

## **For a Better Approach to Lease Accounting:**

*Fixing the remaining sticking points*

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## Background

Lease accounting based on a leased asset's "right-of-use" (ROU Approach), capitalizes the intangible right-of-use and its associated obligation at the present value of expected payments under the lease contract. This new ROU approach adopted by the FASB/IASB Leases Project had its origins in G4+1 papers written in 1986 and 2000. The project rose to an active level following the financial crisis of 2001-2 (Enron, WorldCom, et al) and the passage of the Sarbanes Oxley Act. The Act mandated the SEC to identify off balance sheet arrangements that could hide or obscure financial risk. In the SEC's 2005 report on off balance sheet arrangements<sup>1</sup>, operating lease obligations were identified as one of the largest off balance sheet items. This prompted the FASB to add the Leases Project to its agenda of FASB/IASB convergence projects. Work on this important joint effort began in 2006 and thus far, has resulted in a 2008 Exposure Draft and a Second Exposure Draft (ED2) issued on May 16, 2013 with a comment period ending September 13, 2013.

The Joint FASB/IASB lease project has been controversial largely because the Boards' approach completely changes lease classification tests, expense recognition patterns, and balance sheet and cash flow presentation. These changes mean preparers and key users (lenders, credit analysts and equity analysts) will no longer have important information on operating leases (executory contracts) which is now available under current GAAP. Additionally, major changes are proposed in the ED2 for lessor accounting, yet lessor accounting was not cited as having accounting and reporting deficiencies.

The proposed rules are complex, and when compared to current rules, their application in practice may not adequately reflect the economic impact of a company's leasing policy. Because leasing is pervasive, and for many businesses is the only practical means to acquire the use of a necessary asset like a retail location or office space, it is important to establish uniform and uncomplicated rules that improve reliability and comparability of financial reporting. While the Boards made a concerted effort through outreach programs and consultations with experts and advisors, they did not accept feedback that could have allowed the project to be completed without going through a second Exposure Draft. Feedback was limited because many lessees lack the resources and will to write comment letters, while in the case of lessors, the number of comment letters was few because there are far fewer lessors than lessees.

Many controversial issues remain in ED2, and as a result, the Boards should expect to receive a high volume of comment letters that are likely to contain valid issues that will require further work. If ED2 is adopted as is, the new rules will provide less useful decision making information than the current rules for both lessee and lessor accounting. However, a few key changes would make the proposed rules workable and an improvement over current GAAP.

## Summary of the ROU Approach to Accounting for Leases

The ROU approach involves assuming that ***all*** leases transfer rights of use. Specifically, under this approach, the intention is to account for rights and obligations arising from the lease contract. Initially the ***rights*** and ***obligations*** are measured at the present value of the contracted lease payments. The Boards said this is the best proxy for the value of the lease assets and liabilities.

Subsequent accounting involves independently accounting for the asset and liability, breaking apart the unified nature of the contract. For Type A leases (mostly equipment leases whether capital or executory, and some real estate leases that have capital lease attributes) the asset is amortized straight line and the liability is accounted for using effective interest amortization which imputes interest expense. For Type B leases (mostly executory contract real estate leases and a few short term executory contract equipment leases) the liability is accounted for using effective interest amortization which imputes interest expense while the amortization of the asset is a “plugged” amount such that the total lease expense is level over the lease term.

The Boards’ initial objective was to simplify lease accounting based on the idea that **all** leases transfer rights of use. In our opinion there are some shortcomings in the approach. It is oversimplified. There are leases that transfer ownership rights which should be accounted for and reported differently to reflect their significantly different economic effects. All leases do not merely transfer rights of use. There is no step in the ROU approach to analyze the contractual rights and obligations and to separate leases by their legal nature – that is, either capital leases (rights of ownership leases or ROO leases) or executory contracts (rights of use leases or ROU leases).

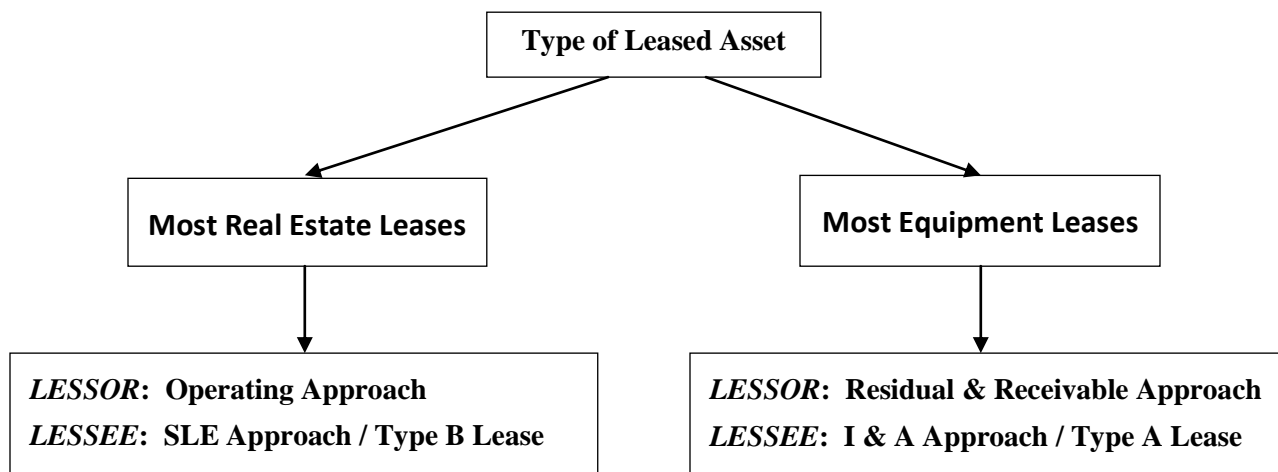
Classification of leases by asset type - real estate versus equipment - does not result in separating lease assets and liabilities by their legal nature. Capital leases create a tangible asset and debt that survive bankruptcy, on the other hand, executory contract leases (the former operating leases) create unique intangible assets and liabilities (non-debt in bankruptcy) that only exist to a going concern. Capital lease accounting should (as it does in ED2) separate the asset and liability and treat them as any other asset or liability of that type. On the other hand, as opposed to the treatment in ED2, the executory contract lease accounting should allocate cost on a level basis as rent expense while the asset and liability should be shown on balance sheet at the best proxy for their value – that is at the present value of the remaining payments. The asset and liability are inextricably linked and the value of the liability and asset arising from the executory lease contract should be the same over the lease term except for impairment, lessor concessions and initial direct costs.

### **Details re: Types of Leases**

If only an ROU is transferred, it should be accounted for as a capitalized executory contract. Leases that transfer rights of ownership should be treated as either capital leases under the scope of the standard or be specifically excluded from the scope and accounted for as a financed purchase. In the ED2, the FASB/IASB decided that lease classification should be based primarily on the underlying lease asset type, and as such, ED2 categorizes leases as either - a **Real Estate Lease** and an **Equipment Lease**. As depicted in Exhibit 1, “for Real Estate Leases, the Lessor will most likely use an Operating Lease Approach, while the Lessee will most likely follow a Single Lease Expense (SLE) Approach (now labeled as Type B leases in ED2). For Equipment Leases, the Lessor will most likely follow a Residual & Receivable (R&R) Approach, while the Lessee will most likely follow an Interest & Amortization (I&A) Approach (now labeled as Type A leases in ED2).” (CPA Journal, Jan 2013, p. 18). This treatment requires the Lessee to record an ROU asset, but subsequently calculate the income effect as a front-loaded expense (I&A Approach, AKA Type

A Approach) for an Equipment Lease, but as a uniform expense (SLE Approach, AKA Type B Approach) for a Real Estate Lease. This approach does not consider the legal nature of the lease contract. “In most cases, an ROU lease is legally an executory contract. The lessee acquires a temporary right to control the use of the underlying asset; it does not purchase or control the ownership interest in the property. This temporary acquisition is designated as the ROU Asset. The liability for making lease payments is not a financing arrangement, and as a consequence, is not equivalent to debt as the Lessor has no claim on the assets of the Lessee in bankruptcy. The Lessee must make its rent payments to obtain future use of the underlying Leased asset’s utility. Contracting the right to use an asset that requires ongoing performance (paying rent), is not the same as purchasing the underlying leased asset, since the ROU asset typically cannot be pledged or sold separately from the Liability.” (CPA Journal, Jan 2013, p.21). This being said, the ED2’s requirement to use a front-loaded Type A Approach for equipment leases that are executory contracts, makes it appear as though there is a financed purchase, where in subsequent accounting, the asset is separated from the its accompanying liability. This approach is contrary to the legal and economic substance of the lease.

Exhibit 1  
Types of Leases Under the Second Exposure Draft

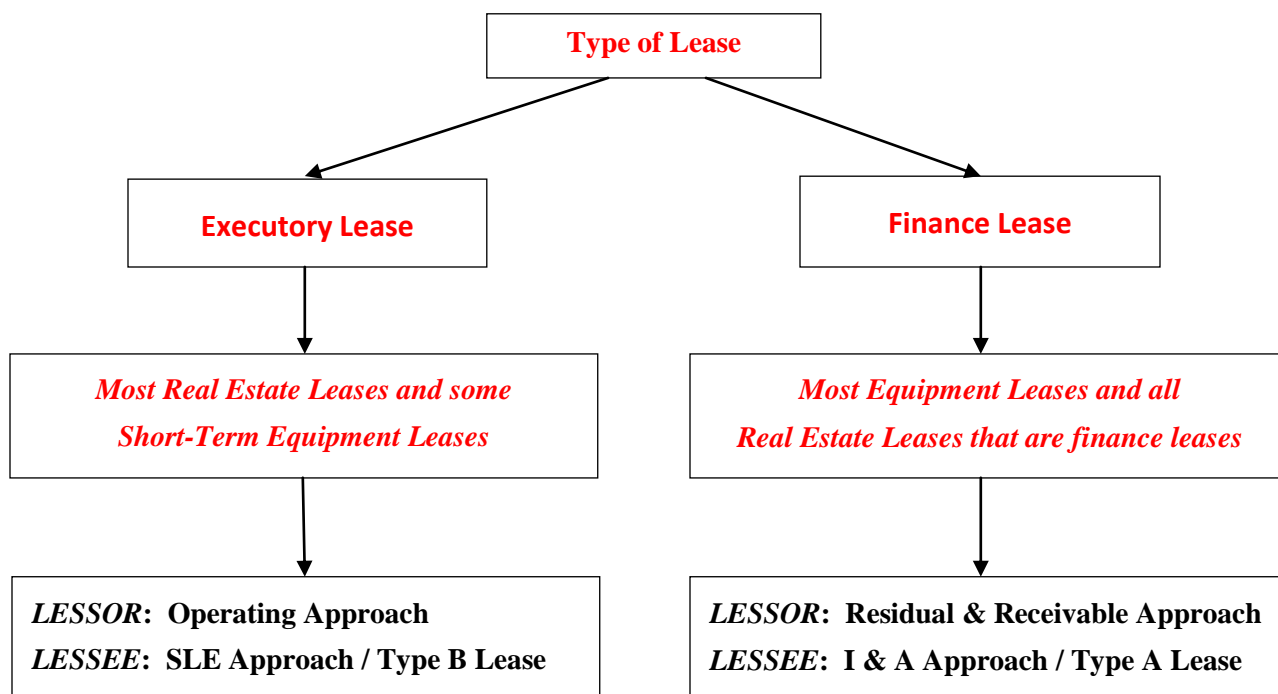


The decision in the Second ED to have two types of leased assets, each with different classification tests, lacks a common principle. There needs to be one principle for all leases, by lease type (executory versus finance/capital leases) regardless of the type of leased asset. This was included in the 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 AAA Financial Accounting Standards Committee’s mission includes advising the FASB on proposed rules. 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. 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 problem with the FASB/IASB ED2 is the advocacy of an accounting approach that is based primarily on the type of leased asset, rather than type of lease. As depicted in Exhibit 2, there should be two types of leases based on an examination of rights and obligations in the lease contract.

Exhibit 2  
Types of Leases by Substance of Lease Contract



The legal (UCC), tax (U. S. Federal Tax - IRS, local property tax , and sales/use taxes) and the current accounting regime in the U. S. 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 (for the most part) to satisfy all compliance and information needs. ED2's proposed Leases standard will break the alignment and force preparers to (1) keep sets of records for accounting purposes and records for tax compliance and (2) to provide information to lenders and credit/equity analysts as to which leased assets are intangible versus tangible, and which liabilities are executory contract liabilities versus true "debt" in bankruptcy.

The Boards need to develop a Conceptual Framework for 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). Additionally, the Boards need to re-examine the legal issues and economic substance issues that distinguish intangible assets from tangible assets and executory contracts from debt. In summary, the boards should amend their classification of leases by type of asset (Exhibit 1) to a classification based on rights and obligations created by the lease contract (Exhibit 2).

### **Lessee Balance Sheet Presentation**

Under the new rules, operating leases will be the first executory contract to be capitalized by preparers. The nature of an ROU asset is that it is an intangible contract right. It is an asset to a going concern provided the lessee continues to make payments to enjoy continued right of use, but it is not an asset in most bankruptcy scenarios.

Presentation and labeling should allow a user of financial statements to differentiate assets and liabilities that may exist on a going concern basis, but do not exist in bankruptcy. There is a growing concern about the lack of guidance on going concern, bankruptcy, and risk of bankruptcy, as evidenced by the FASB’ issuance of an exposure draft on June 26, 2013 entitled ***Disclosure of Uncertainties about an Entity’s Going Concern Presumption***. Improving presentation and disclosures regarding the bankruptcy and going concern nature of lease assets and liabilities would be in line with objective of improving the usefulness of financial information.

A prospective lender to an entity does a bankruptcy risk analysis to determine the outcome of a possible bankruptcy. This involves identifying “true” assets and “true” debt of the entity that would compete with the new loan for claims on assets. As a result, debt analysts and lenders need more specific definitions of assets and debt, especially in reference to their standing in a bankruptcy.

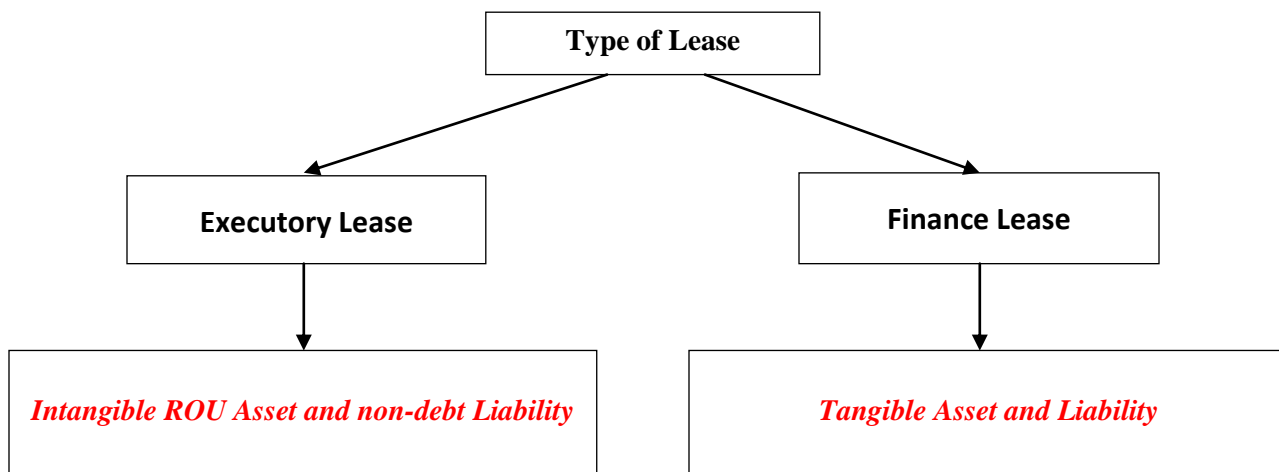
In bankruptcy, the court rejects the lease if (1) it is an executory contract and not essential to any planned operation of the bankrupt entity or (2) the bankrupt entity is to be liquidated. This means the leased equipment is returned to the lessor who is the legal owner of the equipment, and the lease is terminated so that no asset remains in the bankrupt estate (bankruptcy law views the ROU asset as undelivered future services) and no further liability exists to make lease payments. In other words, the contract rights and obligations disappear.

Since capital leases are legally purchases of the asset financed by debt, their treatment in bankruptcy is completely different than an operating lease/executory contract. 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 with no differentiation as to contract type, gives less key information than is available under current GAAP.

The ED2 solution where the classification tests are different for equipment and real estate (as shown in Exhibit 1) and where the classification tests are not aligned with legal classification tests, means that financial information regarding lease activities is not as useful as the information available from the footnoted operating lease obligations under current GAAP. **The ED2 approach does not provide users with enough detailed information to adjust the reported numbers to get**

**the information they need regarding the legal nature of leases.** We are not saying that operating lease obligations should continue to be footnoted, but rather, due to their unique nature, the capitalized operating lease (executory contract), which are ROU assets and liabilities, should be presented separately on the balance sheet. In other words, as depicted in Exhibit 3, if the Boards would differentiate leases based on the substance of the contract, the intangible ROU asset and liability created from an Executory Lease and the tangible asset and debt created from a Finance Lease could be shown separately on the balance sheet of the lessee. Failure to correctly label capitalized operating lease obligations as “non-debt” liabilities will also cause debt limit covenants to be broken. Those existing debt limit covenants were set by lenders with full knowledge of the existing operating lease obligations, but at the same time, lenders knew those obligations would not compete with their claim in a bankruptcy.

Exhibit 3  
ROU Leased Asset versus Capitalized Leased Asset



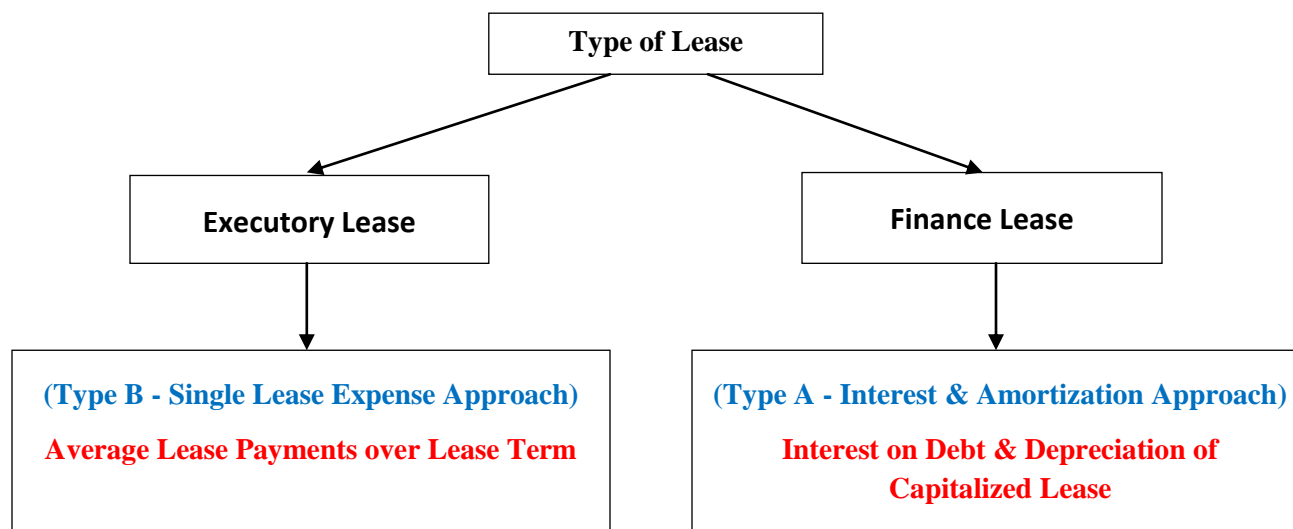
**Lessee Cost Recognition**

As shown in Exhibit 4, the cost recognition pattern should be different for leases that are capital leases and for leases that are capitalized executory contracts (former operating leases). Capital leases are a debt obligation because the UCC and IRS view them as interest bearing contracts and a purchase of the leased asset. As such, the delinking of the asset and liability for subsequent accounting is appropriate. As with any financed purchase of a depreciable asset, the accounting will entail recording depreciation and recording interest on the obligation.

On the other hand, operating leases are executory contracts because periodic payments are 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 asset and liability that arise from the executory lease contract are not separable. Their values should decline at the same rate and the best proxy for the value at any time is the present value of the remaining payments. We recommend a Modified SLE Approach for all leases that are executory in nature (see an example in the Appendix). This recommended approach is much simpler than the proposed I&A and SLE

approaches. We agree with the I&A Approach for all leases that are not executor contracts, but rather are financed purchases.

Exhibit 4  
Lessee Cost Recognition over Lease Contract



In ED2, the Boards intend for most equipment leases to be Type A leases and appear as financing arrangements, irrespective of the rental nature of those equipment leases. In their deliberations, the Boards decided that a lease ceases to be an executory contract when the lessor delivers the asset to the lessee. This opinion cannot be legally supported, and hence, should not be a determining factor in the analysis. The Boards ignore the continuing 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. These continuing performance obligations may seem to be insignificant, but are not insignificant under the law. 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 that accounting for Equipment Leases should include the use of the interest method of accounting in cost allocation. In our opinion, the present value calculation using a Modified SLE Approach (see Appendix) is the appropriate way to determine the value of the capitalized equivalent of an executory lease. This is especially true for users who need an accurate number for the debt-like operating lease liability. It is a pseudo debt because legally it is not the same as debt and this distinction is important to users of financial statements. The point is, we do



not think the interest method should drive the accounting for a capitalized executory lease contract.

In reality, the only case where an executory contract lease contains a financing element is when the rents are back ended. That is, when a future payment is made for the lessee's current right-of-use. That financing element is actually captured under current GAAP since it requires a lessee to accrue the average rent so a back ended rent lease will have an accrued rent liability on the balance sheet until the rent is actually paid. It does seem illogical that most real estate leases are deemed Type B leases by the Boards, and consequently, not having a finance element even though most real estate leases have stepped up or back ended rent patterns. On the other hand, most equipment leases have level payments yet the Boards have deemed that most equipment leases are Type A and have a financing element. Prior to ED2, this inconsistency was not discussed at any of the Boards' public meetings to deliberate the issues. In our opinion, the decision lacks conceptual grounding.

Under ED2 (refer to Exhibit 1), a lessee's equipment lease would most often be designated as a Type A lease. The designation causes a front loading of lease costs by amortizing the ROU asset straight line and imputing interest causes a mismatch with the tax treatment of an executor contract 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 ED2 cost methodology versus the legal and tax view of executory leases. Additionally, bank regulators have special capital rules regarding deferred tax assets. When the amount of deferral reaches a set limit they force higher capital requirements to support deferred tax assets.

ED2 bases the classification tests on the extent to which the value of the underlying asset is consumed during the lease term. ED2 has different criteria for Real Estate leases (more like current GAAP) and for equipment leases (different from current GAAP). In our opinion, there is no apparent conceptual grounding for this dichotomy. 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." For executory leases, the Boards should account for the values of the rights and obligations in a unified contract – not account for the value of the underlying asset. Focus on the underlying asset perpetuates a deficiency from current lease accounting GAAP.

### **Some Lessee Accounting Recommendations**

Because the ROU asset in a Type A lease on the lessee's books amortizes more quickly than the ROU liability, any executory lease using Type A accounting with its front loaded cost pattern will show a gain on early termination. This seems to be a clear indicator that the accounting method does not correctly value the asset and liability arising from the lease contract. Our recommendation is for the Boards to do a conceptual analysis of capitalizing executory contracts.

We further recommend that the Boards (1) abandon the equipment/real estate lease types under ED2 (Exhibit 1) and use the executory/finance lease types (Exhibit 2), and (2) if changed, modify ED2's SLE accounting and instead use our recommended executory contract accounting method as demonstrated by the example contained in the Appendix. In the Appendix example, the following simple steps are used to account for a lease as a capitalized executory contract:

1. Capitalize the PV of the lease payments on each reporting date as an ROU asset and a capitalized executory lease obligation, reversing the previous reporting period's entry.
2. Accrue the average rent, charging rent expense and crediting accounts payable.
3. Pay rent charging accounts payable.
4. Impairment, initial direct costs, and lessor concessions, if any, would be set up as sub-accounts of the ROU asset and amortized straight-line over the lease term and classified as a part of rent expense.

The Staff and Boards have chosen a complex bookkeeping method for SLE lease accounting (Single Lease Accounting Approach) where despite their conclusion that there is no financing element, they see the need to calculate an imputed interest portion of the expense and an asset amortization component to the lease cost (the sum of the two components results in a straight line cost). Why if standards are principles based must they proscribe detailed bookkeeping methods where instead they could leave it up to the preparers? We believe their complex method creates unintended consequences when impairment adjustments are made to the ROU asset. Their method prevents them from allowing a pattern other than straight line even when warranted by the leased asset's pattern of usage. Current GAAP allows for operating lease rent expense to be other than straight line. Our recommended executory contract accounting method (Modified Type B/SLE Approach in Appendix) would avoid the unintended consequences of the proposed Type B/SLE bookkeeping method.

### **Sale leasebacks with non bargain purchase options**

Sale leasebacks are very common transactions. Three examples are: (1) land and buildings sold and leased back, (2) airplanes ordered by and with progress payments made by the lessee with the intention of leasing them when completed, and (3) master lease arrangements where, for convenience sake, the lessee orders and pays for many small ticket assets and the lessor does a once a month sale lease back (for convenience sake) to put the assets under the master lease. Even though these leases may contain non-bargain purchase options, the current decision in ED2 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 arrangement. The current decisions regarding the criteria to determine sale treatment 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 treatment seems like a step backwards from current GAAP which allows sales treatment even when there is a non-bargain purchase option (current GAAP uses a risk and rewards analysis). We believe this is another case where lease accounting will be out of step with the legal and tax views of the transaction.

### **Lessor lease classification**

In their desire to simplify things, the Boards' ED2 employs the notion that Lessor lease classification and accounting should be symmetrical with lessee accounting. In our opinion, this symmetrical treatment is not conceptually supportable, however, because the lessee and the lessor often have two completely different perspectives given the same transactions. As an example, there are financial lessors (like banks and finance companies) who view leases as a discrete investment 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 lessors (like commercial real estate and full service rail car leasing companies) who view the leased asset as their stock-in-trade 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 the returned asset when their lease ends. As a result, the lessor classification test should be based on the business model of the lessor. That is how real estate assets are currently treated for lessors under IAS 40 and essentially carried over in the ED2 proposed rules (refer to Exhibit 1) as Type B leases. Since the Type B treatment is for real estate assets and only a few equipment leases, and not for equipment leases that would otherwise meet the definition of investment property, the ED2 lacks a common principle for leases of any type of asset.

The principle under IAS 40 is a business model principle, that is, if a lessor manages the leased assets with the intention of re-leasing and selling the assets at the end of the first lease, the lessor is **not** a financial lessor and the operating lease method provides the most useful information to users. Specifically those investment property/operating lessors keep the physical asset on their books rather than record a receivable and residual. They use the current operating lease method to account for their leases. They depreciate the asset over the assets useful life and show rents and residual sales proceeds as revenue. Analysts want to see rent as revenue and depreciation of leased assets, as well as, service and maintenance costs in the lessor's P&L.

Financial lessors, especially banks which dominate the US leasing market, should be using the R&R method proposed by the ED2, also known as the receivable and residual method. This approach portrays the rent receivable as a financial asset and the residual as a physical asset like a balloon payment in a loan, albeit monetized by a sale of the residual asset. This is similar to loan accounting and portrays the economics (revenue) of the transaction as it is priced and as it is intended to play out. Financial lessors are measured by analysts using net revenue from funds invested as a key performance measure and the R&R method results in finance income. It also avoids co-mingling depreciation expense of leased assets (a result of the operating lease method) with depreciation of assets, like ATMs, that they use in their business. Co-mingling depreciation of leased assets with assets used by the financial lessor distorts financial leverage measures used by analysts to measure performance of financial institutions.

We believe that users of financial statements would be better served if lessee classification was based on the legal nature of the lease and lessor classification was based on the business model of the lessor.

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

In our opinion all residual guarantees and residual insurance change the nature of a lessor's residual from a physical asset to a financial asset. This is the treatment under current GAAP for direct finance leases. The view in ED2 is that residual guarantees are included in the lessor's minimum lease payments in Type A/R&R Leases only when the lessee is also entitled to any "upside" (gain) when the leased asset is sold for more than residual value as in a lease containing a TRAC (Terminal Rental Adjustment Clause). 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 and insured residuals represent a minimum lease payment since the lessor is guaranteed the amount insured/guaranteed. The importance of this is twofold. First, the amount of minimum lease payments affects up front gross profit recognition in leases where the carrying value of the leased asset is less than fair value. This occurs most often where a manufacturer also has a captive finance company to provide a lease option to customers. Secondly, it is also important in classifying the residual asset as a financial asset. Only financial assets can be securitized, and under current GAAP, guaranteed residuals are financial assets and are part of asset securitizations particularly with vehicle leases.

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

## **Leveraged lease accounting – netting, tax credits as revenue, and after-tax yield amortization**

ED2 proposes to eliminate existing leveraged lease accounting by the Lessor, and furthermore, will require the lessor to apply the Receivable & Residual Approach to existing leveraged leases retrospectively. This problematic stance eliminates what many consider to be an ideal accounting method for portraying the substantive economic effects of a leveraged lease. Furthermore, elimination of existing leveraged lease accounting will effectively eliminate an important means for lessors to (1) arrange a lease for the use of very large, ticket sized assets with tax benefits, and (2) lease these assets to the lessee at less cost than if the lessee were to lease the same asset under another lease structure.

Sophisticated U. S. 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, and hence, there is no "common ground" for the Boards to consider. ED2's elimination of the leveraged lease structure means the US gets a "dumbed down", lowest common denominator set of rules for this type of transaction. As reported in the Journal of Accountancy, Leslie Seidman, FASB Chairman 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 accounting is unique by including in income the effects of income tax benefits directly related to the leased asset. Tax cash flows directly related to the leased asset are viewed the same as rents and residual proceeds by the lessor in its lease pricing calculations. Significant tax credits (like ITC and tax grants) that 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. By inference tax credits are recognized as an element of revenue for non-leveraged leases. 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 in leveraged leases and in the yield to recognize revenue in non-leveraged leases. 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, and hence, in the MISF yield.

Existing accounting for leveraged leases reflects the true financial risk and the effects of taxes directly related to the investment. The assets presented are the net rent and residual – the two assets that are at risk to the lessor/preparer. Bank regulators view this 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. The lessor/preparer cannot sell the rents or get any other economic benefit from them since they belong to the leveraging debt lender per a three party leveraged lease agreement. The lender reports the net rents as an asset on its balance sheet, while under ED2's proposal the lessor would also show a receivable for the gross rents as an asset. The rents cannot 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 would not meet this definition, but is required to be recorded on a gross basis under ED2's receivable & residual approach. In our opinion, it is misleading to report assets and liabilities that are not assets or liabilities of the lessor and would not survive bankruptcy of the lessor.

In addition it is our opinion that the rents and debt service in a leveraged lease should qualify for set off as it meets the following criteria:

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

The leveraged lease revenue recognition method under existing US GAAP recognizes revenue in the lease at a constant rate of return versus the net cash invested in periods where the net cash investment is positive. In simple terms this method matches the pattern of revenue recognition with the pattern of interest expense incurred by the lessor to fund its lease investment. The concept of matching income and expense has not been in vogue as we move more towards a fair value model and towards a regime where earnings are less a predictor of future value of an entity (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). Failure to reflect tax benefits in revenue recognition will severely distort revenue on leases where the leased asset has significant tax benefits.

If tax benefits are ignored in lease revenue recognition, there will be 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. Revenue recognized from a lease with tax benefits, like a leveraged lease, will have no logical income pattern when compared to the pattern of the amortization of the lease investment. In fact, the income pattern 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. Again the ED2 will be a step backwards in lessor accounting by allowing for a converged standard which is not a good outcome for the US.

## **Conclusion**

Current GAAP clearly lacks an accurate present value calculation of operating lease obligations because of the difficulty determining (1) the appropriate incremental borrowing rates for each lease, (2) the variable rents based on an index or rate, and (3) expected payments under residual guarantees. These operating lease obligations are currently disclosed off balance sheet while at the same time most users employ estimates in their calculations to capitalize them and view them as a debt-like equivalent for purposes of measures and ratios. ED2 could have dealt with this issue by capitalizing all operating leases simply with a decision to put the present value of operating lease payments on balance sheet on each reporting date (our Modified Type B / SLE Approach) while keeping the P&L cost and the cash flow presentation unchanged. The approach would satisfy all preparers most all users, and the SEC. 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, or different, information, a needs analysis should be done. 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.

**Appendix: Example of our recommended Executory Contract Lease accounting method (Modified Type B / SLE Approach).**

Accounting using the Modified SLE Approach is compared to accounting under the proposed Type A/Interest & Amortization method per the ED2.

Assumptions	
Base year annual rent	\$450,000
Annual step up %	10%
Payment timing	Arrears
Term in Years	10
Inception month	January
Lessee incremental borrowing rate	8%
Present Value of rents	\$4,531,604

Lessee's Supporting Calculations for ED2's Type A/I&A Lease				
year	Capitalized lease obligation amortization			ROU asset amortization
	Obligation Balance	Rent	imputed interest	
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





## Stepped Rents Case Comparative Financial Statements

### ***ED2's Type A/I&A Accounting***

<b>Balance sheet</b>	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 obligation	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
<b>P&amp;L</b>										
ROU asset amortization	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

### ***Modified SLE Approach***

<b>Balance sheet</b>	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 lease obligation	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)
Accrued 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)	-
<b>P&amp;L</b>										
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
<b>rent paid</b>	450,000	495,000	544,500	598,950	658,845	724,730	797,202	876,923	964,615	1,061,076

### Comparative P&L – ED2's Type A/I&A versus Modified SLE Approach

P&L Pattern	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10
<b>Modified SLE Approach</b>	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184	717,184
ED2 method	815,689	808,691	797,533	781,523	759,876	731,706	696,011	651,663	597,390	531,759
Difference	(98,505)	(91,507)	(80,349)	(64,339)	(42,692)	(14,522)	21,173	65,521	119,795	185,425
% Difference	-14%	-13%	-11%	-9%	-6%	-2%	3%	9%	17%	26%
Cum % Difference	-14%	-26%	-38%	-47%	-53%	-55%	-52%	-43%	-26%	0%