LEASING 101

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July 23, 2013

Re: Leases – Topic 842 Proposed Accounting Standards Update (Revised), Issued: May 16, 2013

Dear Chairman Golden and Chairman Hoogervorst:

Thank you for the opportunity to provide comments. This second Leases Project exposure draft (ED) is much improved versus the first exposure draft, eliminating complexity and better defining the lease term and lease payments to reflect the economic effects of a lease. I think there are relatively few changes that need to be made to the ED to provide the information that the majority of users need and to simplify the compliance for preparers while not compromising the prime objective of putting an accurate value on the lessee's balance sheet for assets and liabilities arising from the rights and obligations in operating leases based on a calculation methodology that is consistently applied. Although the changes I suggest are few they do involve a re-thinking of major premises that ED2 is built on.

A summary of the major issues I see is as follows:

Major Issue	Suggested changes to ED	Basis for suggested changes
Lessee lease classification	Lessee lease classification should be based on the legal nature of the contract which is best accomplished using the risks and rewards criteria in current GAAP.	There is a need for a conceptual framework analysis for capitalizing executory contracts as the rights and obligations are unique. Revisions are needed to the definition of debt and

	The result will be 2 types of leases for lessees - capital leases where ownership rights are transferred (aka rights of ownership or ROO leases) and executory leases where only temporary rights of use (ROU leases) are transferred.	assets creating new categories for ROU lease assets and liabilities that are "contract" assets and liabilities. The legal definition of an asset and liability in bankruptcy should be reflected in the accounting and presentation to provide debt analysts and lenders information about the assets available in bankruptcy and the debt that will survive bankruptcy. Tangible assets (ROO assets) are taxed differently than intangible assets (ROU assets) so preparers need them to be reported separately to avoid having to create and maintain a second set of records for leases. ROO liabilities are treated as debt in bankruptcy while ROU liabilities are not debt in bankruptcy. The IAS 17 criteria are more robust than FAS 13, allow for more judgment and, in my opinion, get to the substance of the lease contract.
Lessee cost allocation	Lessee cost allocation for ROO leases should follow current GAAP for capital leases and ROU leases should recognize straight line rent expense as per current GAAP for operating leases.	ROU leases are executory contracts where periodic services (the right of use) are delivered and the lessee makes a periodic payment as consideration. There is no financing element unless the payments for current services are paid in the future. The periodic payment is an operating cost and should be accounted for under accrual accounting as per current GAAP for operating leases. Rent expense is used by users in their analyses as well as preparers in tax compliance.
Lessee balance sheet presentation	ROO lease assets and liabilities should be presented as tangible assets and debt. ROU lease assets and liabilities should be presented separately and clearly labeled as intangible assets and non-debt liabilities.	ROU lease assets and liabilities are unique and have a different treatment in bankruptcy that is important information for potential lenders and for credit analysts. They may be assets and liabilities to a going concern but not in most bankruptcy scenarios. The nature of leased assets and liabilities is important information for lenders and credit analysts.
Sale Leaseback Accounting	Sale treatment in a sale leaseback should be determined using the same risks and rewards lease classification criteria as per current GAAP and the legal and tax view of a sale.	The accounting concept that a non bargain purchase option gives a seller control, negating sale treatment, is not in line with the legal view. In bankruptcy and under tax law a sale with a non bargain purchase option is a sale because all the risks have transferred and

		all the expected benefits have transferred as well. The seller only controls unexpected benefits through a non bargain purchase option. It is misleading to a user to report assets and debt that are not treated as such in bankruptcy.
Lessor lease classification	Lessor lease classification should be based on business model. “Financial” lessors should use the Receivable & Residual (R&R) method. “Operating” lessors should use operating lease accounting.	Users measure “Financial” lessors (those lessors that price and structure each lease as a discreet financial investment with a sale of the residual) on a net revenue from funds invested and operating efficiency basis. Users measure “Operating” lessors, both real estate and equipment lessors, as though the leased assets (their stock-in-trade) are depreciating assets that will be leased multiple times over their useful lives with rent revenue and maintenance and operating expenses reported using accrual accounting.
Tax benefits in lessor revenue recognition	Lessors consider tax credits, grants and temporary book/tax differences related to the leased asset as cash flows in pricing just as they consider rents and residual cash flows.	The effects of taxes related to the leased asset should be included in revenue recognition rather than as a component of tax expense. This is especially true for Financial lessors as they are measured by net revenue/net interest margin from funds invested and operating efficiency – including tax benefits in tax expense distorts/understates the reported revenue from a lease. Some leases like alternate energy (solar and wind) asset leases in the US have no other earnings but from tax benefits.
Leveraged lease accounting	Leveraged lease rents and debt service should be shown net on the balance sheet.	The rents to pay non-recourse debt service and the debt are not assets and debt of the lessor in bankruptcy. A leveraged lease is a 3 party agreement wherein the parties agree that the lessee will pay rent to the lender and the lender has no recourse to the lessor and as such it should qualify for the right of offset. It is misleading to a credit analyst and potential lender to report assets and liabilities that will not survive bankruptcy as bankruptcy analysis is part of their credit review process.
Residual guarantees and insured residuals	All residual guarantees/residual insurance change the nature of the residual to a financial asset.	As per current GAAP a residual guarantee or insurance converts the residual risk to a credit risk. Guaranteed and insured residuals should be

		considered a minimum lease payment for the lessor to the extent of the amount guaranteed/insured.

Lessee Lease Classification:

The Boards' initial objectives were to capitalize the value of all leases (using a defined method to insure accuracy and consistency in reporting) and simplify lease accounting by accounting for all leases in the same manner based on the idea that all leases transfer rights of use. The attempt to simplify accounting is an oversimplification that, in my opinion, is wrong as there are leases that transfer ownership rights which should be accounted for and reported differently to reflect their significantly different economic effects. Part of the "Right of Use" framework is that we are accounting for the rights and obligations in the lease contract. I think the approach should be changed to a Rights and Obligations (R&O) Approach. Under the Boards' ROU approach it should mean that the leases standard must first examine the rights and obligations in a lease contract and then account for those that transfer only a ROU as a capitalized executory contract. Those that transfer rights of ownership (ROO leases) should be treated as either capital leases under the scope of the standard or specifically excluded from the scope and accounted for as a financed purchase. The legal (UCC), tax (US Federal Income Tax, state income tax, local property tax , and state and local taxes sales/use taxes) and the current accounting regime in the US are fairly well aligned in the view that some leases are executory contracts (operating leases) and some leases are financed purchases (capital/finance leases). Having only GAAP accounting as the outlier should beg the question why have a completely different approach? Under current GAAP a preparer can keep one set of books for all leases to satisfy almost all compliance and information needs. The proposed Leases standard will break the alignment. This will force preparers to keep sets of records for accounting purposes and records for tax compliance and to provide information to potential lenders and credit/equity analysts. Those users of financial statements need information as to which assets are tangible/owned physical assets and which liabilities are true "debt" in bankruptcy versus temporary intangible assets and non-debt liabilities that arise from leases that are executory in nature such that they disappear in most bankruptcy scenarios.

What I think the Boards need to do is:

1) To develop Conceptual Framework concepts statement type analysis regarding the capitalization of contracts. This was recommended by the AAA Financial Accounting Standards Committee's "Commentary Evaluation of the Lease Accounting Proposed in G4+1 Special Report"(© 2001 American Accounting Association *Accounting Horizons* Vol. 15 No. 3 September 2001 pp. 289-298).

2) To re-examine and change the definitions of debt and assets to include issues like treatment in of assets and liabilities in bankruptcy and tangible versus intangible assets. Debt should be a precisely defined term and include items that are debt in a bankruptcy but exclude liabilities that do not survive bankruptcy. This would solve the unintended consequence of causing technical defaults in debt covenants caused merely by a change in GAAP treatment of operating lease

obligations or any other capitalized executory contract. I realize that in a going concern an operating lease obligation is a liability, but it is not debt.

Lessee Lease Classification

In my opinion, the current decision to have two types of leases but to have different classification tests for real estate lacks a common principle. There needs to be one principle for all leases, by lease type (executory versus finance/capital leases) regardless of the type of leased asset. This was included in the AAA Financial Accounting Standards Committee's commentary on the G4+1's "New Approach" paper as follows: "The Committee believes that the nature of the asset under lease should not affect the accounting for a lease. In particular, leases of intangible assets and land should be treated in the same way as other leases." The "one principle for all leases" should be to follow the legal view so that the leases are accounted for according to their economic effects and their treatment in bankruptcy. Failure to differentiate executory contracts from capital leases means muddled information for lenders and analysts who need to understand the financial risks in a potential bankruptcy. Bankruptcy should matter in accounting for leases as it does in the accounting for other transactions such as the transfer of financial assets. The FASB's Investors Technical Advisory Committee (ITAC) said this clearly at their meeting with the FASB on July 24, 2012, meeting as reported by a Thompson Reuters article: "Investor Panel Pans Lease Project Progress", by Nicola White - July 26, 2012. The article said "the board's Investors Technical Advisory Committee said attempts to dampen criticism from businesses has watered down the original proposal and still keeps investors in the dark. As a result, investors and analysts will have to continue doing what they've been doing for years—adjusting financial statements for the effects of a company's lease commitments." "The problem is you have such divergent views and approaches out there for users of financial statements, and where you've kind of ended up in all this is this massive compromise to make everybody happy," Moody's managing director Mark LaMonte said. "You just end up with this jumbled mess in financial statements that people are going to still have to adjust. And I'm not sure what's been improved." It is an extremely difficult task to satisfy all users, but to satisfy no one, as appears to be the state of the current ED, should not be acceptable.

It appears to me that a reason for treating real estate leases differently than equipment leases is a result of adopting an exception to the ROU approach to allow for the IFRS investment property rules for lessors and at the same time to maintain symmetry in lessee/lessor methods. Since I advocate using business model as the classification method for lessor accounting, I agree with investment property accounting. In my opinion the better and simpler solution that is principles based is to not require symmetry in lease classification. Lessor accounting should be based on business model as that is what their analysts want. Lessee accounting should be based on the legal nature of the contract and that is what credit analyst users and lender users want. Lessees merely want a right of use when leasing an asset and do not care if the lessor is in the investment property business or in the financial leasing business. Grant Thornton has published 2 papers on lease classification that support the view that there should not be symmetry in lease classification for lessees and lessors.

The FASB Chair Leslie Seidman said "Yet investors continue to say they want more information, particularly when there is a business downturn or failure." in her remarks at the Compliance Week Annual Conference on June 4, 2012 in Washington, DC. The approach taken regarding information key to a bankruptcy analysis in the ED seems counter to what she says users need. The needs of preparers, lenders/credit analysts and equity analysts do vary but the FASB must decide the route to take or who to please. In my opinion the correct approach is to reflect the economic effects of leases in the accounting and financial reports and use disclosures for unique information that is for the benefit of an individual stakeholder group if the cost benefit analysis warrants it. I would favor the needs of lenders/credit analysts and preparers over the needs of equity analysts as equity analysts follow larger companies while small and medium sized companies are more likely to lease. FASB Chair Seidman also covered cost benefit analysis in the remarks with the following quote: "When the FASB says it won't issue a standard unless the benefits justify the costs, we mean the following: We issue standards if the improvements in the quality of the reporting are expected to justify the costs of preparing and using the information." It is always hard to measure costs created by the ED (in my opinion they are high) but it is easier to measure benefits over current GAAP which I contend are few, and in my opinion, much of what is proposed is a step backwards in terms of usefulness of information.

The Boards and staff have had a difficult time figuring to what to call their two types of leases. Now, since the current scheme is muddled where most equipment leases are treated differently than most real estate leases, the best choice is call them Type A leases (front ended with an interest and amortization element) and Type B Leases (with a straight line cost pattern yet they still force a calculation of imputed interest) because, in my opinion, there is no common logic or principle to the classification regime. There should be a single principle for lessee classification for all leased asset types and the differentiating factor should be the legal nature of the rights and obligations in the lease, that is, executory/operating (ROU leases) versus capital/finance (ROO leases) leases. For lessors, again based on business model, the 2 types of leases are finance leases or operating leases.

Lessee Balance Sheet Presentation

Operating leases will be the first executory contract to be capitalized. The nature of an ROU asset is that it is an intangible contract right. It is an asset to a going concern provided that the lessee continues to make payments to enjoy continued right of use, but it is not an asset in most bankruptcy scenarios. In a bankruptcy equipment leases that are executory contracts are reviewed by the bankruptcy judge. If the leased asset is not essential to the plan to operate the bankrupt entity or if the bankrupt entity is to be liquidated, the bankruptcy court rejects the lease. This means the leased equipment is returned to the lessor who is the legal owner of the equipment and the lease is terminated so that no asset remains in the bankrupt estate and no further liability exists to make lease payments. In other words, the contract rights and obligations disappear. The bankruptcy laws consider future rights of use to be undelivered services – not an asset at all. A prospective lender to an entity does a bankruptcy risk analysis to determine the likelihood of bankruptcy and identifies the "true" assets of the entity and the "true" debt that would compete with the new loan for claims on the assets in bankruptcy to estimate the impact of a bankruptcy on recovery of principle. The definitions of a liability and debt need to be more specific especially with reference to standing in bankruptcy since debt analysts and lenders point out that bankruptcy analysis is important to them (see ITAC comments). Since capital leases (ROO leases) are legally purchases of the asset financed by debt, their treatment in bankruptcy is completely different than an operating lease. This is the reason why lenders and analysts need lease assets and liabilities to be broken down by their legal nature and reported separately and clearly labeled on the balance sheet. A one lease solution where all leases are capitalized and the assets and liabilities are lumped gives less key information than is available under current GAAP. A solution where the classification tests are different for equipment and real estate and where the classification tests are not aligned with the legal classification tests means that the information is muddled, again not as useful as the information available from the footnoted operating lease obligations under current GAAP. I am not saying to continue to keep the operating lease obligations in the footnotes, although it is a viable option to disclose the discounted value. Rather the capitalized operating lease (executory contract) assets and liabilities must be presented separately on the balance sheet.

Lessee lease cost recognition

The cost recognition pattern should be different for leases that are capital leases (ROO leases) (in that case the transaction is a purchase and incurrence of a debt obligation from a legal perspective) versus leases that are capitalized executory contracts (ROU leases, AKA the former operating leases) (in that case the payment is a periodic cost to acquire the periodic right to use the asset). Capital leases are a debt obligation because the UCC and IRS view them as interest bearing contracts. Operating leases are executory contracts as the payment is consideration for the right to use the asset for the period. Executory contracts are not interest bearing contracts according to the UCC and IRS. The ED treats them as financings I think in part for the desire to simplify lease accounting using a one lease approach, despite the reality that there are 2 types of leases under the law and according to their economic effects. The ED also treats them as financings which I think may be because the method chosen for capitalization of the liability uses a present value calculation. The ED also ignores the executory nature of the lease where the lessor has performance obligations over the lease term to keep the asset free of liens and to ensure the lessee's "quiet enjoyment" of the leased asset. The AAA Financial Accounting Standards Committee's comments cautioned the Boards against an overly simplified one lease model as follows "The approach should be robust to shifts in the contractual details of lease contracts when such shifts do not materially alter the economic substance of the arrangements. In particular, the approach should require that substantially similar lease contracts be accounted for similarly and substantially dissimilar lease contracts not be forced into a misleading appearance of comparability." The Boards say they treat all payments made over time using the interest method. In my opinion, this is an accounting contrivance to justify capitalization. I say it is justification enough to capitalize the leases based on the fact that analysts need an accurate number for the debt-like operating lease liability (note I say debt-like as legally it is not the same as debt and the distinction is important to users of financial statements). In my opinion the only case where an executory contract that is a lease contains a financing element is when the rents are back ended, that is when the lessee pays for the current right of use in the future. That financing element is actually captured under current GAAP as it requires a lessee to accrue the average rent so a back ended rent lease will have an accrued rent liability on balance sheet until the rent is actually paid.

Front loading lease costs by amortizing the ROU asset straight line and imputing interest causes a mismatch versus the tax treatment where rent is the deductible expense. This will create the need for complex deferred tax accounting for all executory leases with front loaded costs. It also means large and permanent deferred tax asset balances for any entity that continues to lease. Users will be confused by the large deferred tax assets as they highlight the inconsistency of the ED cost methodology versus the legal and tax view of executory leases.

Front loaded costs will create a P&L miss match in cost reimbursement arrangements where the revenue (reimbursed lease cost) will be based on rent paid while the reported cost of the lease will have a depreciation and interest element.

Any executory lease with front loaded cost pattern will show a gain on early termination as the ROU asset amortizes more quickly than the ROU liability. This should be a clear sign that the value of the asset is not correct. My recommendation is for the Boards to do a conceptual analysis of capitalizing executory contracts. I recommend using an executory contract accounting method as illustrated in the example below. In short, under my proposed executory contract accounting method, one would:

- Capitalize the PV of the lease payments on each reporting date, reversing the previous reporting period's entry
- Accrue the average rent, charging rent expense and crediting accounts payable
- Pay rent charging accounts payable

My proposed method assumes that the prime objective is merely to put the operating lease obligations on balance sheet. Why do we need change anything else? In other words merely put the remaining value of the asset and liability associated with operating leases on balance sheet on each reporting date. This means we do not have to concern ourselves with amortizing the asset or imputing interest to a contract that is executory.

The Boards have based their classification tests on whether the value of the underlying asset is consumed during the lease term, although the test for real estate assets differs from the test for equipment assets with, in my opinion, no sound justification. The AAA Financial Accounting

Standards Committee's advice included the following quote which is counter to the approach taken by the Boards "The Committee believes the goal for lease accounting is to represent the value of the rights and obligations conveyed by the lease, not the value of the physical assets, unless there is no material difference between the value of the physical assets and the value of the rights and obligations." The boards seem to lose sight of their decision to account for the contract as the unit of account and to account for the values of the rights and obligations – not account for the value of the underlying asset. Focus on the underlying asset, and not the rights and obligations in the lease contract, in current GAAP has been cited as a deficiency.

Sale leasebacks with non bargain purchase options

Sale leasebacks are very common transactions. Three examples are: land and buildings sold and leased back, airplanes ordered by and with progress payments made by the lessee with the intention of leasing them when completed, and master lease arrangements where the lessee orders many small ticket assets with the intention of leasing them and pays for them as a matter of convenience where the lessor does a once a month sale lease back to put the assets under the master lease. Those leases may contain non-bargain purchase options. The current decision in the ED is to look to the decisions in the revenue recognition project to determine if a sale has taken place in a sale leaseback. If no sale has taken place the transaction is a financing. The current decisions in the revenue recognition project include denying sale treatment if there is a seller buy back option in a sale lease back regardless of whether the buyback option is a bargain. This seems illogical and, in my opinion, is a step backwards from current GAAP which allows sales if there is a non-bargain purchase option. Current GAAP is in line with the legal and tax views and this decision is another break in the alignment of accounting, tax and legal views of a sale leaseback.

Lessor lease classification

Lessor lease classification and accounting need not be symmetrical with lessee accounting. In their desire to simplify things the Boards have decided that there should be symmetry. The reason for not having symmetry is that the lessee and the lessor often have two completely different perspectives given the same transactions. As an example, there are financial lessors who view leases as a discrete investment (they only buy an asset to be leased when the lessee is committed to lease that asset) and intend to sell the asset (often via auction or to a dealer) if the lessee returns it at lease expiry. In contrast there are operating lessors who view the leased asset as their stock-in-trade (they buy assets on spec and add the asset to their inventory of assets available for lease) and they intend to lease the equipment several more times beyond the first lease. In both cases the lessors offer very similar terms to the lessee. The lessee on the other hand is typically only leasing to obtain the temporary right to use the asset and does not care whether the lessor will sell or re-lease that asset when their lease ends and they return the asset. It is my opinion that the lessor classification test should be based on the business model of the lessor. That is how real estate assets are treated currently for lessors under IAS 40, which is being carried over into the proposed rules but for real estate assets only (again a lack of a common principle for leases of any type of asset). The principle under IAS 40 is that if a lessor manages the leases assets with the intention of re leasing and or selling the assets at the end of the first lease and successive leases, the lessor is not a financial lessor and the operating lease method provides the best decision useful information to users. Specifically those investment property lessors keep the physical asset on their books rather than record a receivable and residual. They depreciate the asset over the assets useful life. Rents and residual sales proceeds are revenue. Financial lessors, especially banks which dominate the US leasing market, on the other hand should be using the method proposed by the ED also known as the receivable and residual method. This approach portrays the rent receivable as a financial asset and the residual as a quasi financial asset. This is similar to loan accounting and portrays the economics of the transaction as it is priced and as it is intended to play out. It also avoids showing depreciation expense for leased assed co-mingled with depreciation of assets that financial lessors use in their business which distorts financial leverage ratios and net interest margin measures used by analysts to measure performance of financial institutions.

All residual guarantees and residual insurance should change the nature of a lessor's residual

The view in the ED is that only residual guarantees that also include the lessee getting the "upside" (gain) when the asset is sold for more than residual value as in TRAC (Terminal Rental Adjustment Clause) leases are treated as a minimum lease payment. In my opinion, this is another instance of the lack of one principle to account for all types of guaranteed/insured residuals for lessors. It would seem that all residual guarantees represent a minimum lease payment to the lessor as the lessor is guaranteed the amount insured. The importance of this is twofold. First the amount of minimum lease payments affects up front gross profit recognition is leases where the carrying value is less than the fair value. This occurs most often where a manufacturer also has a captive finance company to provide a lease option to customers. It is also important in classifying the lease asset as a financial asset rather than a residual asset. Only financial assets can be securitized and under current GAAP guaranteed residuals are financial assets and are part of asset securitizations particularly in vehicle leases.

There are many possible types of residual guarantees and residual "upside" sharing. The ED does not give any guidance or principle. How will partial guarantees or partial upside sharing be treated? How would first loss or last loss guarantees be treated?

Leveraged lease accounting – netting

Leveraged lease accounting is considered by many to be one of the best accounting methods in terms of portraying economic effects of a transaction, specifically reflecting the true financial risk and the effects of taxes directly related to the lease investment. Leveraged lease accounting is unique in 2 ways. First the assets presented are the net rent and residual that are at risk to the lessor/preparer. The bank regulators view that only the net investment as the asset requiring regulatory capital. Also the net rent due to the lessor meets the definition of an asset (as opposed to the gross rent which does not as the lessor/preparer cannot sell the rents or get any other economic benefit from them as they are for the account of the leveraging debt lender who reports them as an asset on its balance sheet – can an asset be an asset of two entities?).

Under their Conceptual Framework—Elements and Recognition Project the Boards have tentatively adopted the following working definition of an asset:

An *asset* of an entity is a present economic resource to which the entity has a right or other access that others do not have…

The gross rent due to the leveraging lender do not meet the definition of an asset for the lessor.

Additionally a leveraged lease is a 3 party agreement wherby the lessee agrees to pay the rent to the non recourse lender – there is no recourse to the lessor. This fact pattern seems to fit the rules for the right of offset by the lessor as follows:

1. Amounts of debt are determinable
2. Reporting entity has the "right" to set off
3. The right is enforceable by law
4. Reporting entity has the "intention" to setoff

The second reason why leveraged lease accounting uniquely reflects the economics is the recognition that tax benefits directly related to the leased asset are reflected in the revenue recognition method – this is explained below.

The sophisticated US capital markets and tax system with tax incentives for equipment created the environment that spawned the leveraged lease structure. The same elements are not in place yet in all IFRS countries. To eliminate the leveraged lease structure means the US gets a lowest common denominator set of rules. As reported in the Journal of Accountancy, Leslie Seidman, FASB Chairman has said “U.S. financial reporting needs more precise, clear guidance than the IASB’s broad, principles-based approach offers.” “Precise guidance is necessary in the United States, which has a more litigious culture. The U.S. financial reporting system can’t function over the long run with accounting standards that provide only broad principles,” “This apparent need for some adjustments does not mean that IFRS is flawed,” Seidman said. “It simply suggests that a goal of 100% comparability such as a single set [of standards] is not achievable in the near term, for very legitimate reasons, in some of the world’s largest capital markets.”

Leveraged lease and tax lease revenue recognition – tax credits as revenue and after-tax yield amortization

Leveraged lease accounting is also unique in its including the effects of income taxes directly related to the leased asset in the revenue recognition methodology. Fixed tax cash flows directly related to the leased asset are viewed the same as rents, and residual proceeds by the lessor in its pricing calculations. Tax credits like ITC and tax grants as are available for certain alternate energy assets like solar panels and wind turbines are treated as revenue under the current GAAP leveraged lease accounting method. They are also treated as a cash flow in the calculation of the after-tax yield (also known as the MISF or Multiple Investment Sinking Fund yield) that is used to recognize revenue. There are tax cash flows related to the accelerated depreciation tax deductions (also known as Modified Accelerated Cost Recovery or MACRS deductions) and the cash basis income recognition treatment of rent and residual proceeds. The combination of accelerated depreciation and cash basis rents and residual income creates a tax deferral. Tax cash flows resulting from the tax deferral are reflected in the net cash investment that the MISF yield is based on. In summary the leveraged lease revenue recognition method is to recognize the revenue in the lease at a constant rate of return versus the net cash invested in periods where the net cash invested is positive. In simple terms this method matches revenue with the pattern of interest expense incurred by the lessor to fund its investment. The concept of matching of income and expense has not been in favor as we move more towards a fair value model but it seems to have created a regime where earnings are less a predictor of future value of an entity as per “Matching and the changing properties of accounting earnings over the last 40 years” by Ilia D. Dichev, Stephen M. Ross School of Business, University of Michigan and Vicki Wei Tang, McDonough School of Business, Georgetown University, May 2008. The failure to reflect tax benefits in the revenue recognition will severely distort revenue on leases where the leased asset has significant tax benefits.

If tax benefits are ignored it makes for less comparability among lessors and financial institutions as the revenue recognized under non-tax transactions like a loan will be at a constant rate versus the investment yet revenue recognized from a lease with tax benefits like a leveraged lease will have no logical pattern (in fact they will be back ended making the lease appear to be a poor investment in the early part of the term and then highly profitable towards the end of the term).

Conclusion

The project is controversial largely because of the Boards approach to completely change the classification tests, expense recognition, balance sheet classification and cash flow statement presentation for lessees which means preparers and key users (lenders, credit analysts and equity analysts) will no longer have important information on operating leases (executory contracts) that is available under current GAAP. Another reason for controversy is that leases are used by virtually all companies and the proposed rules are complex and in many cases will not reflect the economic effects of leases as well as the current rules do. Small and medium sized companies rely heavily on leasing as do banks, retailers and transportation companies. There are many business reasons for leasing and particularly, in the case of real estate, leasing often is the only practical means for an entity to acquire the use of a necessary asset like a retail location or office space. Additionally major changes are proposed by the ED for lessor accounting yet lessor accounting was not cited as having accounting and reporting deficiencies (the Boards get few comment letters from lessors versus lessees because there are many fewer lessors than lessees possibly making the lessor issues seemingly less of an issue). The Boards have made concerted efforts through outreach programs and consultations with experts and advisors but have not accepted feedback that, in my opinion, could have allowed the project to be completed without going through a second Exposure Draft. Many controversial issues remain in the Exposure Draft so it should receive a high volume of comment letters that will, in my estimation, contain valid issues that will need further work. It is a fact of life that many preparers do not write comment letters because of a lack of resources and the feeling that they cannot change things. If adopted as is it is my opinion that the new rules would provide less key decision making information than the current rules for both lessees and lessors. A few key changes would make the proposed rule workable and an improvement over current GAAP.

The issue of lack of an accurate present value calculation of the operating lease obligations (including use of the appropriate incremental borrowing rates for each lease, variable rents based on an index and a rate and expected payments under residual guarantees) and that operating lease obligations are off balance sheet while most users capitalize them as a debt equivalent for purposes of measures and ratios needs to be dealt with by capitalizing operating leases. In that case all preparers, most all users and the SEC would have been satisfied by a decision to merely put the present value of operating leases payments on balance sheet on each reporting date while keeping the P&L cost and the cash flow presentation unchanged. In addition disclosures could have been expanded to include the weighted average discount rate for all capitalized operating leases and the amount of imputed interest expense included in the rent expense using the actual discount rates (incremental borrowing rates) in the capitalized operating leases. To satisfy those analysts who need more information, a needs analysis should be done and if the costs justify it, further information could be disclosed to satisfy their specific needs without obscuring the true economic effects of leases in the financial statement presentation.

I value the relationship built over the years with the FASB and IASB. The Boards and staff have always given me access and allowed me to provide my views on various accounting and financial reporting matters. You all have listened and in some cases changed your views. I hope that my input here is valuable to furthering the mission of the Boards to help improve transparency in financial reporting. I look forward to continuing to work with the Boards and staff on this matter and stand ready to assist in any way I can.

Sincerely,

William Bosco
Leasing 101

Example of my recommended executory lease accounting method compared to the proposed ROU/Type A front end cost method per the ED:

Assumptions	
Base yr annual rent	$ 450,000.00
Annual step up %	10%
Payment timing	arrears
Term in years	10
Inception month	January
Lessee incr borrowing rate	8.00%
PV of rents	$4,531,604

Method as proposed in the ED for front end cost leases I&A or Type 1 leases:

Supporting Calculation for Type A ROU Method				
	Capitalized lease obligation amortization			
year	obligation balance	rent	imputed interest	rou asset amortization
0	$4,531,603.89			
1	$ 4,444,132.20	$ 450,000.00	$ 362,528.31	$ 453,160.39
2	$ 4,304,662.78	$ 495,000.00	$ 355,530.58	$ 453,160.39
3	$ 4,104,535.80	$ 544,500.00	$ 344,373.02	$ 453,160.39
4	$ 3,833,948.66	$ 598,950.00	$ 328,362.86	$ 453,160.39
5	$ 3,481,819.55	$ 658,845.00	$ 306,715.89	$ 453,160.39
6	$ 3,035,635.62	$ 724,729.50	$ 278,545.56	$ 453,160.39
7	$ 2,481,284.02	$ 797,202.45	$ 242,850.85	$ 453,160.39
8	$ 1,802,864.05	$ 876,922.70	$ 198,502.72	$ 453,160.39
9	$ 982,478.20	$ 964,614.96	$ 144,229.12	$ 453,160.39
10	$ (0.00)	$ 1,061,076.46	$ 78,598.26	$ 453,160.39
		$ 7,171,841.07	$2,640,237.18	$ 4,531,603.89

Journal entries

Proposed Type A ROU accounting		
dr ROU asset	4,531,604	
cr Capitalized lease obligation		4,531,604
To capitalize the lease		
dr Amortization expense	453,160	
cr ROU asset		453,160
To depreciate the asset 1st yr		
dr Interest expense	362,528	
dr Capitalized lease obligation	87,472	
cr Cash		450,000
to record 1st yr rent, ROU asset amort & imputed interest		

Recommended executory contract accounting		
dr Right to use equipment	4,531,604	
cr Capitalized operating lease obligation		4,531,604
To capitalize the lease		
dr rent expense	717,184	
cr Accrued rent payable		717,184
To accrue first yr rent expense @ the average rent to be paid		
dr Accrued rent payable	450,000	
cr Cash		450,000
To pay 1st year rent payment		
dr Capitalized operating lease obligation	4,531,604	
cr Right to use equipment		4,531,604
To reverse last period's lease capitalization entry		
dr Right to use equipment	4,444,132	
cr Capitalized lease obligation		4,444,132
To re-book capitalized lease @ PV of remaining payments		

Stepped Rents Case Comparative Financial Statements										
Proposed Type A ROU accounting										
Balance sheet	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10
ROU asset	4,078,444	3,625,283	3,172,123	2,718,962	2,265,802	1,812,642	1,359,481	906,321	453,160	(0)
Cap lease oblig	4,444,132	4,304,663	4,104,536	3,833,949	3,481,820	3,035,636	2,481,284	1,802,864	982,478	(0)
Net Assets-(Liab)	(365,689)	(679,380)	(932,413)	(1,114,986)	(1,216,018)	(1,222,994)	(1,121,803)	(896,543)	(529,318)	0
P&L										
ROU asset amort	453,160	453,160	453,160	453,160	453,160	453,160	453,160	453,160	453,160	453,160
Interest expense	362,528	355,531	344,373	328,363	306,716	278,546	242,851	198,503	144,229	78,598
PT expense	815,689	808,691	797,533	781,523	759,876	731,706	696,011	651,663	597,390	531,759
Tax expense	-	-	-	-	-	-	-	-	-	-
Net after tax	815,689	808,691	797,533	781,523	759,876	731,706	696,011	651,663	597,390	531,759

Executory contract accounting

Balance sheet	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10
ROU asset	4,444,132	4,304,663	4,104,536	3,833,949	3,481,820	3,035,636	2,481,284	1,802,864	982,478	(0)
Cap op lease oblig	4,444,132	4,304,663	4,104,536	3,833,949	3,481,820	3,035,636	2,481,284	1,802,864	982,478	(0)
Accr rent payable	267,184	489,368	662,052	780,286	838,626	831,080	751,062	591,323	343,892	-
Net Assets-(Liab)	(267,184)	(489,368)	(662,052)	(780,286)	(838,626)	(831,080)	(751,062)	(591,323)	(343,892)	-
P&L										
Rent expense	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184
Tax expense	-	-	-	-	-	-	-	-	-	-
Net after tax	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184
rent paid	450,000	495,000	544,500	598,950	658,845	724,730	797,202	876,923	964,615	1,061,0

P&L Pattern	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10
Exec cont method	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,18
Type A ROU method	815,689	808,691	797,533	781,523	759,876	731,706	696,011	651,663	597,390	531,75
Difference	(98,505)	(91,507)	(80,349)	(64,339)	(42,692)	(14,522)	21,173	65,521	119,795	185,4
% Difference	-14%	-13%	-11%	-9%	-6%	-2%	3%	9%	17%	26

ED Questions and Answers:

Scope

Question 1: Identifying a Lease

I agree with the definition except that I would go further and deal with lease contracts that also transfer rights of ownership in addition to rights of use. I believe as under current GAAP that there are 2 kinds of leases – capital (ROO or rights of ownership leases) leases and operating leases/executory contracts (ROU or rights of use leases) and the accounting for the 2 should be different. I think the boards could either scope out capital leases or include language to deal with leases that transfer rights of ownership. The framework that the ED is supposedly based on is accounting for rights and obligations but there is no discussion of analyzing rights and obligations to determine the nature of the lease as either a right of use lease or a right of ownership lease - so it is a misnomer to call the approach a right of use approach. I think the Boards should reconsider their ROU approach and use a rights and obligations (R&O) approach. This is not a new issue in accounting for leases and the extensive outreach and comments received by previous Boards led them to the current risks and rewards classification tests. The basic legal truths regarding leases still exist. Failing to recognize that there are 2 types of leases creates many of the sticking points that prevent broader acceptance of the ED. Listening to the public meetings it appears that many Board members do think there is more than one type of lease but say they cannot agree on the dividing line. I think the dividing line should be based on the legal nature of the contract in the jurisdiction of the preparer and that is what current GAAP is based on. In the US the legal nature of a lease drives the tax treatment and treatment in bankruptcy. The legal nature of the contract is economic reality and new contrived accounting theories do not change that.

The Boards base much of their thinking in developing the ROU model on their view that once a lessor delivers the asset no significant lessor performance obligations remain. That is an accounting theory that does not match legal reality. Under the law the remaining lessor performance obligations are important enough such that the lease is still viewed as executory in nature. Examples of lessor performance obligations are to provide quiet enjoyment of the underlying asset and to keep it free of liens. The Boards may think those are insignificant but the law does not and the legal treatment of the contract is economic reality.

Question 2: Lessee Accounting

I do think that the lease term compared to useful life of the leased asset is one of the criteria that differentiate an executory contract/operating lease (ROU lease) from a capital lease (ROO lease). I do not agree that real estate executory contracts (ROU leases) should be treated differently than equipment lease/executory contracts (ROU leases). In my opinion the idea that there must by lessee/lessor symmetry should be re-opened. Lessees should use the current GAAP classification tests and the lessor classification should be based on business model. Investment property accounting is an exception to the ROU model (it is a business model based approach). I do agree that operating lessors should use the operating lease accounting method. I believe the granting of Type B status for most real estate leases was done to accommodate granting operating lease treatment to real estate lessors such that there could be symmetry for real estate leases. We are mixing principles. To solve the dilemma the Boards should use the rights and obligations (not the ROU) approach for lessee classification based on current GAAP classification tests as the principle for lessee accounting (that is what most users want). The Boards should use the business model approach for lessor accounting as that is what most users want. Lessees view leases differently than lessors. Lessees either want merely a right to use an asset or they want a right to own the asset. Lessors either view the lease as a discreet investment, buying the asset that is ordered by the lessees and planning to sell the asset when the lease ends (as in a “financial” lessor’s business model) or they view the leased asset as their stock in trade, that is, they plan to manage that asset over time and lease it many times to multiple lessees (as in an “operating”/investment property lessor business model). Following this approach is a principles based approach and would mean there is no exception regarding investment property for the lessor and there is no need to differentiate real estate from equipment leases for either the lessee or lessor. Any other approach will not give users what they need.

I agree with lease asset and lease liability initial measurement as being the present value of the minimum lease payments as defined in the ED. I believe that capital leases represent tangible assets and “true” debt that survive bankruptcy and as such the asset should be included in PP&E and the liability should be labeled as a capital lease liability (debt). The asset in a capitalized operating lease/executory contract is an intangible asset that disappears in bankruptcy (legally it is viewed as undelivered future services) and the liability is a “special” liability (not debt) as it also disappears in bankruptcy. The asset and liability must be reported separately and clearly labeled as it is important for potential lenders and credit analysts. It is also important for the Boards to directly state that a capitalized executory contract liability is not debt so that debt limit covenants are not breached.

Subsequent measurement should be different for capital leases and capitalized executory contracts. Capital lease accounting should follow current GAAP as the asset is owned and therefore independent of the liability in bankruptcy. The capitalized executory contract leases are not financings as the periodic payment is a performance obligation that the lessee must make to obtain the periodic right of use. This is the legal and tax view and it is economic reality. The value of the asset and liability of a capitalized executory contract lease over time is always the same (absent impairment). The value is the present value of the remaining minimum lease payments. The asset and liability are inextricably linked and should not be accounted for separately as in a capital lease. The periodic P&L cost allocation should be the accrual of the average minimum lease payments. The cash flow treatment of capital lease payment should as any other loan payment. The cash flow treatment of rent paid should be as an operating cash outflow.

Question 3: Lessor Accounting

No. I believe the lessor classification should be based on business model as per my answer to question 2 above. Financial lessors like banks and finance companies should us the R&R method. They should not use the operating lease method as it distorts the P&L and financial measures used by analysts. Analysts measure financial lenders/lessors by such measures as net finance revenue over interest cost (net spread/net revenue from invested funds) and operating efficiency (the ratio of net revenue to expenses). The operating lease method’s revenue being rent and residual bears no relationship to the declining financial asset and its cost to carry. Mixing depreciation of leased assts with assets used in the business makes the bank/finance company look less efficient. For the same reasons, the boards must re address accounting for tax credits and tax benefits for financial lessors. Reporting tax credits in tax expense rather than as a component of lease revenue and failing to recognize the reduction in cost to carry from tax shelter distorts the net revenue and operating efficiency ratios. Users want to see the results of investments considering all the elements of revenue in the appropriate line on the P&L based on the substance of the transaction.

Question 4: Classification of Leases

I do agree that the relationship of lease term to the economic life of a leased asset is one of the factors used to determine if the rights and obligations in a lease are ownership rights or merely rights of use. It should not matter what the leased asset is – real estate or equipment. See my answers above. I believe that the current GAAP risks and rewards tests accomplish the goal of classifying leases according to their legal nature and those classification tests should be part of the new lease accounting model. If they are not then users will have less information regarding key information to analyze credits. Preparers will have to keep 2 sets of records to identify those leases that are capital leases versus executory contracts as the distinction is an important factor in tax compliance. Federal income tax treatment of executory contracts only allows deduction of rents. State income tax apportionment is based on tangible assets and intangible (executory lease) assets using formulas using rent expense to value the intangible assets, sales tax is payable up front in a capital lease while in an operating lease/executory contract it is paid in the rent (each rent is considered a “sale”) and finally local property taxes are payable by the lessee on any capital lease (tangible) asset while the lessor is responsible for property tax on executory/operating lease assets (intangible).

Question 5: Lease Term

I agree with the definition of the lease term at inception. I do not agree that a renewal or extension should be treated as an extension of the initial lease and result in a re booking. I think it should be treated as any other lease and only booked at commencement. The impact of the front loaded cost pattern in the re booking of a type A lease means that costs of the renewal lease are accelerated into the term of the initial lease. If the Boards change their lease classification test such that former operating leases get straight line cost allocation, as I suggest above, this will be much less an issue. I also submit that it is illogical for a lessee to have to immediately account for a renewal or extension where as if that lessee agreed to lease that same type asset from a different lessor it would not book that lease until it commenced. We should have one principle for future lease commitments, but as I said the problem is exacerbated by the front loading pattern of Type A leases.

Question 6: Variable Lease Payments

I agree with the treatment of variable lease payments

Question 7: Transition

Lessee transition for Type A I&A leases is far too complex all because the method front loads costs and the transition method attempts to lessen the current period P&L impact. As I said in my answer to Question 1 I do not agree with the cost allocation for executory contracts. Another issue here is the classification of most equipment leases as Type A leases even though they are executory contracts. Most equipment leases are small in dollar value and they are numerous, yet they will be subject to the highly complex transition.

I believe the entry in the **842-10-55-77** example of a Type A lease transition lacks a charge to deferred tax assets.

In 842-10-55-89 the fair value of an asset may not be readily available for many asset types. In 842-10-55-90 it seems to allow the residual to be "written up" is it is higher that the residual value at inception. To simplify things and to conform to the principle that residuals cannot be written up, I would use "at inception/commencement" data for cost/fair value, residual and implicit rate. As a result the value of the lease at transition will be the PV of the rents and original residual using the original implicit rate to PV the amounts.

In 842-10-65-1 paragraph s I think it should read as follows with additions highlighted in yellow: "For leases that were classified as direct finance or sales-type leases in accordance with Topic 840, the carrying amount of the lease receivable and residual asset at the beginning of the earliest comparative period presented shall be the bifurcated carrying amount of the net investment in the lease immediately before that date (using the implicit rate in the lease to calculate the amounts) in accordance with Topic 840."

Question 8: Disclosure

I do not agree that a lessee in a lease with services needs to disclose future non lease components/service contract payments as the same disclosure is not required for a service contract with the exact same terms that is contracted separate from the lease. Also if an asset is owned and a preparer enters into a service contract on the asset that has the exact same terms as the service contract connected to a lease it would not need to be disclosed. In all cases I cited the service contract is legally the same – an executory contract.

The requirements in **42-20-50-4** to disclose reconciliations for the assets and liabilities for both Type A and Type B leases is a great deal of information that I wonder if users really need. I suggest that question be posed in targeted outreach with lenders, investors and analysts.

The fact that most companies lease many types of assets and have numerous leases means that the requirements in **842-20-50-3** to describe lease terms will result in very general descriptions**.**

Questions 9, 10, 11, 12

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