Lease Accounting Project Update & Commentary as of May 18, 2013
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The Boards have issued new Leases Project Exposure Draft(s) (ED) on May 16, 2013. The FASB and IASB issued separate drafts as there are minor differences mostly due to differences in IFRS and US GAAP. Three FASB board members and two IASB board members dissented. The ELFA notes that several changes are still needed to make the proposal acceptable to stakeholders. The major lessee issues surround lease cost allocation, lessee classification which should be based on the legal nature of the contract and the tightened/restrictive, leveraged leasing should be retained and tax benefits should be reflected in the revenue recognition of true lease definition of what is a sale in a sale leaseback. The major lessor issues are that lessor classification should be based on the business model of the lessor

The following project update represents the tentative decisions **(which are unlikely to change and will be included in the new ED)** and includes what is new since January with significant changes in the text below are in ***bold italics***.

Executive summary

Estimated timeline:
-***New ED is MAY 16, 2013. Comment period ends September 13, 2013*** followed by re-deliberations that will begin late in the fourth quarter and continue on into 2014.
-This means the new rules will not be issued until 2014
-**Transition date has not been announced** but is <u>likely to be no sooner than 2017</u>

Lessee Accounting:
-Capitalize all leases @ the PV of estimated payments.
-Some leases (most equipment leases) will have a P&L pattern that is front ended – rent expense replaced by amortization and imputed interest, now called Type A (formerly called Interest and Amortization (I&A)) leases. Some leases (mostly real estate and some long lived equipment leases with relatively short terms (possibly 10% of the original life)) will have straight line rent expense, now called Type B (formerly called Single Lease Expense (SLE)) leases. Real estate leases are presumed to get straight line expense unless the lease term and PV of rents are meet similar tests as current GAAP while equipment leases are presumed to get front ended costs unless the lease term and PV of rents are <u>insignificant</u> compared to the original useful life and current fair value of the leased asset. <u>Insignificant</u> remains to be defined.
-Lease term = substantially the same as current GAAP definition.
-Variable rents based on a rate (i.e. Libor) or an index (i.e. CPI) are booked based on spot rates with adjustments booked when the rate change changes contractual lease payments. Variable rents based on usage or lessee performance (e. g. sales) not booked unless a tool to avoid capitalization (disguised minimum lease payment). Estimated payments under residual guarantees are booked with review and adjustment at each reporting date.
- Short term leases, including most short term renewals, can elect to use operating lease method with additional disclosure.
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Lessor Accounting:
- Two methods identified for lessors – The "receivable & residual" (R&R) method (much like the current GAAP direct finance lease method) for most equipment leases, and existing operating lease accounting which will cover most real estate leases and some (few) equipment leases. There is a short term lease election to use current GAAP operating lease method. The classification tests will be the same as those for lessees (see above) meaning Type A/I&A leases will be treated as R&R leases while Type B/SLE leases will be treated as operating leases.
-Under the RR method assets are the PV of the receivable and a plugged residual with earnings recognized using the implicit rate in the lease.
-Certain residual guarantees where guarantor gets the residual upside are considered minimum lease payments.
-Sales-type gross profits are limited with residual portion of gain be deferred until resolved through a sale or release.
- Leveraged lease accounting is eliminated with no grandfathering and tax credits will not be reported as lease revenue. This is a FASB only issue.

Details

Item	**Commentary**
Re-exposure – ***The new exposure draft was issued on May 16, 2013*** with a 120 day comment period ending **September 13, 2013**. In ***late*** 2013 they will review comment letters and decide on which issues to re-deliberate in the ***4th quarter of 2013 and on into 2014.*** They will not issue the new standard until 2014.	This is good news as it allows the industry and its lessee customers another chance to comment. ***The main problem areas are treating equipment leases differently than real estate leases for lessee accounting resulting in few equipment leases getting straight line rent expense, commingling capital lease and operating lease assets and liabilities, it is not appropriate for there to be symmetry in lease classification for lessees and lessors (rather business model, meaning financial lessor vs. operating lessor should be the guide to classify lessor leases), the failure to treat all guaranteed/insured residuals as a financial asset for the lessor, the loss of leveraged lease accounting (including the loss of treating ITC as a revenue item in a non-leveraged lease), failure to allow sale leaseback accounting where a purchase option is included in the lease back terms and complexity/compliance costs.*** . Readers and your lessee customers should read the new exposure draft when issued and send a comment letter to the FASB/IASB.
Effective Date of New Standard - Not decided yet but most likely will not be sooner than 2017	2017 is the last transition date mentioned at the last meeting based on his view of the work ahead. Public company preparers will have to show 2 prior years' comparative data (meaning full year results for 2015 and 2016 in the year of transition for all leases on the books in the year of transition. There will be a need for beginning asset and liabilities under the new rules in the 2015 finani0il statements.

Lessee & Lessor Transition Methods – For lessees: - Capital leases are grand fathered - Operating lease leases now classified as Type A/I&A leases- obligation booked at PV of remaining rents at earliest date presented, offsetting ROU asset booked but adjusted by the ratio of remaining rent to total rents at inception and the difference is charged to equity and deferred tax assets. Option to do a full retrospective booking. - Operating leases now classified as SLE leases obligation booked at PV of remaining rents at earliest date presented, offsetting ROU asset booked. - Existing sale and leaseback transactions: Sale and leaseback transactions that resulted in capital lease classification are grandfathered, including continuing to amortize any deferred gain or loss on sale over the lease term in the statement of comprehensive income. - For a sale and leaseback transaction that resulted in operating lease classification or the sale recognition criteria previously were not met, a seller/lessee would reevaluate the sale conclusion based on the criteria for transfer of control of an asset in the proposed Revenue Recognition standard and 2 <u>additional</u> criteria - if the term is a major part of the useful life of the asset and/or if the PV of the rents equals substantially all of the fair value of the leased asset it indicates control retained by the seller/lessee. If the criteria were met, a seller/lessee would measure lease assets and lease liabilities in accordance with the Boards' decisions regarding transition for leases that are currently classified	The lessee transition methods have been changed as they came up with a new lessee straight line (SLE) subsequent accounting method that deals with the front loading issue. It is important to note that real estate lessees will be relatively happy with the decision as they will get straight line rent expense as the lease cost for most leases. They will probably not comment to the new ED. There are 2 unknowns in transition for individual real estate sale leasebacks. One is whether the sale will be still considered a sale under Revenue Recognition if there is a purchase option in the leaseback that is less than the sales price(if not a sale then the leaseback is treated as a loan). The other issue is whether the leaseback will qualify for straight line P&L due to the length of the lease term versus the useful life or the PV of the payments versus the fair value of the property. Don't expect good news here. For lessee's using the optional full retrospective transition method will smooth the lessee transition year P&L impact for leases with front ended costs as it would move the initial "hit" of front ending lease costs to the inception of each lease. This will result in a large hit to retained earnings and the creation of a large deferred tax balance in the year of transition. This will be a problem for a capital strapped banking industry. It will also be burdensome for lessees to go back to the inception of each lease. *For lessees with leases with front ended costs (Type A/I&A leases)* the proposed modified retrospective approach would start the new accounting method for the lease liability for each lease (as though it were a new lease for the remaining term) beginning in the earliest period presented

as operating leases and would recognize any deferred gain or loss in opening retained earnings upon transition to the new leases guidance. - Alternatively, a seller/lessee may elect to apply the requirements in the proposed leases standard retrospectively. - For lessors - Direct finance leases and sales type leases are grandfathered - For operating leases that are R&R leases under the new lease classification tests book the PV of the rents as an asset, derecognize the operating lease asset and the difference is the residual. No decision on how to handle transition for operating leases with a gross profit element that would now be R&R leases under the new standard. - Use operating lease accounting for operating leases that continue to meet the operating lease classification tests. Early adoption will be allowed for IFRS preparers and first time IFRS adopters.	when a lessee converts to the new rules (likely to be in 2015). The ROU asset for *each individual lease* is adjusted in a complicated way by using a ratio of remaining rents to total rents to reflect a partial retrospective result. This is an attempt to lessen the first year P&L cost front ending. Instead the charge from this depreciation adjustment is to equity and deferred tax assets rather than to current P&L. This adds tremendous complexity for the lessee. This means that existing leases will have a front ended pattern as though they were new leases but with the front loading impact pushed back to prior periods. The difference between this new method and treating the existing leases exactly as though they were new leases is the charge is to equity and deferred tax assets not current earnings– still not an outcome that reflects the economics of a lease to the lessee. This method will still create large increases in reported lease costs until the lessee's lease portfolio reaches a point where an equal amount of expiring leases are replaced by new leases. At that point the front ending phenomenon leaves all lessees with a *permanent reduction in equity* and a *permanent deferred tax asset*. In a going concern that is growing and considering inflation the portfolio of leases will grow and the lessee company *will never reach a point of steady state leases costs*. The front ending of lease costs has the appearance of an increase in funding costs for lessees. The typical reaction of a business to an increase in its costs of funds is to reduce expenses hence the ELFA's position that the failure to allow straight line cost for equipment leases will increase unemployment and further dampen economic recovery.
Scope - All leases of a "specified asset," which includes leases of explicitly or implicitly identifiable property, plant and	Any lease where the lessee is deemed to have control, as defined by the Revenue Recognition Project, of the underlying

equipment as under current GAAP but also certain “inventory items” such as spare parts.	leases asset should be out of the scope of the leases project but that is not clear. Presumably those will be leases where there is an automatic transfer of title in the leased asset would be out of the scope. Those transactions will be accounted for as financed purchases of the underlying asset. Leases where the lease terms include a bargain purchase option are within the scope. Those transactions will be accounted for as financed purchases of the underlying asset. The Boards could have dealt with the issue of what leases are financings and what leases are not in the scope but they chose not to. Unfortunately when they made their decision on lease classification they did not consider a 2 lease solution based on the legal nature of the lease.
Definition of a lease (need to distinguish from service contract) - Regarding leases vs. installment purchases, the Boards decided to eliminate the scope exclusion therefore all lease contracts should be accounted for in accordance with the leases standard. Guidance will not be provided in the leases standard for distinguishing a lease of an underlying asset from a purchase or a sale of an underlying asset (that may come from the revenue recognition rules). If an arrangement does not contain a lease, it should be accounted for in accordance with other applicable standards (for example, property, plant, and equipment). The Boards agreed to tentatively confirm the 'specific asset' notion versus a notion of an asset of a certain specificity. Physically distinct portions of a larger asset can be specified assets and non-physically distinct portions are not specified assets. The description of “control”, as defined in the Leases ED, should be revised to be consistent with the revenue recognition project while including	The tension in the definition of the lease is due to the fact that all operating leases are to be capitalized while services (service contract/executory contracts) remain off-balance sheet executory contracts. Under current GAAP, full service leases that contain an operating lease element and a service element are accounted for in the same manner – that is as off balance sheet executory contracts. There needs to be a crisp definition to avoid capitalizing more contracts than intended (for instance there is no intention to capitalize any portion of an outsourcing contract where it is difficult to identify specific assets employed to deliver the service). The decisions will mean fewer contracts are considered leases vs. current GAAP, including EITF 01-08 (The revised guidance would result in certain contracts that are considered leases under current standards (e.g., certain take-or-pay contracts) to no longer be considered leases.). They did away with the EITF 01-08 grandfathering of contracts booked before May 2003 so some long term

guidance on separable assets. The Boards agreed that the right to control the use of a specified asset is conveyed if the customer has the ability to <u>both</u> direct the use of the asset and receive the benefit from its use. The Boards decided to require an assessment of whether, in contracts where the supplier directs the use of the asset used to perform customer services, the asset explicitly or implicitly identified in the contract is an inseparable part of the services. If the asset is inseparable, the customer would be deemed not to have the right to control the use of the asset and the arrangement would be accounted for as a service contract with no embedded lease of that asset. Under the newly-proposed guidance, any one of the following may indicate the customer has obtained the right to control the use of a specified asset: (a) The customer controls physical access to the specified asset; (b) The design of the asset is customer-specific and the customer has been involved in designing the specified asset; (c) The customer has the right to obtain substantially all of the economic benefits from use of the specified asset throughout the lease term. They did not conclude on but are in favor of concepts like not including in lease accounting assets that are incidental to the provision of a service or insignificant to the services provided.	contracts that were formally exempt from lease accounting may now be covered and capitalized.
Rates for lessee and lessor accounting - Lessees use their incremental borrowing rate, unless the implicit rate in the lease is known, to capitalize the lease and impute interest expense in the P&L. Lessors use the implicit rate in the lease to calculate the PV receivable and to accrue revenue. For the residual revenue accretion, the implicit rate is used. For leases with a gross profit element, the ending accreted residual amount is net of the deferred gain	The good news here is there are fewer instances where the lease term will be changed due to the high threshold for estimating the lease term. There also is dim hope (now we have to get this through comment letters) that they will view renewals and extensions as new leases thus eliminating the need to adjust the existing lease to in effect make it a longer lease with P&L implications of front ending the renewal costs into the base lease term.

associated with the residual portion. The lessee must use the new, current incremental borrowing rate to adjust for changes in estimates of the lease term. Other changes in estimated payments would not require a change in the discount rate.	
Lessee P&L pattern – The Boards decided that there are 2 types of leases: 1) those that get straight line rent expense, now called Type B leases (formerly SLE or Single Lease Expense leases), and 2) those that are considered a purchase of a right of use and a financing so that the combination of ROU asset amortization and imputed interest creates a front loaded cost pattern, now called Type A leases (formerly called I&A (Interest and Amortization) leases). The Boards decided that the classification tests to determine whether a lease gets straight line or front ended expense are different for real estate leases and equipment leases as follows: The dividing line is a newly created idea where real estate and equipment leases are treated drastically differently. • For equipment leases it is presumed that the lease is a front ended cost lease for lessees and an R&R lease for lessors unless the lease term is an insignificant portion of the **<u>original</u>** economic useful life of the underlying asset or the present value of the fixed lease payments is insignificant relative to the current fair value of the underlying asset. This new line is vastly different than under existing GAAP and for legal and tax purposes causing more equipment leases to have front ended costs and causing	The apparent reason the Boards reversed their view is so they could break the impasse over lessee accounting that was preventing the issuance of a converged ED and have reasonable assurance that the real estate lessees and lessors will accept the ED conclusions. The different classification treatment appears to be an arbitrary decision to get a desired answer that will not be seriously challenged in the comment letter process. Another reason may be to allow for acceptance of IFRS 40 investment property accounting (operating lease accounting) for real estate lessors combined with the idea that there should be symmetry in lease classification. In other words, to grant operating lease accounting to investment property lessors, they had to give lessees straight line cost recognition. The allowance of investment property accounting is an exception to the "rights of use" model/principle as one would expect a lessor to record a receivable in every lease where the lessee is recording a liability to make lease payments. The Boards could have avoided this exception to the basic principle in the ROU model by recognizing that users needs re: "financial" lessors are different from needs Re: "operating" lessors. For lessees the same classification principles should apply to equipment leases as real estate leases as they are both the same for legal (bankruptcy) purposes which is an important for distinction for credit analysts and potential lenders. The legal analysis

equipment lessees to still keep records under the existing rules for tax compliance purposes. • For real estate leases it is presumed the lease is a straight line method lease for lessees and operating leases for lessors unless the lease term is for the major part of the economic life of the underlying asset; or the present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset. This line is virtually the same as the line under existing GAAP. For leases with more than one type of asset the Boards decided to include guidance in the revised Exposure Draft on how to determine the nature of the underlying asset (for example, leases of property or leases of assets other than property) for classification purposes when one lease component contains the right to use more than one asset. The Boards decided that an entity should determine the nature of the underlying asset for classification purposes on the basis of the nature of the primary asset within the lease component.	determines whether a lease asset in tangible (as in a capital lease) and survives bankruptcy or intangible (as in an operating lease/executory contract) and is viewed by the bankruptcy law as undelivered services – not an asset of the lessee. The same is true for the lease liability – in a capital lease it is debt in bankruptcy while an operating lease liability disappears when the bankruptcy judge returns the leased asset to the lessor. They seem to forget that the unit of account is the contract – not the underlying asset -and that we are accounting for rights and obligations (a real estate lease that is legally the same in terms of rights and obligations will get significantly different accounting treatment). They are switching principles from the overall principle (accounting for rights and obligations) to a principle re consumption of the value of the underlying – pick a principle – just one principle! The Boards have not ***fully*** addressed details in lease classification such as the definition of insignificant. The proposed SLE straight line method for most real estate leases will be popular for real estate lessees and that will mean many fewer comment letters as the real estate lobby will be satisfied. Real estate operating leases represent 75-80% of the operating lease dollars so it was an important decision to insure fewer comment letters. Leases of long lived equipment where the lease term is short compared to the **origina**l useful life will be classified as SLE leases – good news to the full service rail and aircraft leasing segments. The proposed I&A front loaded P&L cost pattern will be an extremely unpopular

	decision with equipment lessees and many users of financials (analysts). It will have unintended consequences regarding contracts and regulations that allow cost reimbursement for rent as reported lease expense will exceed the cash paid for rent that will be reimbursed (This is an important P&L mismatching issue that they have not resolved.) Front ending lease costs will eat up capital and profits for banks and other lessees. It will create large deferred tax assets as the lease costs will be largely non-cash charges in the early years of every lease. For a growing company lease costs will never level off. Inflation alone will mean most companies will never see lease costs leveling off unless they cut back on leasing. Since the current FAS 13 classification tests are the based on the same risks and rewards concepts as in the UCC code, bankruptcy laws, personal property taxes and income taxes lessees will have to maintain records under existing GAAP for legal and tax compliance and to provide information to potential lenders. They are overly concerned with financial engineering of leases to avoid the front ending of lease costs. The Boards should have slowed down the project and taken the time to analyze capitalized executory contract issues and amend their Conceptual Framework. They should have focused on the fact that the unit of account is the contract and its fair value is the important balance sheet value – both the ROU asset and lease liability should have the same value over time except for impairment and initial direct costs (to keep the asset and liability value the same it means recognizing straight line rent expense for all leases that are not financings of the underlying asset). Additionally, due to the front loading of

	lease costs, *any time* a lease is terminated early the lessee will report a gain! This is not logical and points out the fact that lease costs are recognized too early.
Lease term - The lease term is tentatively defined as the contractual term plus renewals where the lessee has a "clear economic incentive" to exercise the options. This is essentially the current GAAP definition.	The final draft is very much the same as current GAAP where the renewal options have to be a bargain or create economic compulsion to exercise to be considered a minimum lease payment to be capitalized. They did not decide that a renewal or extension is a new lease to avoid complex adjustments, so now we need to push for this in comment letters.
Termination Option Penalties - The accounting for termination option penalties should be consistent with the accounting for options to extend or terminate a lease. If a lessee determines it will terminate a lease early and would be required to pay a penalty, the term is shortened and the termination penalty is considered a lease payment to be capitalized. If a lessee would be required to pay a penalty if it does not renew the lease and the renewal period has not been included in the lease term, then that penalty is considered a lease payment to be capitalized.	
Purchase options - They decided the exercise price of a purchase option should be included in the lessee's liability to make lease payments and the lessor's right to receive lease payments only when there is a "significant economic incentive" to exercise the purchase option. If so, the ROU asset should be amortized over the useful life of the asset. Other purchase options are not considered lease payments to be capitalized.	.These conclusions are consistent with their conclusions on the lease term and renewals so it is good news except for the concerns re: frequency and details of reassessment in practice.
Reassessment of Options in a Lease - The Boards discussed how lessees and lessors should reassess whether a lessee has a clear economic incentive to exercise: - An option to extend or terminate a lease, and -An option to purchase the underlying	The fact that most real estate leases get straight line expense will lessen the complexity of adjustments due to changes in variable payment assumptions and other assumptions. Equipment leases that use the front ended method will still be subject to complex adjustments when

asset. The Boards tentatively decided that a lessee and a lessor should consider whether it has a clear economic incentive to exercise an option. The Boards tentatively decided that the thresholds for evaluating a lessee's economic incentive to exercise options to extend or terminate a lease and options to purchase the underlying asset should be the same for both initial and subsequent evaluation, except that a lessee and lessor should not consider changes in market rates after lease commencement when evaluating whether a lessee has a significant economic incentive to exercise an option. The Boards decided that changes in lease payments that are due to a reassessment in the lease term should result in: - A lessee adjusting its obligation to make lease payments and its right-of-use asset; and -A lessor adjusting its right to receive lease payments and any residual asset, and recognizing any corresponding profit or loss (pending the Boards' decision on lessor accounting). **-**There will be no reassessment of a lease (I&A vs. SLE) if assumptions change – only if there is a new lease***.***	assumptions change. These conclusions are consistent with their conclusions on the lease term and renewals so it is good news except for the concerns re: frequency and details of reassessment in practice.
Variable payments - Variable lease payments will be included in the lease payments to be capitalized by the lessee and to be included in the lessor's lease receivable, but the specific variable payments will be limited vs. what was proposed in the ED. Details are as follows: - All variable lease payments that depend	The fact that most real estate leases get straight line expense will lessen the complexity of adjustments due to changes in variable payment assumptions. Equipment leases that use the front ended method will still be subject to complex adjustments when assumptions change.

on an index (e.g. CPI) or a rate (e.g. LIBOR based floating rate leases) must be estimated and booked using the spot rate. . When the index changes the lease has to be adjusted. The P&L is "hit" for the current and prior period impacts and the ROU asset and liability are adjusted for the future impacts. - Other variable lease payments based on usage (e.g. cost per mile) or lessee performance (e.g. rents based on sales) will not be capitalized unless they are deemed to be "disguised" minimum payments. - Disclosure will be required within the notes of contingent rent leasing arrangements (details to be determined later). For lessors, when the rate charged to the lessee reflects an expectation of future variable lease payments, as actual variable payments are received that are different than estimated, the residual must be adjusted. If the variable payments were not expected, they are accounted for as revenue when received/earned.	This still means complexity for floating rate equipment leases, like fleet leases, but it is a logical decision. The changes re: variable rents based on usage and lessee performance are good news for both the equipment and real estate leasing industries as it will lessen the complexity and amounts capitalized. Guidance on determining when variable rents are disguised lease payments are to be decided and may very well be left to the preparer and auditor to determine on a facts and circumstances basis. The object is to capture transactions structured to lessen capitalization by having below market contractual rents but with variable rents that are virtually certain to occur and will "make up for" under market contractual rents.
Residual Guarantees **-** for lessors residual guarantees structured like a TRAC lease provision (where any difference between a specified amount and the market value of an underlying asset at the end of the lease term is paid to, or received from, the counterparty (who would typically be the lessee in these circumstances)), are considered a minimum lease payment for the lessor. A stand-alone residual guarantee or residual insurance is not considered a minimum lease payment. - lessees should only record the likely payment under a residual guarantee – not	It is good news that TRAC-like residual guarantees are minimum lease payments for the lessor. The decision that a stand-alone residual guarantee or residual insurance is not a minimum lease payment is not good news as it may limit sales type lease profits recognized up front. It also means <ins>**only some**</ins> guaranteed/insured residuals are a financial asset that can be securitized off balance sheet. In our opinion the charges regarding

the full amount of the residual guarantee but rather the amount it is “in the money”. - for lessees, residual guarantees should be reassessed when events or circumstances indicate that there has been a significant change in the amounts expected to be payable under residual value guarantees. An entity would be required to consider all relevant factors to determine whether events or circumstances indicate that there has been a significant change; - for lessees, changes in estimates of residual value guarantees should be recognized (a) in net income to the extent that those changes relate to current or prior periods and (b) as an adjustment to the right-of-use asset to the extent those changes relate to future periods. The offsetting entry is an increase or decrease in the capitalized lease obligation. The allocation for changes in estimates of residual value guarantees should reflect the pattern in which the economic benefits of the right-of-use asset will be consumed or were consumed. If that pattern cannot be reliably determined, an entity should allocate changes in estimates of residual value guarantees to future periods. For lessors a <u>stand-alone</u> residual guarantee or residual insurance will not be recorded until the residual is resolved nor will it convert the residual asset to a financial asset. It will not affect gross profit recognition.	changes in the estimate of the amount payable under a residual guarantee should be allocated to future periods, meaning offsetting entry to the change in the lease liability is an increase or decrease in the ROU asset and the new balance in the ROU asset is straight lined over the remaining lease term. In our opinion <u>**all**</u> types of guaranteed residual should be considered a lease payment, labeled a financial asset and it should increase gross profit recognition.
Short term leases/renewals - The Boards will allow short term leases by asset class election to use the current operating lease method. This applies to lessors and lessees. A short term lease is defined as, a lease that at the date of commencement of the lease has a maximum possible lease term,	The decision to allow operating ease accounting for short term renewals where the lessor and lessee have the right to terminate with no significant penalty is good news. It means simple off balance sheet accounting for lessees in month to month lease renewals.

including any options to renew or extend, of 12 months or less. This means that typical fleet/spilt TRAC/synthetic leases that have 12 month terms and month to month termination/renewal options will not be considered short term leases. Lessees are required to disclose rental expense incurred under short-term leases during the reporting period and whether there are circumstances or expectations that would indicate that the entity's short-term lease practices would result in a material change in the next reporting period. Month-to-month renewals where both the lessee and lessor have the right to terminate with no significant penalty are considered short term leases eligible for the operating lease accounting election.	
Subleases **-** A head lease and a sublease should be accounted for as separate transactions. The lessee accounts for the head lease by capitalizing the ROU asset and liability and following either the front ended I&A or straight line SLE method. The lessor accounting for the sublease must follow decisions on lessor accounting. - If a SLE head lease is impaired it changes to an I&A lease.	The decision to allow most real estate leases to use the straight line method for lessees and the operating lease method for lessors should be good news for real estate sublessors. It should mean the P&L will show rent expense and rent income with the same pattern. The exception is if the head lease is impaired as it switches to the I&A method while the sublease will likely be an operating lease with straight line revenue thus creating a P&L mismatch. Equipment lease subleases that do not qualify for straight line accounting will remain complex. Subleasing of equipment leases is not common so it should not be a big issue, but applying the R&R method to a sublease will be difficult.
Sale leasebacks - If the transaction is considered a sale under the Revenue Recognition Project (means that control of the asset has been transferred – there is a question of control transfer when a purchase option at less than the sales price is included in the lease) account for	The questions of the interplay between the leasing rules and the Revenue Recognition Project are unresolved. The presence of a purchase option at less than the sales price will mean that the sale leaseback is considered a financing

the transaction as a sale leaseback, otherwise consider it a financing/loan. When the sales price and leaseback rents are at fair value, gains or losses arising from the transaction are recognized immediately. When sales price and rents are not at fair value, the assets, liabilities, gains and losses should be adjusted to reflect the current market. In transition any deferred gains in existing sale leasebacks will be credited to equity.	meaning the asset stays on the books, there is no gain booked and the sales proceeds are recorded as a loan. The transition rules are bad news for the banks that did sale leasebacks to raise capital. The asset will come back on books and the deferred gain will not flow thru earnings but rather be a credit to opening retained earnings.
Contract Modifications or Changes in Circumstances after the Date of Inception of the Lease -A modification to the contractual terms of a contract that is a substantive change to the existing contract should result in the modified contract being accounted for as a new contract. As a result, the existing lease would be closed out and a gain would result in any lease with a front ended pattern of accounting for the lease costs (there will be no gain for lease under the straight line method***).*** A new lease would then be recorded and classified as either an I&A or SLE lease. -A change in circumstances other than a modification to the contractual terms of the contract that would affect the assessment of whether a contract is, or contains, a lease should result in a reassessment as to whether the contract is, or contains, a lease.	
Lease inception vs. commencement - Lessees and lessors initially measure (calculate the amount capitalized) and recognize (book) the lease assets and liabilities at the date of lease commencement. Lessees use the incremental borrowing rate at the lease commencement date to calculate the amount capitalized.	They have not concluded that a renewal is a new lease so if a renewal is executed before the end of a lease term or is a lessee determines that there is a significant economic incentive to renew, the renewal is booked before commencement – this is not logical as a new lease is not booked until commencement. In those I&A leases with lease costs are front loaded it means the lease costs from the renewal period will

	begin to be recognized during the remaining term of the original lease. As a result it would be in the lessee's best interest to terminate a lease and sign a new lease. In termination the lessee would record a gain on the old lease. This would somewhat offset the front ending of costs in the new lease.
Pre-commencement payment/interim rents - Interim rents are recognized as a rent prepayment and at the date the commencement the prepayments will be included in the cash flow discounting to determine the value of the right-of-use asset and capitalized lease obligation.	Interim rents are now officially part of the capitalized lease amount for lessees and as a result, lessees will be more aware of the cost of the lease. For lessors, although it is yet to be clarified, as it reads, for leases with interim fundings the earnings on the interim rents will be deferred and amortized over the lease term beginning at the commencement date of the lease.
Lease incentives - Cash payments received from the lessor are included as a cash inflow in the cash flow discounting to determine the value of the right-of-use asset and capitalized lease obligation.	
Bundled lease payments - Payments must be bifurcated by lessees and lessors. Lessees bifurcate using observable stand alone prices if know for all elements, consistent with the revenue recognition project; if only one element is observable assume the cost of the other is the residual cost. Where no observable market prices available, lessees capitalize the whole payment as a lease.	Unless they are more lenient in allowing estimates when market rates are not available to the lessee, this will mean that lessors will be forced to disclose the breakdown of elements in a full service lease as lessees will not accept capitalizing the full bundled payments.
Initial direct costs - These are costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made. Lessees should capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset and as a result the initial direct costs will be amortized straight line over the lease term. Lessors will include the initial direct costs as a reduction in the amount of the right to	

receive lease payments placed at time zero. The effect is to reduce the implicit rate and as a result the lease revenue recognized over the lease term will be reduced.	
Foreign Exchange Differences - The Boards discussed the accounting by lessees for leases denominated in a foreign currency. The Boards tentatively decided that foreign exchange differences related to the liability to make lease payments should be recognized in profit or loss, consistently with foreign exchange guidance in existing IFRSs and U.S. GAAP.	
Impairment **-** The Boards decided to affirm the proposal in the Leases Exposure Draft to refer to existing guidance in IFRSs and U.S. GAAP for impairment of the right-of-use. -If a SLE lease is impaired the expense accounting will no longer be straight line – instead the imputed interest will be recognized and the amortization of the lower ROU asset will be straight lined basically converting the lease to an I&A lease.	
Lessee presentation and disclosures On the balance sheet the lessee must present the I&A and SLE ROU assets with PP&E based on the nature of the underlying asset either separately or by providing a breakdown in the notes. The I&A and SLE ROU lease liability may be presented separately on the balance sheet or disclosed separately in the notes. For I&A leases on the income statement the lessee will present amortization of the ROU asset separately from the implied interest on the lease liability. Interest on	The decision to have 2 types of leases with different classification tests for real estate and equipment means the numbers in the disclosures are a conglomeration of capital leases (real assets and debt) and capitalized operating leases (not an asset or debt in bankruptcy) resulting less information and clarity than provided by current GAAP – this is a critical issue for credit analysts and potential lenders.. For I&A front end cost leases that are executory contracts (the former operating leases) the presentation in the income

the lease liability must be reported separately from other interest expense. SLE leases will report average rent accrued as an operating expense. On the statement of cash flows the implied I&A lease “principal” payment is considered a financing activity and the implied I&A interest, variable rent costs and operating (short term lease) and SLE lease rents are considered cash outflows from operating activities. *Disclosures include:* -Describe the nature of, and restrictions imposed by, lease arrangements. – Provide information about judgments and assumptions relating to amortization methods, renewal options, contingent rentals, termination penalties, residual value guarantees, and discount rate and changes to those judgments and assumptions’ - Sale and leaseback terms and conditions, gains and losses. - A separate reconciliation (roll forward) between the opening and closing balances for I&A and SLE lease right-of-use liabilities to make estimated future lease payments. - A combined maturity analysis of the gross undiscounted liability to make estimated future lease payments under I&A and SLE leases on annual basis for the first five years, and a lump sum for the remainder, showing contractual maturities, reconciled to the liability recognized. -Lessees applying U.S. GAAP would be required to include in their maturity analysis cash flows related to services embedded in lease contracts that are accounted for separately from the leases.	statement and cash flows statement will not reflect the economic effects of leases. The current GAAP straight line rent expense and rent reported as an operating cash outflow provide more useful information. These issues are a consequence of the decision to create the front loaded cost pattern. The lessee disclosures are more extensive than current GAAP. The proposed disclosures do not give users enough information to reconcile the proposed P&L and cash flow presentation to what would have occurred under current GAAP. Under regulatory and contract reimbursement is unresolved

- A tabular disclosure of all expenses related to leases not included in the lease liability and right-of-use asset, and short-term lease expense. -A qualitative disclosure about circumstances or expectations that the entity's short-term lease practices would result in a material change in the next reporting period.	
Lessor accounting model –The Boards decided there must be symmetry with lessee accounting so the same lessee lease classification tests for real estate and equipment leases will apply for lessors. The Boards decided that there will be 2 lessor accounting methods: the "receivable residual" ("R&R") method and the existing operating lease method. There are is an exception for short term leases as they can be accounted for under the current GAAP operating lease method if so elected. The assets under the R&R method are the PV of the rents using the lease's implicit rate and the residual. The residual is the difference between the PV receivable and the leased asset book value. The residual is accreted to its estimated value at lease expiry using the implicit rate in the lease. Under the R&R method sales type profit is allowed but limited to the ratio of the PV of the rents to the fair value of the asset. The balance of the profit related to the residual portion is deferred. . Leveraged lease accounting will not be	This decision means that most equipment leases will be R&R leases which is good news for financial lessors. **<u>Although if we win the argument that equipment leases and real estate leases should be treated the same it would mean more equipment leases will be operating leases</u>** (we think the lessor lease classification should be based on business model – financial lessors use the R&R method while operating lessors use the operating method). The R&R method is very similar to the current direct finance lease method. Allowing partial sales type profit on all leases is good for the former operating leases but worse for the former direct finance leases. The decision to accrete the residual is important good news. The failure to label a guaranteed residual as a financial asset is an issue for lease classification, transfers of financial assets and gross profit recognition. Manufacturers and dealers <u>may</u> use more third party lessors to provide leases to customers so they can maintain the same level of profitability as under current sales type accounting rules. This may mean the costs to lessees will increase and 3rd parties may not approve all the credits that a captive would thereby tightening

included in the new rule. They will not allow grand fathering of existing deals. They will not allow a tax affected revenue recognition method or inclusion of tax credits as a lease revenue item.	availability of credit The news on leveraged lease accounting is bad for the industry and the cost to lessees. The cost of capital will rise for leveraged lease portfolios which is particularly bad for bank lessors. The cost of leases will rise for all the lessees of large ticket assets that would have been candidates for leveraged leases as alternative structures are not as cost effective. The loss of reporting tax credits in lease revenue is important for alternate energy leases as they have significant tax credits such that the pretax earnings are negligible. This will cause banks to avoid those leases as the reporting of tax credits as a reduction of tax expense hurts efficiency ratios which equity analysts consider an important measure of bank profitability.
Lessor presentation and disclosure: The lease receivable and the residual asset are presented separately in the statement of financial position, summing to a total "lease assets"; or combined as "lease assets but with the breakdown disclosed in the notes. The finance income on the rents and the residual accretion are presented as interest income net of initial direct cost amortization. Sales-type profits may be reported gross or net of cost of sales. Disclosures required are: - lease income generated from the	The lessor disclosures are extensive. For large organizations it will be difficult to comply and still provide meaningful information without a voluminous footnote. The likely result will be very general "boiler plate" statements

entity's leasing activities (in tabular form) disaggregated by (a) profit recognized at lease commencement, (b) interest income on the lease receivable, (c) accretion of the residual asset, (d) variable lease income for amounts not initially recorded in the lease receivable and (e) short-term lease income.
- fixed-price purchase options which exist on underlying leases.
- information about variable lease payments and lease term (i.e., disclosing the basis and terms on which contingent rentals are determined and the existence and terms of options, including renewal and termination options).
- a reconciliation between the beginning and ending balances of the lease receivable and residual asset.
- a maturity analysis of undiscounted cash flows that are included in the lease receivable, with reconciliation to the amounts reported in the statement of financial position for the lease receivable. Time bands for the maturity analysis should, at a minimum, include each of the first five years following the reporting date and the total of the amounts for the remaining years.
- how it manages its exposure to the underlying asset, including:
    o its risk management strategy;
    o the carrying amount of the residual asset that is covered by residual value guarantees and the unguaranteed portion of the carrying amount of the residual asset; and
    o whether the lessor has any other means of reducing its exposure to residual asset risk (e.g., buyback agreements with the manufacturer from whom the lessor purchased the underlying	

asset or options to put the underlying asset to the manufacturer). However, disclosure would not be required for: o initial direct costs incurred in the reporting period and included in the lease receivable. o the fair value of the lease receivable or the residual asset. o the range or the weighted average of discount rates used to calculate the lease receivable	
Business Combinations: Lessees: Record the lease liability and ROU as though the lease was a new lease but use the incremental borrowing rate on the acquisition date. Adjust the ROU asset if the lease rents are off market. For short term leases no entry is necessary. Lessors: For leases where the R&R method is applicable record the PV of the rents using the implicit rate on the acquisition date. The residual is the difference between the PV receivable and the fair value of the leased asset on the acquisition date. For short term leases no entry is necessary. For lessors that do not follow the R&R method use existing business combination guidance. For securitized operating leases that were recorded as secured borrowings lessors cannot retrospectively record the securitization as a sale.	Lessees will immediately report front ended lease costs as the acquired leases are considered new leases. The requirement to adjust for off market terms will be difficult to apply for equipment leases as there is no market for used equipment to get observable lease rates. For lessors the proposed rule makes sense as that is how a lessor will price an acquired lease. For securitizations of operating leases retrospectively recording the transactions as sales, if they qualify, would give the user more useful information as the alternative is to report assets that do not meet the definition of an asset.

Conclusion – It is hard to believe that the Boards allowed the issuance of the new ED with so many problems in it that the analysts on the Board will dissent and the FASB's analyst advisory group (ITAC) have expressed clearly that the decisions will give them less of the critical information on leases that they get from current GAAP. The Boards made decisions that recognize there are 2 types of leases but the decisions on the new lease classification line are not founded in a single principle but are rather arbitrary rules to create their apparent desired outcome for equipment leases and real estate leases, that is, to consider them financings and to front load lease costs. In the summary of the project decisions the FASB staff called the classification decision a "practical expedient" and if you parse those words the staff is saying - let's classify leases in a manner without theory or ideals that is contrived and is a means to the end that we desire. The result is lack of clarity as to the financial results from leases that transfer ownership rights versus leases that merely transfer a temporary right of use. This is clearly information that users need as evidenced by the disastrous reaction by the ITAC committee. We as an industry have been telling the Boards this since the project began. We did get many of the changes we pointed out that make the proposed rule more reasonable but there remain several important advocacy issues:

- Most important is that the Boards treat equipment leases and real estate leases the same in terms of lease classification to allow straight line expense recognition for the leases that are now considered operating leases. Regarding lease classification, they need to define "insignificant".
- It is also important that lessors' business models be the basis for lessor lease classification so that financial lessors use the R&R method while operating lessors continue to use the operating lease method.
- We would like the lessee lease liability in capitalized operating leases to be classified as an "other" liability – not as debt so as to avoid debt covenant issues and to give credit analysts and potential lenders critical information on what would happen in a bankruptcy. Likewise the asset in a capitalized operating lease should be classified as an intangible asset as it is not an asset of the lessee in bankruptcy.
- We need clearer definitions of factors that determine the lease term and reassessment criteria.
- In a sale leaseback with a non bargain purchase option, the definition of a sale in the leases project conflicts the definitions in the revenues recognition project. This is important to clear up by allowing non-bargain purchase options in a transaction considered a sale as many equipment leases are sale leasebacks. It is our position that an "out of the money" purchase option should not negate sale treatment.

- Lessees and lessors need relief from the complexity and compliance burden in areas like transition, adjustment of estimates in the lease term, accounting for variable rents and disclosure.
- We need to get some relief in accounting for leveraged leases – at the very least to grandfather existing leases. It would be a more faithful representation of the true assets and liabilities of a lessor if the rent and the non-recourse debt continue to be reported net as it best reflects the true economic risks for the lessor. The after tax yield argument is valid as well for leases with tax benefits but the Boards are reluctant to open up revenue recognition and accounting for income tax rules to deal with taxes.
- Regarding residual guarantees, we need the Boards to recognize that all types of residual insurance or residual guarantees change the nature of the residual to a financial asset. This is important in lease classification, gross profit recognition and transfers of financial assets.
- Tax benefits should be addressed in the revenue recognized for lessors by treating tax credits as revenue and using an after-tax earnings rate like the MISF yield for all leases with tax benefits.

To get these last points addressed we need comment letters that present the issues, why they need to be addressed and present suggested outcomes with sound accounting and business arguments.