ELFA/BNA Web Seminar Q&A

The following information is provided as a follow up to the ELFA/Bloomberg BNA web seminar, "Changes in Lease Accounting: Analysis and Implications for your Business," held June 27, 2013.

Question: How do we write letters on behalf of US and International lessors?

ANSWER: The ELFA website has comment letter guidance – see http://www.elfaonline.org/Issues/Accounting/pdfs/CommentLetterGuidance2013FINAL.pdf -- that explains how to submit a comment letter and outlines the issues that the ELFA thinks need improvement along with supporting arguments. As we said on the web seminar, lessors are also users of financial statements and users' comment letters are viewed as more important than lessors or preparers of financial statements. To the extent your comments can take the user perspective, the letters will be more effective.

Question: For lessor accounting, it appears Type B Assets (Real Estate) are "exempt" and uses previous lease models. What about other "major" assets with long term lives/leases, such as Aircraft and/or Ships/Vessels?

ANSWER: Equipment leases can get straight line P&L treatment for lessees and operating lease treatment for lessors but only if their lease terms are insignificant when measured against the useful life of the asset or if the PV of lease payments is insignificant vs. the fair value of the asset. These are difficult hurdles to overcome.

Question: Does this mean that a lessor could load up one side of the deal to affect the capitalize cost - i.e., IBM could put all the costs on the software vs. the hardware?

ANSWER: The lessee is required to separate the lease into its component parts. There are rules, e.g. multiple element contracts, that are designed to deal with that from the lessor's perspective as well. We think the lessee and its auditors have a responsibility to correctly portray the economics of a transaction. In our opinion the answer is no.

Question: If we believe implementation is in 2017-2018, what is the look-back period for lessors and lessees, as suggested in the draft (understanding that these contracts may already be in place)?

ANSWER: SEC rules for public companies require two previous years' results displayed for comparative purposes (see slide 6). Any lease in effect on the transition date has to be included in the results as converted to the new rules. We do not know if SEC registrants will need to present five years of financial data using a new leasing standard.

Question: In a split TRAC lease, does lessee include the maximum responsibility amount upon return or does it include the full TRAC if it anticipates exercising purchase option?

ANSWER: In a split TRAC with a purchase option, the lessee would include the purchase option as a payment to be capitalized ***only*** if it has a significant economic incentive (the option is a bargain or there is economic compulsion) to exercise the option to buy the asset. If the lessee ***does not*** have significant economic incentive to buy the asset it would include, in lease payments to be capitalized, the amount that the lessee expects to pay under the residual guarantee (the amount that the guarantee exceeds expected FMV of the asset).

Question: Lease payments - it looks like a synthetic lease structure may come back as a means of capitalizing a smaller asset; would you agree with this?

ANSWER: It does seem that residual guarantee structures will be popular as only the expected payment is included in lease payments to be capitalized. We do expect that this may be re examined by the Boards – at least in lease classification - as a synthetic would most likely be considered a Type A lease under a risks and rewards analysis. It does seem that under the ROU model that it is logical to include only the likely payment under a residual guarantee rather that the full amount of the guarantee. We think this area may be reinterpreted as the project progresses.

Question: Please clarify again - when does reassessment occur?

ANSWER: Reassessment occurs whenever the lessee reports financial results. Naturally this will be more frequent for public companies than for small and medium sized companies.

Question: Can you more clearly identify Type A vs. Type B assets?

ANSWER: Type A leases are intended to be leases of assets where there is a financing element in the lease. The ED would include the following in Type A:

- **Real estate** leases may be Type A leases if the terms of the lease include automatic transfer of title, a purchase option that meets the significant economic incentive hurdle, where the term is for substantially all the of the original useful life or where the PV of the payment equals substantially all the fair value of the asset. Basically this is like a capital lease under existing GAAP.

- **Equipment** leases will be Type A **except** where the lease term is insignificant (possibly 10%) of the original economic useful life and where the PV of payments is insignificant (possibly 10%) vs. the fair value of the asset and there is no automatic title transfer or bargain/compelling purchase option.

Question: Will a lessee have to re-book leases it entered into prior to the adoption of the new accounting rules?

ANSWER: A lessee will have to re-book any operating lease that exists on the date of transition. Capital leases are grandfathered. It is also important to note that all sale lease backs that exist on the transition date also have to be re-examined to see if they meet the new criteria to determine whether a sale took place.

Question: Will you need to go back and place your past leases on balance sheets?

ANSWER: A lessee will have to re-book any operating lease that exists on the date of transition. Capital leases are grandfathered. It is also important to note that all sale lease backs that exist on the transition date also have to be re-examined to see if they meet the new criteria to determine whether a sale took place.

Question: Regarding Type A/B - would the term "insignificant" relate to the total economic life, or the remaining economic life?

ANSWER: The total or original useful life is the measure. In other words, for a used asset one would look at its useful life as though it were new.

Question: **How is economic life determined on a forklift, and who can make that determination?**

ANSWER: A lessor or lessee can make that determination. If you are a lessor, for example, you can use your asset risk manager (the person who sets residuals) as they will know the sources to go to or they have that knowledge. If you are a lessee, you can ask your lessor to help give you support or sources you may go to, or you can consult with dealers or appraisers of the asset type.

Question: Are there any concerns that Type A lessors de-recognize a tangible asset and it is replaced with only intangible/financial assets by the lessor and lessee? The tangible asset seems to disappear from the universe!

ANSWER: We think the Boards believe that a right of use of the leased asset appears on the lessee's books and is classified with other PP&E and that the residual asset (a non-financial asset) remains on the lessor's books such that all is right with the universe.

Question: How does the proposal address the matching of revenue and expenses on the lessee side? For example, assume the lessee is only using less than 75% of the estimated useful life of the equipment, and is likely to return the equipment at end of lease, and revenue recognition is constant year over year. Does the proposal address the inconsistency between the timing of revenue recognition vs. lease expense (which is front loaded)?

ANSWER: The Boards believe there is symmetry for Type A and B leases. In the case of Type A leases, the financing components are symmetrical. In the case of Type B leases, the rent expense and the rent revenue are symmetrical.

Question: So, to correlate these Type A and B leases with the old classifications of leases, can we say that: Type A are more of Operating leases and Type B are Sales Type / Direct Financing?

ANSWER: For equipment leases the reverse is the case. Type A leases will include equipment lessors leases that were accounted for as sales-type, direct financing and operating leases. Type B will predominantly be previously existing operating leases of real estate.

Question: This ED is an improvement to the 2010 one, but it is still much worse than FAS13.

ANSWER: Agree. Equipment leases for lessees are not viewed correctly and are treated for P&L cost allocation purposes to what is probably the wrong expense pattern. For lessors some sales type profits are deferred, guaranteed residuals do not all get the right treatment, leveraged lease treatment is lost and with it the ability to count tax credits as revenue.

Question: Any change in how residual value is to be determined?

ANSWER: In booking a new lease the rules are virtually the same. You assume a residual and lease payments, determine the implicit rate and book a PV receivable and PV residual and recognize revenue using the implicit rate. However in transition it is less clear. The ED says the lessor should use the fair value of the asset at the earliest date reported when transitioning to the new rules for booking an existing lease. We will comment on this and we think we have to wait and see how this plays out as the project moves forward.

Question: If the object of this new model is transparency, why after eight years is the ED so muddy, complicated, inconsistent in application and confusing? It seems that one of its purposes is to amend and change US Accounting standards vs. providing global clarity to stakeholders.

ANSWER: The ELFA tends to agree. The Boards could have merely amended current GAAP and had lessees present an asset and liability valued at the PV of the payments.
Question: Can you provide an example of the accounting of a transaction where the lessor benefits from a 30% investment tax credit and the residual and rents do not recover the equipment cost (Type A Lease)?

ANSWER: The ED does not provide an example. We believe one would look to tax accounting rules for the accounting for the ITC. It would either flow through on day one or be amortized straight line over the lease term. Both choices report the ITC as a credit to tax expense. Regarding the negative implicit rate, we would say you book a loss on day one, record the non-discounted rent and residual.

Question: I work for a captive finance company and was really looking for a detailed review of the lessor accounting. It seems like you spent a nice amount of time on the lessee section (which is great), but you blew through the lessor section...and many of us on the webcast are lessors. Very disappointing because it seems that most of these webcasts focus on lessee impacts and not on lessors.

ANSWER: We apologize for the rushed lessor presentation. Except for the accounting of residual, however, the Type A model is the same as the sales-type lease model and it is exactly the same as the direct finance lease model. While determination of lease term and lease payments has changed, those elements were covered in the presentation. The web seminar does include a detailed example on slides 36 & 37 that has all the calculations to support the proposed lessor accounting with a sales type profit.

Question: Can we consider a coordinated response effort between ELFA and members of the real estate finance community?

ANSWER: The ELFA is working with the real estate industry in two separate coalitions. One group is lead by the US Chamber of Commerce. The other is a coalition of international leasing trade associations. Our views are generally aligned so we are working towards common goals. The dichotomy in the treatment of real estate and equipment does complicate advocacy efforts but both we and the real estate industry are interested in rules that best portray the effects of leases for lessees and lessors and rules that result in benefits that outweigh the costs to comply.

Question: One of the polling questions asked if the latest exposure draft is better than the 2010 version. What you didn't ask is whether we thought the whole thing is a good idea or not. Maybe that is moot at this point, but I would have answered that I do not think it is a good idea. It does not enhance the accounting or understanding of these transactions and creates much more work on both sides of the equation. If nothing is actually improved, why is the change needed?

ANSWER: We agree and the ELFA's advocacy efforts focus on changes to the ED that will result in a new lease accounting rule that makes sense for lessee, lessors and users of their

financial statements while presenting information on lessee operating lease obligations that users had to make educated guesses at to satisfy their needs.