

LEASING 101

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The Honorable Leslie F. Seidman, Chairman
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Chairmen of the Boards:

As a member of the Lease Project Working Group, I want to give you feedback on the final decisions in the leasing project. I also listened to the ITAC meeting.

As ITAC pointed out, the final decisions on lessee lease classification created results that will not clearly differentiate leases that are in effect financings of the underlying asset and leases that merely transfer the right of use. As ITAC said, that information is critical to users. The final decision to use the same classification criteria for lessor accounting also means that equipment lessors who are in the "operating" lease business will be required to use the Receivable and Residual method for many leases that formerly were operating leases and thus have financial statements that do not reflect that they are operating lessors but rather will look like they are in the "financial" leasing business. This was not mentioned at the ITAC meeting as lessor accounting does not get the same attention because there are many fewer lessors than there are lessees.

I would like to suggest two simple, in my opinion, fixes that would satisfy concerns of ITAC and other analysts and lenders. For lessee accounting I would use the same classification tests for equipment leases as you have chosen for real estate. For lessors I would use business model as the basis for determining their accounting method (this is similar to the investment properties

exception that you had decided on several months ago, but subsequently dropped) for their leases.

Lessee accounting – The lines drawn for real estate and equipment are drastically different. The line for real estate seems to be in keeping with the existing risks and rewards concepts that are the basis for the legal and tax view of whether a lease is a financing of the underlying asset. The line for equipment breaks from that view. Questions being asked are:

- Shouldn't there be one principle for determining which leases are in effect loans as the real estate and equipment leases are legally both the same, that is, executory contracts? Moving the line for equipment seems arbitrary, and there was not much discussion or debate over the split. I would also continue to use the existing GAAP terminology for the capitalized asset and liability – call the I&A leases capital or finance leases and call the SLE leases capitalized operating leases.
- Why not use the Revenue Recognition concepts of control (if the lessee controls the residual asset, then it is a financing of the purchase of the underlying asset) to determine which leases are financings? Actually the Revenue Recognition concept of control needs to be expanded to include “effective” control, that is, to include the concepts of the lease term vs. useful life and PV of payments vs. fair value. The old risks and rewards thinking is being brought back and its focus is on the underlying asset's value to determine if there is a financing of the right of use. This seems to be a mixing of concepts – are we talking about the financing of the underlying asset or the financing of the right of use? If Rev Rec's definition of control, modified for lease term and PV considerations, was used as the filter, then all leases that fall out are executory contracts and, in my opinion, should have straight line cost recognition.
- Since leases that merely transfer a right of use are executory contracts where the expectation is level periodic payments made for the right to use for the period, it would seem that the only executory contract leases that have a finance element regarding the right of use are those where the payments are not level. Real estate leases typically have rents that escalate indicating that the current right of use is not being paid for until the future yet the Boards have decided there is no finance element to them. The opposite is true for most equipment leases where the rents are level. This seems illogical.
- Why did the Boards not use existing GAAP classification tests for all leases? Although it may be inconsistent with Revenue Recognition at least it would be consistently applied to all leases and match the legal and tax views that are built onto the business process and reflect the economic characteristics of a lease contract. Failing to have the same line for equipment leases will mean keeping records under current GAAP for tax compliance purposes (US local personal property tax rules use existing GAAP to determine if the lessee, as owner of the underlying asset, is responsible for property tax) and to give lenders information on which assets and liabilities survive bankruptcy (ITAC said this is a basic need). I would hope the Boards consider the cost of keeping two sets of records versus the benefit (if one agrees that it is a benefit) of having a P&L that reflects imputed interest and amortization. Aligning the

- lease classification tests for equipment leases with the real estate lease tests will eliminate the need for two sets of records for equipment leases. The difference between straight line and the front ended cost pattern will not be material for the vast majority of equipment leases as they have lease terms of two to five years (PCs, copiers, fax machines, cars, trucks, etc).
- As the outreach has shown, users have diverse information needs with respect to leasing. I believe their needs are best met by keeping periodic rent expense the same for those former operating leases which do not convey control to the lessee and by requiring expanded disclosures so that users can readily make adjustments tailored to their specific needs. I note that “as if” capitalization calculations historically made by the rating agencies did not change periodic rent expense; instead they generally allocated reported periodic rent expense first to interest expense with the residual amount treated as periodic depreciation expense. I also note that requiring non-public companies to report I&A expense which varies considerably from the cash rent expense (generally at or approximating straight-line due to income tax considerations) generally would not serve the reporting needs of their users.

Lessor accounting – There was no real discussion regarding the view taken is for complete symmetry. The question being asked is: shouldn't business model as the means to classify leases have been debated? Financial lessors like banks and finance companies have one major issue with current lessor GAAP and that is that using operating lease accounting does not best reflect the economics of their business where revenues should be finance revenues and depreciation expense in their P&L should be only from assets used in their business. Adding leased asset depreciation to their P&L makes them look like they are less efficient to analysts when compared to their peers. Their business model is to sell the leased asset at the end of the lease – not keep it and release it where depreciation would be reflective of the transaction. Operating lessors should use the operating leases for their leases that do not transfer effective control of the leased asset. If they have to use the Receivable and Residual method for some leases and operating lease accounting for other leases that are very similar then their financials have a mixture of revenues and expenses that analysts will not be able to adjust for.

I still am concerned that some other lessor issues merit further consideration. Under current GAAP, residual guarantees and residual insurance are treated as changing the nature of the residual asset to a financial asset. I do not recall a discussion as to why that needs to be changed. This will impact gross profit recognition and securitization options. Current US GAAP treats tax credits arising from the leased asset as a revenue element and as a cash inflow to determine the rate to recognize revenue. Elimination of including tax benefits in lease revenue recognition will reduce comparability of financial results between lessors with tax benefits in their leases versus those where they have no tax credits. Grossing up leveraged leases puts a rent receivable on the books that is not an asset for the lessor in bankruptcy which should

create an issue for analysts based on ITAC's comments regarding the importance of the financial statements reflecting assets and liabilities are viewed in bankruptcy.

To reiterate my major concerns:

- There are two types of leases but the ROU assets and lease liabilities need to be reported separately (called capital/finance lease assets and liabilities and capitalized operating lease assets and liabilities) to give creditors the information they have today as to the legal nature of the new assets and liabilities in bankruptcy
- The lessee classification tests for all leased asset types should be along the lines of FAS 13 without bright lines as they are well tested and understood and mesh with prevailing legal and tax regimes
- Lessor classification should be based on business model
- The short term lease exception is helpful and could possibly be moved to two or three years to give compliance relief to immaterial leases
- The new classification "line" for equipment leases needs a cost benefit analysis as it is radically different than what has been field tested and will have consequences for the millions of equipment leases

Thank you for the opportunity to comment. The project has come a long way and only a few changes are needed to satisfy the users' issues presented by ITAC.

Sincerely,

A handwritten signature in black ink, appearing to read "W. Bosco". The signature is fluid and cursive, with a large initial "W" and a long, sweeping tail.

William Bosco
Leasing 101

