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International Accounting Standards Board
30 Cannon Street
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February 9, 2010

SUBJECT: LEASE ACCOUNTING PROJECT

Dear Chairman Herz and Chairman Tweedie:

The Equipment Leasing and Finance Association wishes to comment on your recent meetings and Agenda Papers as they relate to the Lease Accounting Project.

ELFA is the trade association representing financial services companies and manufacturers engaged in financing the utilization and acquisition of capital goods. ELFA members are the driving force behind the growth in the commercial equipment finance market and contribute to capital formation in the U.S. and abroad. Its over 600 members include independent and captive leasing and finance companies, banks, financial services corporations, broker/packageers and investment banks, as well as service providers. The equipment finance business is estimated to be a \$600 billion industry in annual volume of equipment cost. For more information, please visit <http://www.elfaonline.org>

Our major concerns are:

- Lessor Accounting - The lessor performance obligation model does not reflect the lessor's legal and economic position in a typical equipment lease and it does not

- fit the business model of lessors who lease single assets to one lessee for terms of one year or more with no incremental services provided.
- Contingent Rents and Options for Lessees - The current tentative decisions for estimating and capitalizing contingent rents and non-bargain options do not fit the current conceptual framework and related definitions.
 - Complexity for Lessees - The initial recognition of estimates of contingent rents and options and the continuous review and adjustments are burdensome and costly.
 - Linked Accounting for Lessees – The Boards view the unit of account as the lease and recognize the linkage of the leased asset and lease obligation at the point of initial recognition. This should result in the linkage existing in subsequent accounting by the lessee.

Similar concerns have been stated by other commentators. We understand the Boards seek the views of users and value them highly; unfortunately, few users provided formal comments during the development of accounting standards. Given this situation and the limited user feedback received by the Boards during the comment letter process, we undertook a review of user views. Our review included:

- Reading the comment letters of the users (Fitch and Moody's did not comment, although we met privately with all three rating agencies to get their views in March 2009).
- Meeting with a senior credit officer at a commercial bank who analyzes the financials of prospective bank customers.
- Discussions with three equity analysts from the Forbes and Financial Times list of top equity analysts.

We commend S&P for its comprehensive comment letter but note that, generally, analysts are not motivated stakeholders, hence the lack of comment letters from them. The three equity analysts we spoke to were not aware of the details of the project and their companies did not submit comment letters. Moody's and Fitch told us in early 2009 that although they are actively tracking the project, they would not comment. Fitch and the equity analysts we surveyed stated they would likely have to make new adjustments based on the direction of the project. The equity and credit analysts know the information they need to make their judgments and will learn the new rules and make whatever adjustments they need to make. They are more concerned about the economics and cash flows of the company, the ability of the company to meet financial obligations, and the valuation of the company's worth now and in the future. The capitalization of leases by lessees will save the analysts some work but some clarity will be lost based on the project's direction. In our opinion, the analysts generally are not motivated enough to comment on the details of the proposed rules at this point. We believe these user observations need due consideration during the development of a lease accounting standard.

In the absence of meaningful user feedback, we believe the views of the major accounting firms need to be given significant weight. In our judgment, they are

independent parties, knowledgeable and motivated stakeholders in the accounting standards setting process. They have the clarity and informational value of financial reporting and “auditability” in mind when they consider a new accounting standard. We read their comment letters as part of our review, and their thoughts are included in the section below.

LESSOR ACCOUNTING

Our overall position on lessor accounting is that there may be several methods needed to deal with different types of leases. The differing models are necessary to reflect differing lease transactions and are not an attempt to advocate differing methods of lease accounting based upon the lessor’s business model. We believe a derecognition model is appropriate for leases of a whole asset to one lessee for one year or longer, and an operating lease model is appropriate where the leased item is intended to be leased to several lessees over time under short term leases. In the case of these latter leases, the derecognition model does not add meaningful information to financial statements. The operating lease model is also appropriate where the asset is leased to multiple lessees, as in commercial real estate and fractional share leases, or where the right of use of the asset is embedded in a service contract. These differences are meaningful and lead to similar leases with similar characteristics being accounted for on the same basis. The differences do not depend upon the development of lessor accounting using an intent or business model framework, which should be a positive for the Boards.

The performance obligation method was fairly well discussed at the Working Group meeting and most all agreed it was not the appropriate method for all lease types. It is our position that a lessor in a single asset lease does not have any future promises or commitments (either explicit or implicit) to the lessee once the asset is delivered. It is worth noting the PricewaterhouseCoopers, KPMG and S&P comment letters also did not agree with the performance obligation method. Grant Thornton said no single approach works for all leasing businesses. Deloitte and Ernst & Young declined to comment stating there was not enough information in the Discussion Paper to allow for robust comments.

The bank analysts we spoke with stated the model did not fit the business of bank lessors and did not reflect the lessor’s economic position. Banks are measured on “net revenue from funds” generated by their credit products, including their lease business, and the current GAAP finance lease model is the best fit. Bank leasing activities involve no performance obligation other than paying the manufacturer or dealer for the asset when the asset is delivered to the lessee. Additionally, in the case of banks, the depreciation expense in the performance obligation model will be considered an operating expense rather than a deduction from revenue. Banks are measured and compared based on revenue vs. expense “operating leverage” statistics that include depreciation of assets they use in their business as an operating expense. Depreciation of leased equipment does not fit as an operating expense.

We fear the Boards will go straight to the Exposure Draft with the “performance obligation” method, as it is the only method the staff is working on. The only way to make the performance obligation reflect the business of banks is to net the performance obligation against the leased asset and net the depreciation against the lease revenue, which is a round-about and illogical way of getting to a result that is basically derecognition. These steps would ameliorate the inconsistencies between leasing’s economics and legal framework and the performance obligation model, but it would not eliminate all of them.

The performance obligation method of lessor accounting is not a true and factually accurate representation of the lessor’s rights and obligations under a typical right of use (ROU) equipment lease. It misrepresents the lease transaction, inflating the lessor’s assets, liabilities, revenues and expenses. As an example, assume a bank lessor leases a \$100 million aircraft under a 20 year ROU lease where the present value of the lease payments is \$90 million. The performance obligation method would have \$190 million in assets and \$90 million in liabilities on the lessor’s books at lease inception, but the only pre tax, pre financing cash flows would be the lease payments and the residual flow. In fact, the bank has no financial liability – the performance obligation will never be cash settled -- and only \$100 million in assets exist once the lease commences. Its performance obligation was satisfied when the aircraft was delivered and paid for at lease inception. Control and “quiet enjoyment”, in other words the right of use of the leased aircraft, were transferred to the airline for 20 years.

Assets are bundles of rights – in this case the right to use and the right to sell – and those rights exist in all PP&E. No new right of use is created by the lease as the lessor owned that right prior to the lease. The lease transfers the value of the use for the period of the lease term in exchange for the right to receive rent, hence the need to derecognize the value of the transfer from the lessor’s balance sheet when it recognizes the lease receivable. Both the right of use and the right to sell are goods, not services. In a right of use (ROU) lease, the lessor transfers the ROU to the lessee and, as a result, the value of the asset retained by the lessor is reduced to reflect the “unleased” value of the asset. The assets the bank lessor has are the lease receivable (right to receive rent) and the residual value of the aircraft (right to use and sell the aircraft when the lessee returns the aircraft at lease expiry). If the bank lessor in the example above chooses to sell its interests in the lease and the leased asset, it would only receive \$100 million.

We are also concerned that manufacturer/dealer profit has not been discussed yet, and what appears to have been discussed would preclude a manufacturer/dealer from recognizing the profit margin that arises from the ROU lease financing. This position, if adopted, would discourage companies from using captive finance subsidiaries, which would lead to a small but meaningful increase in costs to lessees as captive finance companies in the United States often benefit from sales type leases not generating current taxable income and often price this benefit into leases.

We are also concerned about the possible gross up of the balance sheet, which would be inconsistent with the tentative conclusions in the revenue recognition project. It does not

seem appropriate that under the “performance obligation” method, the whole leased asset remains on the books of the lessor, while part of its value is also shown on the lessee’s books. The lessor no longer controls the ROU asset, while the lessee does control the ROU of the leased asset and gets all of the economic benefits of the right of use during the lease term. The same asset cannot be an asset of both entities.

Board members often express the view that “the lessee has bought the ROU” and “the lessee has financed the purchase of the ROU by making payments over time”. If the lessee has bought an asset, we would pose the question: hasn’t the lessor sold an asset? If the lessor has a lower basis in the ROU portion of the asset (manufacturer/dealer cost) sold, should not there be some up front profit recognized in addition to the finance income recorded over time? The recent EITF decision to allow Apple to record profit up front on the sale of iPhones appears to be relevant to lessor accounting. The former GAAP on revenue recognition would have deferred the manufacturer’s profit due to the continuing involvement in the software, but Apple is now allowed to recognize the multiple elements based on internal estimates of values and record a gain on sale and a deferral of profits based on its continuing obligations related to the software. This position appears to be similar to that of a lease with multiple elements. Our position is that where there is a manufacturer or dealer’s profit in an ROU lease, there should be a gross profit recognized on the value of the asset sold. The sale of the ROU is a sale of a good under the revenue recognition project’s tentative decisions.

Other than for short term rentals, equipment leases are priced as a financing decision with the implicit rate (the pre tax yield) to the lessor, cost of funds, after tax cash flow and equity returns driving the lessor’s decisions. These are the economics of equipment lessors. This is also the basis for current GAAP. Short term leases and commercial real estate leases are not priced in the same way, but that does not necessarily mean that a derecognition method is not the theoretically correct accounting method for those leases as well. From a practical perspective, one would not want to go through the effort of derecognizing in a daily rental or even a three month or six month rental; so the operating lease method is appropriate and may better portray the economics where the asset may lay idle for a while.

Leveraged leasing is a major product offering of US banks and finance companies and is the product offering that more accurately reflects the impact of tax attributes on lessor economics than even the direct finance lease model. Lessees in leveraged leases enjoy lower lease rates because of the accounting treatment. We know the sentiment of the Boards is to do away with it. We hope that the Boards are planning time to analyze the size of the market and discuss the issues of leveraged lease accounting, especially transition.

LESSEE ACCOUNTING

Contingent Rents and Options

We note that several of the major accounting firms' comment letters state the conceptual framework and asset and liability definitions may not support the view that contingent rents and options are liabilities of the lessee at inception. The Boards seem to justify their conclusions citing the contract signing as the past event that obligates the lessee. We agree with those who believe that stating the unit of account is the lease does not serve as reasonable or adequate support for the inclusion in the lease liability of items that do not meet the conceptual framework definition of a liability.

It is our position is that the past event that triggers a liability for contingent rents and non-bargain options is the occurrence of the contingent event. The present burden to pay contingent rents or non-bargain options does not exist at inception and the obligation is not legally enforceable until the contingent event occurs. Present burden and obligations are concepts in the definition of a liability that appear to be ignored when analyzing leases.

Complexity

The need to reduce complexity is a majority view from the comment letters and the working group. We would hope that there will be more changes to the project to simplify the rules.

The Boards' new view that lease contracts that are financings of the acquisition of the leased asset should be excluded from the scope will reduce lessee accounting complexity caused by the former "one-size-fits all" view as it will eliminate the need for deferred tax accounting for leases judged to be financed purchases. As a word of caution, when considering transition, the Boards should be aware of the large volume of the former finance leases that will now be considered ROU leases. It appears the Boards' criteria for differentiating ROU leases from financed purchases will be materially different from existing GAAP, so the volume of adjustments to existing finance leases will be large.

We think that the area of estimating contingent rents, options and the estimated lease term can be simplified and made principles-based rather than rules-based. Contingent rents accounting should be based on the principle that disguised minimum lease payments should be capitalized, which is the practice applied in the US today and endorsed by the major accounting firms. This view recognizes what payments are contractually or implicitly fixed through the lease contract. It identifies the payments that relate to the acquisition of the asset and separates them from the payments that arise from future events. In addition, contingent rents should be capitalized when the triggering event has

occurred and the liability has been incurred, but not before. Contingent rents common in equipment leases are contingent rents to “buy more of” the right to use, such as an excess mileage charge in a vehicle lease or a charge per copy made over a threshold in a copier lease. The economic basis for the contingent rent is the excess use, such as excess miles driven on a vehicle, which diminishes the residual value to the lessor. The excess miles contingent rent compensates the lessor for the diminishment of the residual value. The amounts are not material to the lease yet the complexity of capitalizing these types of contingent rents would be avoided if a “disguised minimum lease payment” principle is employed.

The lease term should be defined using principles in current GAAP such as:

- The period that includes a bargain renewal or when compulsion to renew is evident,
- The period(s) that precede a bargain renewal option and/or a bargain purchase option (or a purchase option where compulsion to exercise is evident),
- Periods where failure to renew creates a penalty.

This is simpler and should also result in greater symmetry between the lessee and lessor view of what the lease payments will be.

Why Linked Accounting for Lessees is Reasonable

The large stakeholders in this issue of linked accounting for lessees are the retail and the banking industries, as they have long term (as long as 20 years) real estate leases, and the transportation industry, as they have long term equipment leases and long term real estate leases. Although the financial health of their businesses will not be affected by the lease accounting rules change, it will appear as if they are less viable entities as the front end loading of leased asset expense will erode book capital when economic capital has not been diminished. We have modeled the capitalization of existing operating leases of major retailers and banks. Lease costs will rise by more than 20% in the first year for many of the companies and the front ending effect can last for as long as 20 years until the lease cost reaches steady state where the back end costs of old leases offset the front end costs of new leases. The cumulative amount of increased lease costs will be a huge drain on capital – the amounts for a large retailer or bank will be in excess of one to two billion dollars.

There will also be a huge build up in deferred tax assets resulting from the temporary book tax differences (book expense being higher than tax expense) and the amounts could be as high as a billion dollars for individual entities. Lessees will object to the front ended expense accounting but generally neither users nor the accounting firms are likely to object because they may not have a stake in the issue, unless users realize that cash rent is now completely divorced from lessee accounting. It should be noted that the CFA Institute did object and we have provided quotes from their comment letter below. The equity analysts we spoke to said it is important to know the operating cash flows and operating profits of an entity and companies who lease assets have a perpetual need for

cash to pay rent on current leases and replacement leases. The new model will not clearly depict the operating expenses or operating cash flows for ROU leases. A linked approach to ROU lease accounting will provide the true picture of the economics of a ROU lease in the income statement. Disclosure is no substitute for getting the cost pattern right. We note that the Boards are receptive to the view from investment property lessors that cash basis rent revenue best represents their economics to users. We therefore pose the question – why isn't cash basis rent expense paid to them by their lessee customers the best representation of their economics to users?

The Boards have decided the unit of account is the contract, and this position is used to justify the inclusion of non liability elements in the lease obligation. When day two accounting is considered, the Boards have determined that some elements of lease accounting retain the lease as the unit of account and some elements do not. Remeasurement for a change in lease term is a single unit of account; remeasurement from ongoing operations may not be.

At inception, the view is that the value to be recorded for the obligation to pay rents is the present value of the payments using the lessee's incremental borrowing rate or the lessor's implicit rate, if known. The ROU asset is more difficult to value but the Boards decided that the best proxy for the asset's value at inception is the present value of the payments. This logic should be true for the value throughout the contract. It would certainly reflect that a lease contract cannot be de-coupled with the asset and liability separately traded or settled. The only contract the lessee can settle is the lease contract; its components are not separable. Despite this, the Boards' tentative decision de-links the asset and liability, breaks the contract into two pieces and accounts for the asset as a separate intangible asset. This de-linking is not logical and the contract is immediately "under water" at the end of month one as the asset amortizes more quickly than the liability. The ROU asset's book or carrying value is less than the liability's book or carrying value, yet we are supposed to be accounting for the whole contract as the unit of account.

The initial recognition and measurement links the ROU asset and liability. Subsequent accounting de-links the ROU asset and liability as to value and amortization. When there is an adjustment to certain estimates, the concept is that there is a link between the asset and liability so both are adjusted equally. Then the asset and liability are de-linked as the adjusted balance for the ROU asset and liability are subject to different amortization methods. The re-linking/de-linking continues as further adjustments occur. Agenda Paper 5B for the November 18 board meeting acknowledges that fair value measurement provides users of financial statements with more relevant information. In our opinion using mortgage amortization of the ROU asset would be a better proxy for the fair value of the asset over time. Linking the asset and liability would seem to provide more relevant information to users of financial statements, and the analysts we talked to agree.

We note the following quote from the CFA Institute comment letter that supports our views on linked accounting:

We believe that the capitalization of operating leases is a significant improvement from current practice. However we would urge the boards to be a little more bold when enacting improvement approaches to both initial and subsequent measurement and not to be constrained by the goal of being consistent with existing reporting standards that bear deficiencies in their measurement basis. Consistency with these standards is often cited in the DP as one of the reasons that the boards avoided fair value measurement (and re-measurement) of the right-of-use asset and the rental obligation. Such consistency is undesirable and hampers the improvement of financial reporting. We also believe the expected value approach is most appropriate for situations with uncertainty such as the measurement of leases with renewal options, contingent rentals and residual value guarantees and that both boards should apply this approach.

The decision to “scope out” “in-substance” purchases should enable a new discussion of linked accounting as linked accounting was rejected in part because “in substance purchases” were still in the scope and the Board did not want to revert to “classifying” leases. The Board has tentatively agreed to do exactly that. We are concerned about due process as the DP was written assuming all leases were accounted for by lessees using the same method, yet a major decision was made that changed that view. Respondents might well have commented differently when asked about the income statement and cash flow presentation if only “rental” contracts are in the scope. The Appendix to November Board meeting Agenda Paper 5C section A5 cites the requirement to differentiate between finance leases and operating leases as a reason not to link. The Appendix was not discussed at any great length at the Board meetings and its rationales for not linking seem weakened given the Boards’ decision on financed purchases.

Further, section A5a of Agenda Paper 5C says no interest expense is recognized under a linked approach. We disagree with this statement and believe it is highly dependent upon how linking is accomplished. For example, if linking is done via mortgage amortization of the ROU asset, “interest expense” may still be displayed. One of the desirable outcomes of linking is the cost of the lease is straight lined as mortgage amortization of the ROU asset plus imputed interest expense on the lease obligation would add up to a straight line expense pattern, avoiding the complexity of deferred tax accounting. Section A5c of the Agenda Paper says although the ROU asset and the obligation to pay rentals are clearly linked at inception of the lease, this is not necessarily the case after inception – but the paper does not provide any support for this statement and the Boards’ decisions to re-link when adjustments are made to the lease term and to certain estimated payments seems to support the idea that they continue to be linked.

Section A6 says that a linked approach is based on the idea that there is a fundamental difference between a lease that is classified as an operating lease and a lease that is classified as a finance lease in accordance with existing standards; therefore, adopting this approach would not be an improvement to lessee accounting and would add complexity to a proposed new standard. The Boards have changed their views and recognized that there are fundamental differences between ROU leases and those leases that are the equivalent to a financed purchase of the underlying asset. The new standard

will have criteria for differentiating the two types of leases for lessees and lessors. Since the major rationales cited by the agenda papers for not linking are no longer on point, we think the Boards should devote more discussion to this issue.

The lessee cost pattern results from the Boards' view that the lessee is financing its purchase of the ROU. As a result, the Boards conclude there must be an interest component to lease expense, and the ROU asset is an intangible that must be amortized straight line. After all, in the view of some Board members, if the lessee could pay all its rent up front, it should, to be a smaller amount due to the time value of money, and presumably one would capitalize that up front rent payment and amortize it. Then and only then would there be straight line cost. That view is reasonable until one looks at the practical implications of the tax, legal, economic and financial analysis considerations that support leasing; with that in mind, the lease expense is a straight line operating expense and an operating cash outflow. The theory of fair value (that is, in our view, using sinking fund amortization for the ROU asset as a proxy) could correct the views preventing a straight line cost pattern for ROU leases. The CFA Institute agrees with our position based on this quote from their comment letter:

We would prefer that the lease asset and liability be measured at fair value as this would provide users with the most decision useful information. We are cautiously optimistic that discounting rental payments would approximate fair value and, for this reason, find it to be an acceptable approach. We support the use of expected value, as applied under IAS 37, in the measurement of lease contracts with options, contingent rentals and residual value guarantees. We believe the expected value approach provides the best answer in the valuation of cash flows with significant uncertainty. We do not support the reasoning that subsequent measurement of lease asset and obligations has to be consistent with that of other non-financial assets and non-lease financial liabilities. Such an approach can only constrain the overall improvement of financial reporting as the reference standards themselves require improvement.

While we may not agree with the CFA Institute's position on components of the lease obligation, we do believe they have made a point that requires repeating: i.e., the Boards should not limit their thinking by only trying to incorporate leasing into other models they are developing. The performance obligation model seems to be based upon the assumption that all leases are service transactions. We disagree and believe many leases, particularly those in the equipment leasing business, are more appropriately categorized as financial transactions given the nature of the lessor's involvement. We believe the Boards should not simply force leasing into a service model, but rather, consider the unique elements of a lease, determine how a lease fits into the model and revise the approach to leasing. If that review indicates the model is not providing information that allows users of financial statements to make informed investment and credit decisions or is overly complex, then the model should be reconsidered. If an accounting approach does not improve the quality of financial information, it has not achieved its purpose. It is our view that the proposed approach to lease accounting does not achieve its goals.

We certainly appreciate the Boards' consideration of our views. We look forward to continuing to work with the Boards and staff to make the proposed new lease accounting standard the most useful and workable model possible.

Sincerely,

Ralph Petta

Ralph Petta
Interim President
ELFA