfolio Manager: Lynn Sciog.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

First South Leasing, LLC
PO Box 548, Greenville, NC 27835, US. Tel: +1 (252) 355 5486; Fax: +1 (252) 355 6590; Email: dbunn@firstsouthnc.com. President/CEO: Donnie Bunn.
Activities: Member of the Equipment Leasing and Finance Foundation (ELFA).

FirstLease, Inc.
185 Commerce Drive, Unit 102, Ft. Washington, PA 19034-2416, US. Tel: +1 (215) 283 9727; Fax: +1 (215) 283 9870; Email: donald@firstleaseonline.com. President: Theodore H. Kapnek, III; Email: tkapnek@apexsmtg.com.

FirstMerit Equipment Finance, Inc.
106 South Main Street, Tow90, Akron, OH 44308-1417, US. Tel: +1 (330) 384 7429; Fax: +1 (330) 384 7439; Email: jeff.vancleve@firstmerit.com. President: Jeffrey J. VanCleve.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Five Point Capital, Inc.
10525 Vista Sorrento Parkway, Suite 304, San Diego, CA 92121, US. Tel: +1 (858) 433 2645; Fax: +1 (858) 266 0412; Email: dgilbert@fivepointcapital.com. Co-CEO: David Gilbert; CFO: Derek Wiesner.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Flamm Walton PC
794 Penllyn Pike, Blue Bell, PA 19422, US. Tel: +1 (267) 419 1507; Fax: +1 (267) 419 1560. Shareholder: Robert E. Walton, Esq.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Fleet Advantage, LLC
401 E. Las Olas Blvd, Suite 1720, Fort Lauderdale, FL 33301, US. Tel: +1 (954) 615 4400; Fax: +1 (954) 615 4401. President: John J. Flynn.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Fleet One, LLC
5042 Linbar Drive, Nashville, TN 37211, US. Tel: +1 (866) 517 2537; Fax: +1 (888) 310 1988; Email: sales@fleetone.com; Website: www.fleetOne.com. President & Chief Executive Officer: Andy Roberts; SVP Sales & Marketing: Michael Thompson.
Activities: Fleet One provides fuel cards and fleet-related payment solutions to commercial and government customers.

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.

I do agree that operating lease obligations that meet the definition of a liability should be capitalised by lessees but I would hope the Boards redeliberate and seriously consider alternative views for lessee P&L and lessor accounting. My views on likely impacts are:

Banks.

- The lessee accounting rules will create capital needs as non-cash front-ended expenses erode retain earnings permanently, far too much is capitalised as intangible assets that will attract 100% capital, and deferred tax assets are created that attract 100% 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).
- The lessor rules changes will gross up balance sheets for leveraged leases creating a capital need. The earnings patterns of derecognition and leveraged leases will likely be back ended compared to current GAAP for direct finance and leveraged leases. ROAs 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 that will tighten availability of credit.
- Banks are still trying to build capital bases from the current financial crisis and this proposal will be 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 be so 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 US. This meant that lower lease rates could be charged by captives and dealers than third-party lessors. Lessees benefited 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 as they use the rent rolls as collateral to finance real estate projects. The real estate lending market is in crisis as it is and the proposed rules will drive commercial real estate 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 create 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 worldwide green energy asset initiatives and fiscal stimulus like 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 financial 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

Leasing services

Walgreen's, the largest US lessee of operating leases, their 2009 pretax earnings were US$3.2bn and using only their footnoted lease obligations they will report a decline of US$456m under the proposed lease accounting. If the impact of renewals and contingent rent triples that number the result could be a decline in pretax earnings of close to 50%.

- 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. Stock market values are likely to decline putting more pressure on the underfunded pension crisis in the US as well as the worldwide economy.

Commenting to the FASB or IASB is the most powerful tool that you the reader have to impact the outcome of the Lease Project. If you are a large company or a member of a large trade organisation you can request a meeting with the FASB/IASB staff or board members to discuss your views. That may be too much of a challenge but certainly you can write a comment letter.

Visit the fasb.org website to view previous comment letters to get an idea of the form of a letter and some of the arguments used against the proposed methods. You can also visit the iasb.org website. Those websites will give you instructions as to how to submit a comment letter. The elfaonline.org website contains additional information on the accounting project. Stay informed, plan for the transition as a lessor and develop customer and product strategies to stay ahead of the curve. Above all send in a comment letter.

About the author:

Bill Bosco is the President of Leasing 101, a lease consulting company (www.leasing-101.com). Bill has over 35 years' experience in the leasing industry. His areas of expertise are accounting, tax, financial analysis, structuring, pricing and training. He has been on the Equipment Leasing and Finance Association accounting committee since 1988 and was chairman for 10 years. He is a frequent author and speaker on leasing topics. He has been selected to the FASB/IASB Lease Project working group. He can be reached at wbleasing101@aol.com or Tel: +1 914 522 3233.

This article was written by Bill Bosco, President, Leasing 101, 17 Lancaster Dr Suffern, NY 10901, US. Tel: +1 914 522 3233. Email: wbleasing101@aol.com. Website: www.leasing-101.com.

TAX TRENDS TO TEND TO AT YEAR-END AND IN THE UPCOMING YEAR

The year 2010 has been one of many changes and proposed changes, including in the stock market and the economy, as well as in healthcare, and the US federal tax regime was no exception in this regard.

On the LILO–SILO front. Although the Internal Revenue Service (IRS) previously decided that a settlement initiative was the most effective way to address its opposition to LILO–SILO structures, it did not extend offers to all parties involved in those deals. In addition, some parties who received settlement offers decided against accepting them. With one exception, taxpayers who decided against accepting offers lost in litigation.

The *Consolidated Edison v. United States* (2009) decision was the one exception, although it is unclear how long it will remain a precedent since it is likely to be appealed.

In that case, the Court of Federal Claims held that the utility company was entitled to claim rent and interest deductions in connection with a LILO transaction which involved a Dutch electric plant. The Court indicated that each of its decisions on LILO–SILO structures should be based on their own facts, and held that Con Ed's facts were distinguishable from other LILO–SILO cases.

Among the facts favourable to Con Ed were that it had a legitimate business purpose in entering into a transaction which was related to its main line of business, it had an equity investment of 25%, the lease term was shorter than the plant's useful life, the renewal rent was approximately 90% of expected fair market value, there was a projected pre-tax profit of 4.44% and there was a realistic possibility of realising a significant profit because of the projected residual value of the facility.

However, less than three months after that decision, the same Court of Federal Claims decided against another taxpayer in *Wells Fargo v. United States* (2010).

In that case, Wells Fargo's deductions were disallowed because the Court found its SILO structure to be offensive on several levels, including that the only money which changed hands was an up-front fee for the tax-exempt lessee and amounts

Leasing services

Fulbright & Jaworski LLP
666 Fifth Avenue, New York, NY 10103-0001, US. Tel: +1 (212) 318 3073; Fax: +1 (212) 318 3400. Partner: David A. Gillespie.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

FundGuard LLC
32825 Myrna Street, Livonia, MI 48154, US. Tel: +1 (734) 306 8938; Email: mikerehling@gmail.com. Contact: Michael Rehling.

Fuyo General Lease (USA) Inc.
733 Third Avenue, 17th Floor, New York, NY 10017, US. Tel: +1 (212) 867 1008; Fax: +1 (212) 867 5153; Email: m-shiraishi@fgl-usa.com. President & COO: Masayuki Shiraishi.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

GATX Corporation
Four Embarcadero Center, Suite 2100, San Francisco, CA 94111-4106, US. Tel: +1 (415) 955 3359; Fax: +1 (415) 403 3517. Senior Vice President - Portfolio Management: Curt F. Glenn.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

GE Capital Corporate Finance
10 Riverview Drive, Danbury, CT 06810-6268, US. Tel: +1 (203) 749 6650. Chief Marketing Officer - GE Capital Solutions: Juan Corsillo.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

GE Capital Fleet Services
Three Capital Drive, Eden Prairie, Minnesota 55344, US. Tel: +1 (952) 828 1000; Website: www.gefleet.com. President & CEO: Clarence Nunn; Direct Tel: +1 (952) 828 2643; Email: clarence.nunn@ge.com; Senior Vice President & General Counsel: Brock Austin; Direct Tel: +1 (952) 828 2526; Email: brock.austin@ge.com.
Activities: Member of the American Automotive Leasing Association (AALA).

GE Healthcare Financial Services (HFS)
20225 Watertower Blvd, Suite 300, Brookfield, WI 53045-3597, US. Tel: +1 (262) 798 4400; Fax: +1 (262) 798 4590. President, Equipment Finance: James J. Ambrose.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

GE_Intermediary Funding
516 Virginia Drive, Ft. Washington, PA 19034, US. Tel: +1 (215) 654 5482; Fax: +1 (866) 417 6693; Email: neil.whitman@ge.com. Contact: Neil Whitman.

General Motors
Fleet & Commercial Operations, 100 Renaissance Center, M/C 482-A20-B68, Detroit, MI 48265-1000, US. Tel: +1 (313) 667 9430; Fax: +1 (313) 667 1181; Website: www.gmfleet.com. General Manager: Brian Small; Tel: +1 (313) 667 8805; Email: brian.small@gm.com; Director, Fleet & Commercial Sales: Bill Gibson; Direct Tel: +1 (313) 665 1407; Email: bill.gibson@gm.com; Manager-Fleet Management Company Business Relations: Steve Auvenshine; Direct Tel: +1 (313) 665 2660; Email: steven.j.auvenshine@gm.com; Director, Rental Sales and Fleet Operations: Dave Kanous; Direct Tel: +1 (313) 667-2390; Email: david.m.kanous@gm.com.
Activities: Associate Member of the American Automotive Leasing Association (AALA).

Genesis Capital Corporation
22372 Rosebriar, Mission Viejo, CA 92692, US. Tel: +1 (949) 476 9304; Fax: +1 (949) 855 9301; Email: gencapca@aol.com. President: Philip D. Pfirrmaun; Managing Director: Andrea C. Roberts.
Activities: Financial advisor to lessees and lessors on new and secondary market lease financings (US$5m-US$100m transactions). Member of the Equipment Leasing and Finance Association (ELFA).

Geneva Capital, LLC
522 Broadway Street, Suite 4, Alexandria, MN 56308-1454, US. Tel: +1 (800) 408 9352; Fax: +1 (320) 762 8402; Email: mwatkins@gogenevacapital.com. President: Mark Watkins.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

Get Recovery, Inc.
2422 Pecos St., Beaumont, TX 77702, US. Tel: +1 (409) 833 9717; Fax: +1 (409) 833 7563. Owner: Jon Hellberg.
Activities: Member of the Equipment Leasing and Finance Association (ELFA).

GFC Leasing - A division of the Gordon Flesch Company, Inc.
2675 Research Park Drive, Fitchburg, WI 53711-4906, US. Tel: +1 (800) 333 5905; Fax: +1 (608) 274 6717; Email: rschultz@gflesch.com. Vice President: Mr. Roland Schultz; Direct Tel: +1 (608) 441 6308.
Activities: Member of the Equipment Leasing and Finance Foundation (ELFA).