December 14, 2010

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Sir David Tweedie, Chairman
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Submitted via electronic mail to director@fasb.org

Re: File Reference: No. 1850-100, Exposure Draft: Leases

Dear Madam and Sir:

Xerox Corporation (Xerox or ‘the Company’) appreciates the opportunity to provide its views on the Proposed Accounting Standards Update, Leases, Topic 840 (the ‘ED’). Xerox is a $22 billion multinational enterprise and is the industry leader in the development, manufacture and, distribution of a broad range of document imaging products (e.g. copiers, printers, digital presses, etc. collectively referred to herein as ‘equipment’) and supplies, as well as the associated technical service and lease financing of those products. We primarily operate in two industry segments – Technology and Services. Our Technology segment is hardware centric and includes the traditional products and above mentioned services long associated with the Xerox brand. Through our Services segment we provide various business services including document outsourcing; business process outsourcing and information technology outsourcing. The leasing of Xerox equipment occurs in both segments. Xerox has diversified in recent years through a series of acquisitions. For purposes of this letter when we refer to ‘the Company’ (or to the Company’s marketing strategies) we will be referring to the traditional Xerox businesses involving document imaging products and document management services.

Leasing has been a central marketing strategy for the Company for over 50 years. Each year, globally, we originate hundreds of thousands of leases in all forms – sales-type, direct financing, operating and imbedded. Our leases range from small standalone contracts to multinational arrangements valued at millions of dollars and involving thousands of underlying leases. Individual lease contracts may range from a few thousand dollars to over $1 million. While an exact amount is not available, a reasonable estimate of the cumulative value of leases originated by the Company is in excess of $100 billion. Accordingly this project is of critical importance to the Company. We have extensive expertise with leasing as an extension of marketing strategy and are pleased to share with the Boards our experiences
as they relate to the proposed changes in lease accounting. Our comments with respect to the ED are largely centered on Lessor accounting since our views with respect to Lessee accounting will likely be consistent with comments provided to the Boards by other large multinational corporations. Accordingly, we believe that concentrating our comments on Lessor accounting would be more beneficial to the Boards.

Executive Summary:

Included in the accompanying Appendix are our detailed responses to Lessor related issues and questions included in the ED. Our most significant comments and concerns are as follows:

- We strongly support revising current Lessor accounting requirements. SFAS No. 13 (as codified in ASC Topic 840) is difficult to apply in practice and its long series of bright line tests, academic measurement models and myriad of confusing requirements (e.g. “old” vs. “new” lease classification for the same asset; extension and renewal options, etc.) make improvements to SFAS No. 13 necessary.

- We support the Board’s conclusion that both proposed Lessor accounting models – the Performance Obligation method and the Derecognition method – have legitimate business and accounting purposes. While we believe both should be retained in the final Standard if, after re-deliberation, the Boards decide to adopt only one method, then we recommend it to be the Performance Obligation method. We believe revenue recognized under the Performance Obligation method is more consistent with the actual economics of most leases (i.e. cash inflows over the lease term.)

- Assuming both Lessor accounting models are retained, it is important the final Standard provide detailed guidance as to when each model should be applied. While the guidance provided in the ED is clear, in our view, it needs further development. For example, the “significant risks and benefits retained” criteria should be expanded to include the concept of continuing involvement, address situations where the Lessor retains a degree of control over the leased asset and the implications of when the Lessor provides, to the Lessee, discreet and non-discreet goods and services which would not likely occur absent the related leased asset.

- Full retrospective application, either as a requirement or as an option, is critical.

- We do not agree that the measurement of leases should include an estimate of contingent revenue and renewal options regardless of how probable such may be. We believe receivables recognized on the balance sheet should continue to represent enforceable claims to cash; it is not an improvement in financial accounting and reporting to weaken this standard. Furthermore, to the best of our knowledge, systems and software solutions do not exist to properly account for and control this provision and it would be extremely costly to implement the Boards’ proposed upfront accounting for future receivables from contingent revenue and lease extension and renewals.
We appreciate the opportunity to express our views on this important project. Please do not hesitate to contact me if you have any questions; we look forward to participating in the January roundtable.

Yours very truly,

[Signature]

Gary R. Kabureck

c: L. A. Zimmerman, Vice Chairman and Chief Financial Officer
APPENDIX

Background on Xerox leasing operations and the annuity business model:

Before providing our detailed comments, we believe it would be helpful to provide some background on our leasing operations so the Boards and staff will better understand the context of our comments with respect to the ED. [Note: much of what follows in this section is included in Note 1, Significant Accounting Policies, of our annual financial statements.]

The fundamentals of the Xerox business rest upon an annuity model whereby a significant portion of our revenue occurs after placement of equipment with a customer. We refer to this revenue as “post-sale” revenue and it primarily includes equipment maintenance, excess copy volume, supplies and financing, among other elements. Approximately 70 percent of the total revenue from our Technology segment is post-sale revenue. From our earliest days, we have said, and we expect in general our customers would agree, that we were firstly in the business of selling copies, not copiers. Even today, a common slogan we use is ‘its all about the clicks…’ (i.e. copy/print volume).

This annuity model is accomplished by placing our equipment with customers under a “bundled lease arrangement” which includes the equipment and associated service and frequently supplies. Xerox has been placing its equipment with customers through the use of a bundled lease arrangement for over 50 years. It has been our preferred business model for placing equipment with customers since it provides us with the maximum amount of revenue associated with the use of the equipment and allows us to maintain critical customer relationships for future placements.

Our typical lease arrangements include equipment, service, supplies and financing components for which the customer pays a single negotiated price for all elements over the contractual lease term. The lease terms usually range from 3 to 5 years. The payments normally include a fixed monthly minimum charge as well as a variable component for page volumes in excess of contractual minimums, which are often expressed in terms of price per page or cost per copy. The payments associated with page volumes in excess of the minimums are contingent on whether or not such minimums are exceeded (“contingent payments”). The minimum contractual committed page volumes are typically negotiated to theoretically equal the customer’s estimated page volume at lease inception. As a result of this bundled arrangement, the customer will typically believe they are purchasing copy and print output services as opposed to the direct ownership of the underlying equipment.

In applying our lease accounting methodology, we only consider the fixed payments for purposes of allocating revenue to the elements of the contract based on relative fair value. Contingent payments are recognized as revenue in the period when the customer exceeds the minimum copy volumes specified in the contract.

The service and supplies elements collectively are the largest components of the bundled lease arrangement. Through the service element we are responsible for break-fix service on the equipment as a result of its performance and usage as well as any product defects that
may arise subsequent to placement of the equipment. This service also includes the remediation of any software errors that may arise in connection with the embedded software in the equipment. Although there are alternative service providers for our equipment, such providers do not have the capabilities available to us as the OEM. In addition, as a condition of our leases we require ourselves (or authorized representatives) to be the service provider for the underlying equipment. The supplies element provides the customer with customized imaging supplies (i.e. toner cartridges, solid ink, etc.) for the equipment that are normally not available from other sources. It is a violation of our lease agreements for a customer to use non Xerox sourced supplies. Accordingly, there is a direct linkage and interdependency between the services and supplies and the underlying lease of the equipment. They are operationally dependent on each other and independent value is limited.

Another important feature of our bundled lease arrangements is a fair value purchase option at the end of the arrangement or lease. In most instances the customer does not exercise the purchase option but returns the equipment to us. While significant at times in the past, currently residual values are not a critical element in our leasing strategy. Even without a recorded residual, the ability to retain control of the equipment at end of the lease has significant value to us in that it allows us to control the secondary market for our products, including parts recuperation, and enhances our ability to retain the customer relationship for the placement of new equipment.

Although we may sell our equipment on a standalone basis for cash, this is not the preferred model and such sales are a small percentage of our total equipment placements from our direct sale channels.

**Specific Comments on the Exposure Draft (ED)**

**Lessor Accounting:**

**The Lessor accounting models: Performance Obligation method vs. Derecognition method (Question 2: Lessors)**

We support the Board’s decision to have both a performance obligation approach and a derecognition approach to Lessor accounting. We strongly agree with the conclusions of the Boards that a single approach to Lessor accounting would not be appropriate for all leases because of differences in the economics of the business models for different Lessors. However should the Boards ultimately decide to adopt only one Lessor model, we recommend it be the Performance Obligation method, primarily because the revenue recognition pattern will much more closely approximate cash inflows which we believe in general would be an improvement in financial reporting. As more fully discussed later under “Transition”, our support for the performance obligation approach is conditioned by the ED’s requirement for retrospective application for the new accounting.

Based on our business model as described above and as we understand the ED, in most instances, the Company would be required to apply the Performance Obligation method. The Performance Obligation method more closely matches the underlying economics (i.e. cash flows) of our bundled lease arrangement which is designed to generate the maximum
amount of revenue from the active management and usage of the underlying equipment being leased. In addition, revenue recognition under the Performance Obligation method comports well when there are significant elements of operational control, continuing involvement, on-going costs and risks, and residual interest in the assets being leased.

Identifying which method we and other Lessors would select for a given lease is critical. Although clearly written, we do not believe the ED’s guidance as to when to apply the Performance Obligation vs. the Derecognition method is sufficiently developed. Accordingly, we believe the ED needs to be revised and to be more consistent with the background conclusions contained in paragraph BC27 of the ED, which appears to focus on the underlying economics of the transaction and the entity’s associated business model rather than whether the Lessor retains significant risks and benefits associated with the underlying asset being leased. We suggest moving the guidance in paragraph BC27 to the body of the ED as it seems to be the clearest and most logical classification guidance. We believe the analysis as to which approach to apply should depend on the nature of the underlying arrangement in totality rather than on the specific asset being leased.

We believe that the Derecognition method is appropriate for a straightforward lease that is used as a surrogate by the Lessee/Customer and the Lessor /Vendor for the financing of a purchase/sale. Although services may be associated with the lease of the asset, such services are not a significant or integral component or element of the arrangement in comparison to the underlying value of the asset and are not bundled or required to be taken by the customer. In addition, there should be clear evidence of the separability of those related services such as follows:

- The asset is frequently leased or sold absent such services;
- Services are routinely performed by third parties on a substantive basis.
- Services are clearly distinct and not directly linked or related to the usage or performance of the asset but rather are value-added or business process type services.

We believe that a business model approach to leasing, where related services are not integral to the leased asset is consistent with a financing transaction and an entity’s obligation is generally satisfied upon delivery of the asset. The primary Lessor retained risk is credit risk.

We believe the Performance Obligation method is more appropriate when there is significant continuing involvement in the underlying asset being leased and the presence of significant additional Performance Obligations apart from just delivery and installation of the underlying asset. Accordingly, we believe the guidance should focus on the indicators of continuing involvement and significant performance obligations rather than whether or not the Lessor retains significant risks and benefits directly associated with the underlying asset. Such significant continuing involvement would be evidenced by one or more of the following:

- The entity receives significant additional revenue through and based on the active usage and performance of the underlying asset. We do not believe this assessment should be limited to contingent rents on the underlying asset but rather expanded to cover those associated with related revenue streams.
• Associated services are bundled within the lease arrangement and are required to be taken by the customer as part of the lease of the underlying asset. The entity infrequently leases its assets to end users on a standalone basis.

• Although a service component may meet the definition of distinct services as defined in the ED, if there is limited evidence of such services being performed by another entity on the underlying equipment or such situations are rare, that would be indicative that the associated services are implicitly linked with the lease of the asset and therefore non-distinct.

• Return of the equipment to the Lessor is expected at the end of the lease term. We believe that an expectation of return is evidence that there is value in the underlying asset, even if not explicitly recorded as a residual value, and that the Lessor wants to retain that benefit.

We believe that the above approach to Lessor accounting and the focus on continuing involvement and significant additional performance obligations is consistent with conclusions in the Exposure Draft on Revenue Recognition. When there is significant continuing involvement and highly related performance obligations associated with the underlying leased assets - control of the underlying leased asset is provided to the customer continuously over the term of the arrangement as the related performance obligations are satisfied. The services are inseparable from the underlying leased asset from the customer’s standpoint and therefore delivery of equipment and services occur jointly or collectively.

Although the Lessor Performance Obligation method may appear to be inconsistent with the Lessee accounting model proposed in the ED, we do not believe there must be symmetry in the accounting models – Lessee/Lessor – since often the economics, perspectives and expectations are different depending on which side of the transaction an entity is on in a lease arrangement and therefore different models may apply. We are aware some commentors to the ED have asserted the Derecognition method for Lessors is consistent with the “right-to-use” Lessee model whereas the Performance Obligations model is inconsistent with the “right-to-use” Lessee model. We disagree. The Performance Obligation method is much more consistent with the recommended Lessee accounting. For example, the Lessee’s “right-to-use” asset is matched by the Lessor’s obligation to allow continued use. The revenue pattern for Lessors correlates to the expense pattern for Lessees. The Lessor’s lease receivable is matched by the Lessee’s financing obligation.

**Lease Term (Question 8: Lease Term):** We generally do not believe that a Lessee or a Lessor should determine the lease term as the longest possible term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease. We believe that including renewal options unnecessarily adds to the complexity of the accounting for leases, but more importantly we do not believe payment obligations as a result of renewal options meet the definition of a liability to the Lessee or an asset to the Lessor under Concepts Statement No. 6, Elements of Financial Statements (“CON 6”).

The ED appears to consider a renewal option a liability/asset because the delivery of the asset created the past event that gives rise to the Lessee’s obligation and the Lessor’s right to payment. However, in the context of the lease transaction, the renewal option is not a past event until the exercise of the option by the Lessee. Until that point the Lessee does not have a present duty or obligation to pay rents that will give rise to an outflow of economic
resources nor does the Lessor have a controlled right, benefit or enforceable claim to payment. Since the Lessee is not obligated until it exercises the option and it has wide discretion over whether or not it will incur the economic sacrifice, we do not believe it has incurred a liability as defined per CON 6 as one of the essential characteristics of a liability is that the entity is obligated to the point that it has “...little or no discretion to avoid the future sacrifice [of assets]”. A renewal option does not appear to meet this essential characteristic. Similarly, we do not believe a Lessor has an asset or a performance obligation or revenue (under the derecognition method) until the Lessee exercises the option to renew.

We believe the existing definitions of “lease term” included in ASC Topic 840 should be left in place. Generally that guidance defines lease term by considering the fixed period of the lease, including renewal periods only when there are factors within the lease or related to the Lessee’s use of the leased asset that economically compel the Lessee to renew the lease, resulting in renewal being reasonably assured. (We understand practice defines “reasonably assured” as greater than “probable” of occurring.) This guidance considers contractual and non-contractual financial factors that including the existence of economic penalties that compel the Lessee to renew the lease. Such guidance would cover situations when the Lessee is leasing special use assets or can’t readily or economically change to another asset. If the Lessee had an explicit or implicit duty to renew, then a lease with a renewal option is the same as a lease with a fixed term that equals the fixed term plus renewal options and use of the current guidance should give consistency in accounting.

**Lease Payments (Question 9: Lease Payments):** Similar to our discussion above, we do not believe that contingent rentals and expected payments under term option penalties that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease. As with payments due under renewal options, we do not believe these contingent amounts meet the definition of a liability to the Lessee or an asset to the Lessor under CON 6 since again, the past event that gives rise to this obligation/receivable is not delivery of the asset but rather the occurrence of the event that obligates the Lessee to make payment. Accordingly, until that point is reached, the Lessee does not have a present obligation or duty to pay rents nor does a Lessor have a right to receive rental payments.

In addition, we also believe the new standard should provide better clarity on the definition of a lease payment. Under current practice of accounting for triple net leases, preparers estimate and exclude from the lease payments any embedded amounts that relate to maintenance, insurance and taxes as the amounts are more properly reflective of period charges and not costs of a right-to-use asset.

With respect to both of these points, we believe the existing definition of “minimum lease payments” for capital leases included in ASC Topic 840 should be retained as the guidance for this area. That guidance defines the minimum lease payment used in measuring a capital lease obligation as “payments that the Lessee is obligated to make or can be required to make [our emphasis] in connection with the leased property, excluding ... the Lessee’s obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property.” We believe the current guidance is operational and the Boards should instead focus on addressing issues with the current definition such as disguised minimum lease payments – e.g. contingent rentals that...
are: i) completely unrelated to the leased asset; or ii) of immediate value to the Lessor; or iii) have level of uncertainty is not significant.

If the Boards proceed with an approach requiring the inclusion of options and contingent rents in the measurement of lease assets and liabilities, we believe the Boards should strongly consider increasing the measurement threshold for including these contingent amounts to at least “reasonably assured.”

**Distinguishing between a lease and a purchase (Question 4(b) Definition of a lease):** We generally agree with the Board’s criteria for distinguishing a lease from a contract that represents a purchase or sale. We believe the focus of the two criteria – i) transfer of title at the end of the contract term and ii) the inclusion of a bargain purchase option; are the appropriate criteria to consider with respect to this question. However, we believe the requirements with respect to determining whether a contract truly includes what would be deemed to be a bargain purchase option should be clarified from the Lessor’s perspective. Specifically, a Lessor should be required to have demonstrated history to support the assertion that a bargain purchase option is “reasonably certain” of being exercised at the end of the contract term. Additionally, exercise of the option should be substantive, with the Lessee expected to take physical ownership of, and operationally use, the asset for a consequential period of time post exercise. For leases where the Lessee exercises the option and then immediately trades in the asset for a new asset with the original Lessor, such leases should be excluded for consideration as bargain purchase options. In these situations, the bargain purchase option is, at most, a disguised form of a residual from the standpoint of the Lessor and therefore the Lessor should be required to apply the lease accounting guidance for that contract from its inception.

**Rate the Lessor charges the Lessee (Question 18: Other comments):** The ED requires the Lessor to measure the right to receive lease payments as the sum of the present value of the lease payments discounted using the rate the Lessor charges the Lessee. We believe there needs to be more guidance for determining the rate the charged the Lessee especially to address situations where a Lessor may charge a rate that is deemed to be unreasonable or other than the market rate of interest (e.g. 0% interest financing offers). We do not believe defaulting to the Lessee’s incremental borrowing rate is an alternative since identifying this rate may be difficult to measure in practice. We strongly believe retaining the SFAS 13 requirement to use the “rate implicit in the lease” is a poor alternative, as calculating this rate is often difficult to operationalize, particularly with respect to determining the fair value of the underlying asset. We believe the Boards should consider the guidance in ASC Topic 835-30, Imputation of Interest, for determining the appropriate rate to discount the Lessor payments. If the rate the Lessor charges the Lessee is unreasonable or not readily available, a Lessor should be able to determine the discount rate based upon a fair value approach for interest rates that considers a variety of factors including local prevailing rates in the marketplace and the customer’s credit history, industry and credit class.

**Lessor Presentation (Question 13: Income Statement):** We do not agree with the Income Statement presentation guidance for Lessor applying the Performance Obligation method which requires an entity to net the satisfaction of the lease liability and depreciation expense in a single line. Similar to a Lessor applying the Derecognition method; a Lessor required to apply the Performance Obligation method is generally realizing value from the underlying
asset as part of its primary business activity. Accordingly, the Lessor should be able to have at least the option for separate presentation of the satisfaction of the lease liability and depreciation expense since the satisfaction of the lease liability will often be part of the entity’s ongoing major or central operations and therefore should be classified as part of Revenues and the depreciation expense associated with the underlying leased asset represents the use of assets to deliver or carry out those operations and therefore should be classified as part of Expenses. We believe this approach is consistent with CON 6 which defines Revenues and Expenses as follows:

“Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.”

“Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations.”

Transition (Question 16: Transition): We appreciate the Boards’ recognition that the full retrospective transition approach would be excessive and that the costs to apply this approach would likely exceed the benefits. However, we recommend the Boards consider allowing companies the option of applying the full retrospective transition approach as an alternative when it is feasible to do so. The Lessor accounting guidance is essentially revenue recognition accounting guidance; accordingly we believe the Boards should allow companies the alternative of applying the full retrospective transition approach since this is currently the transition approach that is required per the Exposure Draft on Revenue Recognition. In addition, since many lease arrangements have bundled service elements, which may need to be accounted for separately under the new revenue recognition guidance, it appears inconsistent that different elements within the same contract could possibly be accounted for differently in transition. Accordingly, we believe the option for full retrospective transition should be allowed, particularly for bundled type arrangements.

Additionally, we believe additional guidance should be provided in the final Standard with respect to the actual technicalities of applying the “simplified” retrospective approach. Specifically, should a company factor in hindsight and actual experience as of the date of actual adoption when determining amounts to record at the “date of initial application” (i.e. 3 years prior for a public company). For example, assume a public company adopts the new standard in 2012. They would be required to measure outstanding contracts as of the beginning of the first comparative period, which would be January 1, 2010 for a public entity. If a contract was outstanding as of January 1, 2010 and at that point the contract had 3 years remaining, but terminated or cancelled at the end of 2011 - would a company initially measure this contract using the 2 years remaining? Or would the entity be required to measure the contract at 3 years remaining and then record a termination in 2011? We believe it would be helpful to include some examples to assist companies in applying the simplified retrospective approach.
**Benefits and Costs (Question 17: Benefits and Costs):** Although we appreciate that the Boards’ have attempted to address some of the more significant concerns and criticisms with the current lease accounting model; we believe that the burden for financial statement preparers to apply all aspects of the proposed model per this ED will be significant. We are particularly concerned with the requirements for the measurement of contingent lease payments, determination of the lease term by reference to a “more likely than not” standard, reassessment of lease term and lease payment and the complexity of disclosures. As a major Lessor of equipment we have systems to handle the fixed contractual aspects of the lease contract, however even we would have significant difficulties addressing the requirements to estimate, account for and control contingent payment terms and conditions. Such a requirement will require us to make extensive system changes and significantly increase our costs to administer our lease program. In addition, the proposed model entails the use of significant estimates and judgments that will substantially increase the audit requirements and efforts. This issue is of particular concern since as noted above we do not believe recognition of amounts associated with contingent terms and conditions meet the definition of assets or liabilities in accordance with CON 6. Accordingly, we believe that if the Boards were to reconsider the guidance related to extension options and contingent payments as noted above, the cost to preparers would be significantly reduced while not reducing the benefits to the users of financial statements.

We also believe that in addition to addressing the direct costs of implementation such as information gathering and system modifications, the Boards should also consider the indirect costs that preparers will need to incur in order to fully address the requirements of the ED including costs to:

- potentially modify customer contracts;
- develop internal controls and processes;
- understand tax impacts; and
- communicate changes to investors and other stakeholders.

These indirect costs will likely not only be significant but could substantially add to the time requirements needed to fully adopt the standard.

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