October 2010

To our colleagues in the international community:

As you may be aware, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have issued jointly deliberated exposure drafts that propose changes to the existing lease accounting requirements for both lessors and lessees. As part of our international activities, FEI is pleased to share the attached White Paper that identifies and explains potential issues associated with these changes.

The objective of the White Paper is to educate constituents of the FASB and IASB regarding the potential impact of the Exposure Drafts and to encourage those affected to provide comments to the FASB and IASB regarding any concerns they may have. FEI will be issuing a comment letter based on the points identified in the attached paper and would welcome other interested organizations and companies to join them as signatories to the letter. As the comment deadline is December 15, 2010, we need to hear from your organization no later than November 30, 2010. At that date FEI will make any final requested edits and issue a final document to all organizations that are listed as signatories prior to filing with the FASB and IASB.

FEI is a leading international organization of senior financial executives. Through its Committee on Corporate Reporting, the senior technical committee of FEI, we review and respond to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of FEI and not necessarily the views its members individually.

We appreciate consideration of the matters discussed in the attached White Paper and welcome the opportunity to discuss any and all related matters. We hope you will join FEI a signing organization that supports the views expressed in this paper. Please feel free to contact John Bober at 203.373.3014 or john.bober@ge.com with any questions.

Sincerely,

Financial Executives International

FEI White Paper on Lessor Accounting, including comments on aspects of lessee accounting

Introduction

Financial Executives International ("FEI") has been following the Financial Accounting Standards Board and the International Accounting Standards Board discussion of lessor accounting with great interest, and FEI is currently evaluating the proposals for lessor accounting contained in the Exposure Draft *Leases*. Based upon the discussion to date and a preliminary reading of the Exposure Draft, FEI has noted certain matters that deserve the attention of constituents.

While the primary purpose of the Boards leasing project is the development of a lessee accounting model that results in the lessee recognizing an asset and an obligation arising from a lease contract, the Boards have also chosen to consider matters related to lessor accounting. While we are pleased the Boards proposed models for lessor accounting have recognized that leasing represents a continuum of transactions, ranging from pure financings to pure service arrangements, we are concerned the proposed approach to lessor accounting is not robust enough to consider the full range of transactions and does not represent an improvement over the lessor accounting models that exist today. In particular, we are concerned the proposed models will:

- Move significant portions of lessor accounting away from the economic model associated with leasing,
- Lead, in the case of the performance obligation approach, to the double counting of assets and an overstatement of revenues and expenses in lessor financial statements,
- Fail to reflect in either model the lessor's position when leases are modified or restructured, and
- May hinder manufacturers seeking to use lease financing in connection with product sales.

The purpose of this paper is to provide further information on the concerns listed above and to provide commentary on other issues and questions lessors have identified to date with the proposed approach to lessor accounting.

FEI believes the existing lessor accounting models presented in ASC 840 and IAS No. 17, *Leases* are well understood by preparers, users and auditors and are considered to provide appropriate financial information to users of financial statements and investors. These models reflect the underlying economic substance of transactions. Any changes to the lessor accounting model should be carefully considered in that context. We are open to improvements in lessor accounting, but we also believe changes to accounting standards should be judged on whether they represent an improvement over the existing standards. If a proposed model is not clearly superior to the existing standards, change should not be adopted merely for the sake of change. If a proposed model fails to reflect the economic framework underlying a whole class of transactions, it should be reconsidered.

Background

When the Boards issued the Discussion Paper *Leases: Preliminary Views* for comment, a number of respondents noted lessee accounting should not be addressed in isolation and stated lessor accounting should be considered at the same time as lessee accounting. In an ideal world, this would be a desirable outcome, as the insights gained from looking at both sides of a transaction are often critical to gaining a full understanding of what is being accounted for. The Boards considered these comments and expended considerable efforts over the past year considering lessor accounting. The proposals for lessor accounting contained in the Exposure Draft are the product of these deliberations, and in many ways the proposed lessor models represent considerable improvement over the alternatives that were under consideration only a few months ago.

In the Exposure Draft the Boards are proposing to eliminate the lessor accounting models that exist in IAS 17 and ASC 840, and replace these approaches with, depending upon the specific facts and circumstances, either:

- A lessor model based upon but not wholly consistent with the goods and service approach outlined in the discussion paper, *Preliminary Views on Revenue Recognition in Contracts with Customers* (the performance obligation approach), or
- A lessor model that assumes a sale of a right to use by the lessor and the partial derecognition of the lessor's asset (the derecognition approach).

Each model contains elements that cause them on balance to be inferior to the lessor models in use today.

The performance obligation approach resolves the matter of the unrecognized financial assets that exist in the current operating lease model, but the resolution comes at a considerable price. The performance obligation model would have lessors record a receivable for lessee payments (the right to receive lease payments), and recognize a *liability* for a performance obligation. We do not believe this approach provides decision useful information to either external or internal users of financial statements. In particular, we believe the proposed performance obligation model for lessor accounting will:

- Not reflect the important economic elements of a lease;
- Not have the benefit of being as easy to apply as the existing operating lease accounting model;
- Not be consistent with the basis for conclusions on the lessee right of use model;
- Result in a noneconomic grossing up of the lessor's financial statements;

- Lead to front end loading of lease income;
- Lead to difficulties in determining and measuring impairments of the leased assets; and
- Undermine the guidance included in the revenue recognition project, as applying the performance obligation approach to lessor accounting is inconsistent with elements of the proposed revenue model and requires an interpretation of the performance obligation concept that is neither reasonable nor sensible.

The derecognition approach resolves some of the performance obligation model's weaknesses, but the model also shares certain difficulties with the performance obligation model and has another unique issue. We believe the performance obligation approach:

- Does not reflect the important economic elements of a lessor's position in a lease;
- May hinder profit recognition by companies that finance product sales using leases; and
- Will lead to difficulties in determining and measuring impairments of the leased assets.

After considering these concerns, FEI has come to believe the case for a change in lessor accounting has not been made and the accounting for leases by lessors should not be subject to the proposed revisions.

Lessor Economic Model: General Matters

While there are some constituents who believe lease transactions are entered into solely for the purpose of obtaining "off balance sheet" treatment under the existing accounting rules, there are a number of economic and financial benefits that companies obtain from leasing that are not available when a company purchases an asset and finances it with either debt or equity, as that is just a pre tax perspective and all lease versus buy decisions are made on an after tax basis.

In a lease transaction a lessor earns its economic returns from the lessee's rent payments, tax benefits associated with asset ownership and through the realization of any retained residual interest, often through the sale of the asset. The lessor's return may be measured in two ways:

- The lessor's pre tax return, which reflects rent and residual cash flows, and
- The lessor's post tax return, which reflects the tax cash flows in addition to the lessee rents and the residual cash flows.

When the lessor is the owner of the leased asset for income tax purposes, the pre tax return is often lower than the post tax equivalent of the pre tax return. The lessor provides a lease rate that is lower than a loan rate because of the tax benefits resulting from asset ownership.[1] In essence the lessee has gained use of the asset and has obtained a beneficial financing rate because it has sold the residual interest and tax benefits to the lessor. These factors are most evident when the lease period covers most of the asset's economic life.

The lessor direct finance lease and sales-type lease models in [ASU] reflect the pre tax flows in a lease and mirror the lessor's economic position in this situation. The only failing in the model is that tax benefits are reflected as a secondary cash flow in this accounting model. The direct finance lease model is predicated on the use of fair values to measure the transaction at lease inception: the fair value of the leased asset, the fair value of the residual and resultant implicit rate. This model is consistent with the separate accounting for each element in a transaction with multiple elements. Each of these components may be compared to market estimates. If the lessor has acquired the asset for the sole purpose of placing the asset out on lease, the fair value of the asset is the amount paid at the inception of the lease. The residual may be determined based upon estimates and market indications of positions taken by other lessors. Finally, the implicit rate provides proof the components have produced a reasonable answer. If the implicit rate is high relative to the credit risk assumed, offset by the tax savings, then the lessor has assumed too much residual risk and needs to recalibrate the lease pricing. The converse is also true. While the implicit rate is not precisely comparable to a loan rate, differences should be explained. This is important feedback to the lessor, and it is provided by referencing the lease to market estimates.

Lessor Economic Model: Manufacturers and Dealers

Many manufacturers finance the sale of their products. The financing may be provided through loans or through leases. If the financing is provided through a lease, in the United States the lessor-manufacturer has an advantage over other financing sources as many lease transactions do not result in a sale of the asset for income tax purposes. This deferral of income taxes is a powerful competitive tool, and lessors often share the impact of this benefit, known as deferred margin credit, with their customers.

When manufacturers use leasing to finance the sale of their product, the lessor's economics derive from the same cash flows described previously: rents, residual and tax benefits. The model is also predicated on the use of fair values: fair value of the residual, the market referenced implicit rate and the estimated fair value of the asset. The only new feature is that the lessor needs to estimate the fair value of the property to a third party purchaser in order to determine the economic value of the transaction.

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[1] A detailed overview of lessor economics is contained in Chapter 6 of *Equipment Leasing*, edited by Ian Shrank. Lessor's may have an additional income tax benefit available to them if they are able to take advantage of like-kind-exchange tax rules, which often is partially shared with the lessee. For these reasons, the pre tax rate on a lease may be significantly lower than the rate on a similar loan.

Lessor Economic Model: Other Considerations

The lease model described in the prior sections is the economic model followed by many equipment lessors. When the lease term is relatively short, especially when the underlying asset is very long lived, or when an asset is leased to several parties at the same time, the lessor returns are generally not fixed using the same equation. The lessor will charge what the market will allow with limited or no reference to the traditional financing guides, such as credit spreads. Under existing GAAP, these lessors follow an amortized cost model – the operating lease accounting model – rather than the financial instrument based direct finance lease model.

The direct finance lease and operating model have generally served lessors and investors well, as both models faithfully reflect differing facts and circumstances inherent in both forms of leasing. In fact, we are not aware of significant concerns being raised concerning the existing lessor model.

Lessors and the Lessee Right of Use Model

Since the development by the Boards of a lessee Right of Use ("ROU") accounting model, the Boards have attempted to develop a lessor accounting model that is consistent and symmetrical with the lessee ROU model and that may be reconciled with the revenue recognition project. Unfortunately, achieving the goal of lessor-lessee symmetry is not straightforward and may result in an accounting model for lessors that is not an improvement on the existing model and may in fact be less relevant, reliable and representationally faithful to the underlying transactions. A lessee's ROU obligation includes elements that are not certain, such as renewal rents, including fair market value renewal rents, and contingent rents, that may not be priced by a lessor. Inclusion of these uncertain amounts in the lessor receivable has an impact on the precision of the lessor estimates. In the best case these are uncertain elements and in the worst case they misstate recorded amounts and require revision. Given this uncertainty and the importance of these amounts to lessor income recognition, the Boards have elected to revise lessor accounting rather than reconsider the criteria used by lessors for recognition and measurement of the lease receivable.

The ultimate goal of lessor accounting should be an accounting framework that allows lessors to make decisions regarding their business and provides investors with financial statements that reflect the lessor's financial position and results of operation. We are concerned the proposed models, particularly the manner in which the lessor performance obligation is presented and described, will impede the flow of decision useful information. In particular we are concerned users will not have a clear and concise picture of the lessor's financial position or results of operations under the performance obligation model as it has been described since:

- The performance obligation approach is not an economic based model;
- Is not fully consistent with the proposed revenue recognition model as it neither looks at the transaction from the customers perspective nor accounts for the lessors net contract asset when considering the

recognition of income;
- The double counting of assets, even if the presentation is essentially linked on the balance sheet;
- The recognition of a lease "liability" that will never be subject to settlement through future cash or *future* asset transfers;
- The accelerated earnings pattern that results from the combined recognition of income and lease income as the lease liability amortizes; and
- The accounting loss – as opposed to an economic loss -- that must always result if a lease is terminated or restructured during its life.

With regards to the derecognition model we are pleased the Boards have recognized there are instances where the lease transaction should not be considered a goods and service transaction.[2] Unfortunately, the derecognition model is a cost allocation model and is not an economic model, unlike the existing direct finance and sales type lease accounting models. It does not consider the residual to be an element of the investment in the lease and the final cash flow the lessor expects to earn. It views the residual as the remaining element of the lessor's asset once derecognition has taken place. Again, we are concerned this presentation will not present a clear and concise picture of the lessor's financial position or results of operations since:

- The model, while closer to lease economics than the performance obligation approach, is still not a complete economic model;
- The cost allocation approach to the residual position in particular will move lessor accounting away from the economic model; and
- The freezing of the residual will cause the accounting for lease restructurings and terminations to no longer reflect the lessor's position.[3]

Some – but not all -- of these concerns may be ameliorated if the lessor models were to work in a slightly different manner.

Alternative Approaches to Lessor Accounting

A model that would better reflect the lessor's financial position and results of operations would be one in which the lessor records a performance obligation

[2] Some observers have noted the two lessor models are based upon conflicting notions of what a lease transaction represents. Some appear to believe that because the lessor has control of the underlying asset, the asset should not be derecognized and the lessor must be providing the lessee with a service with continuous performance. Others note that the lessee model is based upon the concept that once the lessor has delivered the asset to the lessee, the lessor has performed and the lessor has transferred an asset with economic value to the lessee; in essence, the lessor has sold a right of use to the lessee. These competing concepts have not been reconciled by the Boards.

[3] If a lease is terminated early due to a lessee default, the derecognition model as detailed in B30, results in the lessor recording the termination of the lease at amounts significantly less than either the leased asset's fair value or the amount of the asset previously derecognized.

in connection with the lease and then reduces the performance obligation when the customer-vendor obligation is extinguished. In many instances, the lessee's obligation to the lessor, which is discussed later in the paper, is unconditional, and the lessor has no obligation to the lessee once the asset has been delivered at lease commencement. As a result, it is consistent with the model and logical for the performance obligation to be extinguished when the asset is delivered to the lessee in these circumstances.

The performance obligation is only part of the equation because the lessor has transferred an asset to the lessee and the lessor will have a retained interest in the leased asset for the value that has not been leased in addition to the lease receivable. If the performance obligation is extinguished on lease commencement, and a portion of the lessor's asset has also been transferred, derecognizing a portion of the asset is necessary to reflect that revenue has a cost associated with it, a lessor asset has diminished utility and to avoid carrying the leased asset at more than its recoverable value. The asset could be derecognized on a pro rata basis and could be described as a cost of lease revenue as is done under the derecognition approach, but it is arguably best if the residual is accounted for at lease commencement at fair value. This is probably necessary as the weakness of the performance obligation is that it fails to acknowledge the residual as a component of the lease investment. If it is regarded as a component of the lease investment, then it would be accreted to fair value as it is today under existing accounting literature. The accounting for lease restructurings and terminations would be more intuitive, as they would be fair value events as they are today.

There are probably situations where the derecognition based approaches should not be applied and there is a principle-based way of addressing these situations. For example, when the lessor is leasing an asset, such as a building, to multiple parties it may have multiple performance obligations related to its activities and it might not be appropriate to regard the performance obligation as extinguished at lease commencement or to otherwise derecognize the asset. If the leased asset were to be considered the unit of account, then leases of the entire asset could fall under the models described above and leases of an asset to multiple parties could be regarded as having a continuing obligation to multiple parties that constitutes a performance obligation. For the lessee the unit of account may continue to be the space they have leased as that is the asset from the customer's perspective. Similarly, if the lessee's payment to the lessor is conditioned upon the lessor providing a service to the lessee, which is often the case in service contracts, the lessor will have a performance obligation.

Specific Comments

In addition to the general observations and comments presented in the prior paragraphs, we have the following specific comments regarding the proposed approach to lessor accounting.

- ***Leasing does not fit into the proposed revenue recognition model***

Leasing represents a broad range of transactions. Some transactions may contain a good or service element embedded in a financial transaction, some may represent a good or service transaction and others may be purely financial transactions. Some of these transactions may give rise to a performance obligation by the lessor; others, possibly the majority, will not include a performance obligation as that term is introduced in the revenue recognition project. The Boards have recognized a distinction exists by acknowledging that some leases are pure financings, from a legal and economic perspective, and proposing to consider these transactions outside of the proposed model. The Boards have also recognized the financing element of some lease transactions is the principal component of the transaction and have proposed a derecognition approach that partially considers this economic arrangement. We believe it is necessary, however, for the Boards to consider the important elements of lease transactions and what critical characteristics separate lease transactions from goods and services transactions and allow for the appropriate recognition of these differences. The retention of asset ownership and related risks and rewards should not transform a financial transaction into a good and service transaction when a transaction is fundamentally a financing. In addition, it should not be a reason for accounting for the end component of the transaction, the residual, as if it were property, plant and equipment.

- ***The performance obligation model will move lessor accounting away from leasing's economic framework***

  The current direct finance lease and sales-type lease models provide a fair representation of lessor pre tax economics in many leases.[4] Each lease payment and the residual value – the last economic payment in the lease -- are accounted for using the interest method, and the rate that present values those flows to fair value.[5] Many leases are priced and evaluated by lessors following this economic model, which accounts for the initial transaction at fair value. The Boards need a strong rationale for moving leasing away from this economic and accounting model. It is even possible that moving lessor accounting away from this economic model may lead to lessors mispricing their risk, if lessors move to price leases based upon accounting exposure and not economic exposure, for example through analyzing a transaction using the longest possible lease term.

  If the Boards continue with the performance obligation approach for whole classes of transactions, it is important that the manner in which the right to receive lease payments and the lease liability amortize in

[4] This model does not attempt to explicitly consider the tax benefits of asset ownership, which is often a significant element of lease economics. Most of the academic lease versus buy literature proscribes a comparison of after tax cash flows.

[5] SFAS No. 13 was in many respects a pioneering statement for its use of present value, the interest method and fair value measures.

order to prevent a non economic income pattern from developing and to prevent unexpected results from occurring when leases are modified or terminated. The Boards should also consider the implications of this pattern when they analyze lessee accounting.

- ***We believe the lessor in a simple lease does not contain a performance obligation***

  In the discussion paper, *Leases: Preliminary Views*, the Boards state in the case of a simple lease ". . . the lessee has an unconditional obligation to pay rentals [3.19]" that arises out of a past event. Stating this same lease contains a lessor performance obligation is not correct or reasonable, especially given the statements in the discussion paper. The lessor in the discussion paper's example has no future obligation, implied or actual, to the lessee following delivery of the asset. A performance obligation can only exist between the entity providing a good and service and its customer. It cannot exist in isolation nor be used to address any other concerns the Boards may have regarding a lessor model.

  A further analysis of the legal relationship between the lessor and the lessee adds additional information the Boards should consider. If the equipment supplied by the lessor is not manufactured by the lessor, in the United States the lessee is considered to have a "hell or high water" obligation to the lessor. In other words, the lessee's obligation is unconditional and is not dependent upon whether the equipment functions or meets the lessee's needs. In this instance it is not possible to argue the lessor has *any* performance obligation to the lessee. If the lessor is a manufacturer, the manufacturer probably has a warranty obligation, but the warranty obligation is not a reason to preclude revenue recognition under the revenue recognition model. Therefore, even in this situation, it is difficult to argue that the lessor has a performance obligation as a *lessor* to the lessee as it relates to the delivery of the equipment at the inception of the lease. The lessor-manufacturer should account for the warranty obligation separately from the lease of the asset in the same manner as an outright sale of equipment. There may be other situations in which a performance obligation exists between the lessor and lessee, particularly when the lessor is providing significant services to the lessee and the lessee's obligation to the lessor is not dependent upon the mere passage of time. These instances should be evaluated and analyzed and accounted for separately as any other multiple element transaction.

  If the Boards continue to regard leases as transactions that should be within the scope of the Revenue Recognition model, the question of whether a performance obligation exists in a lease should be reconsidered.

- ***The proposed accounting is inconsistent with other transactions under the Revenue Recognition model***

The Boards appear to regard the lessor's asset ownership as the basis for including leasing in the revenue recognition model and the basis for excluding leases from its traditional financial instruments based model. Asset ownership also appears to be regarded as the impediment to the recognition of income as the difference between the fair value of the lease receivable -- and leased asset -- and the asset's book value at the commencement of the lease. It is not clear why retention of asset ownership is regarded as an issue because the lessor has irrevocably transferred to the lessee the right to use the asset for a period of time and cannot recover it unless the lessee defaults.

In addition, leases where the lessor has retained ownership of the leased asset and has transferred a right of use have corollaries with other commercial transactions. For example, in sales of software licenses the seller retains ownership of the underlying asset and only sells a right to use the asset to the software's purchaser. These transactions would be treated as sales with current income under the proposed revenue recognition model and there is no performance obligation related to the period of use. There appears to be no meaningful difference between these transactions and a simple lease, as in both cases, the vendor/lessor retains ownership of the underlying asset while transferring the right to use it to another party. The only difference between these transactions is that only one party can use a leased asset, but software licenses may be infinitely reproducible and the customer may have possession of a CD of the software. This is not a significant difference in the context of the revenue recognition model.

- ***The demarcation line between performance obligation and derecognition leases will have implications for manufacturer-lessors who use lease financing***

Manufacturers sell their products using different forms of financing arrangements. Many manufacturers sell their products through lease financing arrangements that may have more favorable income tax benefits than either a cash sale or a sale with loan financing. Absent the income tax consequences, these transactions are economically the same as other sales transactions. Manufacturing entities are in the business of producing and selling products, which is generally how their performance is measured. That is, there does not appear to be an abundance of "build to hold" business models in manufacturing. However, the proposed lessor accounting model will result in vastly different accounting for economically similar transactions and business models causing significant comparability issues.

In the United States, there is an additional factor that may result in increased costs to customers. When a manufacturer places an asset out on lease, the manufacturer-lessor is not regarded as having sold the asset for income tax purposes. As a result the gross profit that arises in a sales-type lease is not currently taxable as it would be if the manufacturer sold the asset and financed the sale with a loan or sold it to a third party finance company who then leased the asset. This significant timing benefit is commonly termed “deferred gross margin” and is a competitive advantage that captive finance companies have over other lessors. Manufacturer-lessors often share this benefit with the lessee. If sales-type leases are curtailed or eliminated and manufacturers react by reducing their leasing activities, then the cost of leases will rise.

We also believe moving leasing away from the current financial instrument model into a service model or into a model that does not allow for full profit recognition -- when the manufacturer/lessor’s risk profile is often superior to that of a lender in the event of a default -- is not a reasonable outcome. It is true the lessor will have retained risk related to whatever residual position it has assumed and priced into the lease, but measuring that risk at fair value at lease inception and testing it for impairment on a fair value basis, as is done today, is an appropriate financial statement presentation.

Whether a lease will qualify for profit recognition or not will depend upon whether or not the lease meets the criteria for derecognition approach. To qualify for derecognition, a lease must not expose the lessor to significant risks or benefits associated with the underlying asset during the term of the lease or after the expected lease term. Whether the lessor is exposed to significant risks and benefits during the term of the lease may depend upon whether the lessor provides material non-distinct services during the lease. While the Exposure Draft contains a discussion of what constitutes a non-distinct service, we understand there is some debate about whether some normal services, such as maintenance and asset administration qualify as distinct. If these and similar items are not considered distinct, then the universe of leases with profit recognition will be reduced.

- ***Carving leases out of financial instrument transactions creates inconsistencies in the accounting literature***

  Given the nature of the lessee’s obligation under a lease, it is difficult to explain why loans are also not considered to be service transactions whereby the lender is permitting the borrower to use the lender’s money for the life of the loan. If the performance obligation model is considered to be applicable to leasing transactions its applicability to lending transactions should also be explored in order to not disadvantage leasing. This is not our preferred outcome, as we ultimately believe the model does not increase the usefulness of financial statements and should not be applied to either set of transactions.

- ***The approach to lessor accounting raises questions about lessee recognition and measurement***

The lessee right of use model results in the recognition of a liability that does not appropriately reflect the economic liability a lessee has. By including in the recognized liability amounts that *may* be paid during renewal periods or under contingent rents, the Boards have divorced the accounting from the economic obligation and from the amounts that should be recorded under the definition of a liability. One possible consequence of this will be that the lessee's asset can be greater than the fair value of the underlying asset the lessee has the temporary right of use over.

For example, renewal rents have a different risk profile than base rents. Renewal rents and contingent rents and short term rents have a different pricing than longer term rents. If, for example, renewal and contingent rents are components of the lessee's obligation (and asset) and if these rents are measured using the lessee's incremental borrowing rate –- a rate that reflects the lessee's fixed and unconditional payment obligations -- there is a strong possibility the leased asset will be measured at a value greater than the value of the underlying asset and at a value greater than the economic value of the transaction. It is possible this situation, when considered in the context of lessor accounting, is what is causing the Boards to move away from the sales-type lease accounting model. In this situation the lessee right of use model is not generating decision useful information for the evaluation of the lessor—and possibly the lessee's -– economic position. Rather than eliminating a reasonable lessor accounting model, the Boards should explore in greater depth the reasons the proposed accounting model is producing what they may regard as an undesirable result.

Lessee Accounting and the Lease Contract

While the primary purpose of this paper is to consider matters related to lessor accounting, certain observations derived from a review of the lessor model are relevant when the lessee model is considered.

The lessor model is generally based upon the lease contract and on factors related to the underlying asset. The lessee model, on the other hand, either disregards or respects the contract depending upon the matter that is being considered. In the base model, the lessee right of use approach assumes the lessee has purchased a right of use and is paying for it over time. The accounting for these two elements after initial recognition assumes they are independent of each other, which they are not. Unlike an asset acquired with the proceeds of a loan, the asset and obligation may not be separately settled. They are tied together by contract.

Once consequence of this "as if purchased with borrowed funds" model, is that the asset and obligation amortize a different rates. The asset will amortize, in most cases, on a straight line basis and the liability will amortize on an effective interest basis. As a result, the sum of amortization and interest expense will exceed the rent during the first portion of the lease term and will be less than rent during the later portion of the lease. In addition to not properly reflecting the economics of a lease contract, this accounting result has several consequences that all arise because the leased asset will always be less than the lease liability. If the lessee either terminates a lease early or fails to renew a lease that it has accounted for using the base lease term plus the renewal period, the lessee will record an accounting gain. This may enable lessees to manage income by recognizing a lease using base and renewal periods and then electing to return the asset at the end of the base term.

There is also the possibility that lessees might use this accounting to their benefit when renegotiating lease contracts with lessors. While the lessee will always be in a net gain position, a lessor following the performance obligation approach will always be in a net loss position as the lease liability will amortize faster than the lease receivable. Consequently, when a lessee is seeking to renegotiate a lease contract, the lessee will enter the negotiations knowing they are in a net gain position and the lessor is a net loss position. It is possible the lessee will use this to their advantage.

While the lease contract is disregarded to achieve separate accounting for the asset and obligation after recognition, the proposed model elects to consider the contract when services or executory costs are considered. While current accounting requirements call for the separation of executory costs -- such as property tax, insurance and maintenance costs included in a lease payment – and service elements from lease accounting, the proposed model would have lessees and lessor separate these items only if they are "distinct." An item is distinct if:

- The lessor or another entity sells an identical or similar service separate, or
- An entity could sell the service separately because the service has both:
    - A distinct function, and
    - A distinct profit margin.

If a service or executory cost is not distinct it is included in the lease payment, and it becomes an element of the recorded asset and obligation. While the Boards have adopted an in substance purchase model, some Board members believe these costs, which are executory in an asset purchase model, should be accounted for as part of the lease because they arise under a contract. Including these elements in the measurement of lease assets and obligations of a lessee or in the right to receive lease payments of a lessor will not provide a representationally faithful depiction of the lease transaction.

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We are supportive of the project's overall goals of improving the accounting for leases and the convergence, simplification, and comparability of lease accounting across companies and geographical boundaries. We appreciate your consideration of our feedback on suggested clarifications and refinements and are available to meet with you or answer any of your questions.

We appreciate consideration of these matters and welcome the opportunity to discuss any and all related matters. Please contact John Bober at 203.373.3014 or john.bober@ge.com with any questions.