



Mr. Russell Golden
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Financial Accounting Standards Board
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Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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June 25, 2014

Re: Leases Project Redeliberations

Dear Mr. Golden and Mr. Hoogervorst:

We at the Equipment Leasing and Finance Association (ELFA) have been following the Boards' redeliberation of matters related to the *Leases* project. We have noted certain public comments with respect to the allocation of cost related to lease contracts, specifically the comment asserting that the impact of the front loaded expense of Type A accounting is less dramatic than has been reported by supporters of Type B accounting. We are writing to you to provide our observations and insights on this matter.

The ELFA is the trade association representing approximately 600 financial services companies and manufacturers in the \$827 billion U.S. equipment finance sector. ELFA members are the driving force behind the growth in the commercial equipment leasing and finance market and contribute to capital formation in the U.S. Overall, business investment in equipment and software accounts for 8.0 percent of the GDP; the commercial equipment finance sector contributes about 4.5 percent to the GDP. For more information, please visit <http://www.elfaonline.org>.

Background

As the project has progressed, the FASB and IASB have arrived at divergent positions regarding lessee accounting. The FASB has tentatively concluded there are differing types of leases, drawing on IAS 17 to distinguish between leases that represent purchases of the underlying asset (a secured financing) and leases that involve the temporary use of an asset. The IASB, on the other hand, has tentatively concluded that all leases should be characterized as financing transactions, similar in nature to installment sales contracts. In this approach, leases would be accounted for “as if” leases constituted the purchase of an asset (in whole or in part) and the separate incurrence of debt. This approach essentially reverts back to the lease model proposed in the first exposure draft, which was not supported by many constituents.

We believe a final standard needs to reflect the economic and commercial substance of lease transactions and should not simply equate leases to another class of transactions and effectively produce a *pro forma* adjustment to financial statements. As further explained below, we believe the FASB’s approach to leases and cost allocation represents the best path forward. It reasonably draws a distinction between leases that convey ownership rights and leases that convey the temporary right of use, while achieving the goal of recognizing lease assets and obligations in the balance sheet. We believe the distinction is substance-based and provides a solid foundation for an accounting model consistent with the broad consensus of constituent feedback. We believe the positive impacts of basing the leases standard on this bedrock principle outweighs the benefits that would be achieved by a single converged standard that was not based upon this principle.

Income Statement Effects

We have read the *Compliance Week*, article of April 18, 2014, which reported that an analysis prepared by a lease consultant on the income statement effects of Type A vs. Type B accounting was provided to the Boards. In the article, the consultant concluded that front-end loading of lease costs under the Type A model is not as significant as some commentators have indicated, especially with respect to property leases.

The analysis has not been placed in the public domain, and, consequently, it is not possible to provide a detailed review of it. As is the case with all financial modeling exercises, it is possible to achieve a minor variance in results by using a static or steady state set of assumptions. A mature portfolio of leases that is homogenous and is not increasing in either volume or in value will generally exhibit a level expense pattern regardless of the accounting method used once the portfolio normalizes. This convergence in measurement occurs around the half-life of the portfolio. Based upon our industry’s experience with lease portfolios, however, we do not believe a static or steady state analysis is indicative of the impacts many entities would report if they were using Type A accounting for all of their leases.

There are many reasons why this steady state is not likely to occur. First, old leases are not replaced by new leases in a ratable pattern. Lease expirations are likely to occur at differing

points in time.¹ Equipment assets are often delivered in batches and growth in real estate portfolios will also be uneven. Second, asset values change over time. If asset values increase, rent will increase, which will in turn impact the asset and liability that might exist at a renewal date. Third, public companies grow over time. While the correlation of lease volumes and business growth is probably not one-to-one, a company will add leases merely to accommodate growth. Further, an income statement-only analysis is analogous to only applying the rollover approach to assessing materiality and drawing conclusions without the benefit of the iron curtain method. Accordingly, we believe the lessons learned from an analysis such as that referred to above would be incomplete and fundamentally flawed if it did not also fully consider the balance sheet effects.

Balance Sheet Effects

Even if Type A lease costs are relatively stable in a steady state environment, the timing of lease cost recognition will have an impact on the balance sheet beyond the recognition of an asset and a liability. After transition, companies with Type A leases will have what is effectively a permanent loss of equity and a permanent deferred tax asset merely because of the Type A lease cost allocation methodology.

As is discussed below, based upon the modeling work we have performed on seven public companies, we believe the reduction in equity will be significant. It is worth noting that equity has not been eroded in economic terms; it has only been reduced as a consequence of a change in the method of allocating the cost of lease contracts. This decrease in equity and increase in deferred taxes is difficult to explain other than by reverting to accounting conventions. We question the decision usefulness of reporting these dilutive effects for leases that convey temporary use (executory contracts) when major users of financial statements have advised the Boards they will need to recast the accounting in a manner that will eliminate these effects for financial analysis purposes.

For banks and other regulated entities with leveraged balance sheets, equity capital is costly and its adequacy for regulatory purposes depends on the quality of the assets it holds. Since deferred tax assets reduce the regulatory capital of banks, Type A accounting will place significant stress on bank capital and could on its own prompt banks to raise additional equity capital. We believe this stress has no basis in economics, as it merely results from a change in how contract costs are allocated, and lease capitalization should not impact capital unless the lease is impaired. Banks worldwide have capital issues as Basel rules have increased required capital levels in response to the financial crisis of 2008. Type A accounting for the former operating leases will add to the capital issues of banks worldwide.

To illustrate the significance of the equity reduction and also to review the impacts of Type A accounting for all leases on the income statement, we have developed an Excel model that

¹ For example, the most significant portion of rent expense in the airline industry often relates to terminal and ground facilities, which neither renew ratably nor correlate with aircraft lease volume. Further, aircraft volume depends on dynamic factors such as changes in technology and competition. Leasing's share of such volume also varies based on available tax benefits and an airline's own vs. lease strategy.

uses the future operating lease commitments disclosed in the notes to financial statements to estimate the amount of permanently lost equity and the amount of the deferred tax asset that results from capitalizing all leases and accounting for them under the Type A model, assuming no inflation or growth. The model may also be adjusted to consider assumptions related to inflation and growth. Adding inflation and growth assumptions result in a correlated growth in the permanent amounts. The dilutive effects only disappear when an entity ceases to lease entirely. This is not a real world case.

Included in the Appendix are the results of this modelling exercise for eight public companies. We have also included the results for one generic example. The analysis estimates the amount of lost equity and deferred tax asset amounts resulting from capitalizing lease obligations and accounting for them using the Type A model. The analysis also includes a comparison to projected results assuming reasonable estimates of price inflation and growth in the replacement leases. The generic case indicates that, assuming price inflation and growth, the loss of equity will grow -- as will deferred taxes -- by approximately 50% compared with a steady state "normalized" portfolio at the half-life point (15 years in the test case). In the case of one of the retailers, we performed a retrospective comparative analysis. We used 2003 reported results and projected the permanent loss of equity assuming a steady state normalized portfolio analysis. We compared the results to the actual reported results from 2013. The actual loss of equity was 13% greater than a "normalized" portfolio would predict. We, therefore, believe the impact of accounting for leases using the Type A is likely to be significant for a number of companies.

Conclusion

We believe the goal of capitalizing leases on the lessee's balance sheet needs to be met in a way that does not diminish the relevancy and usefulness of the financial statements. The view of lease accounting embodied in the FASB's approach to lessee cost allocation is the best way to achieve the project's goals in a cost effective manner.

We certainly appreciate the opportunity to provide our views on this matter. As always, we are pleased to provide additional information on this or other matters in connection with the Boards' redeliberation of the *Leases* project.

Sincerely,



William G. Sutton, CAE
President and CEO

Appendix

Impacts of Type A Accounting on Companies

| Type A vs. Type B Summary | | | | | | | | | | |
|---|--|---------------------|-------------------------|------------------------------|---------------------|------------------------------|-------------------------------------|-------------------------|------------|-----|
| (in \$ millions) | | | | | | | | | | |
| Per year Inflation assumption 0.50% | | | | | | | | | | |
| Per year Growth assumption 2.00% | | | | | | | | | | |
| Composite income tax rate 40% | | | | | | | | | | |
| New leases replace runoff | | | | | | | | | | |
| Without and with inflation and growth assumptions | | | | | | | | | | |
| | No Inflation or Growth Assumed | | | Inflation and Growth Assumed | | | Increases due to Inflation & Growth | | | |
| | Perm Lost Equity | % of current Equity | Perm deferred tax asset | Perm Lost Equity | % of current Equity | Permanent deferred tax asset | Perm Lost Equity | Perm deferred tax asset | % Increase | |
| Case | | | | | | | | | | |
| 1 | Generic case: 15 yr term \$100 MM rent leases per year | (679) | N/A | (452) (100) | (1019) | N/A | (679) | (340) | (227) | 50% |
| 2 | Retailer 1 | (1509) | -8% | (6) | (1982) | -10% | (1321) | (473) | (315) | 31% |
| 3 | Retailer 2 | (584) | -11% | (389) (102) | (769) | -14% | (513) | (186) | (124) | 32% |
| 4 | Retailer 3 | (1544) | -1% | (9) | (2029) | -1% | (1353) | (485) | (323) | 31% |
| 5 | Bank 1 | (528) | -4% | (352) | (694) | -5% | (463) | (166) | (111) | 31% |
| 6 | Bank 2 | (413) | -1% | (276) | (565) | -1% | (376) | (151) | (101) | 37% |
| 7 | Bank 3 | (528) | 0% | (352) | (694) | 0% | (463) | (166) | (111) | 31% |
| 8 | Airline 1 | (1156) | -10% | (771) | (1515) | -13% | (1010) | (359) | (239) | 31% |

Notes:

- For Bank 1, leases principally relate to real estate and IT equipment.
For Bank 2, leases principally relate to real estate.
- For Airline 1, approximately 80% of its rental expense is related to property leases (terminals, etc).

Detailed Analysis of One Retailer

This analysis was prepared using one Retailer's operating lease disclosures from 2003 to 2013 -- with no replacement leases assumed to --show annual impacts:

| Retail Company | YEARS | | | | | | |
|----------------------|------------|------------|-----------|-----------|-----------|-------------|-------------|
| | 1 | 2 | 3 | 4 | 5 | Thereafter | Total |
| Future op lease pmts | | | | | | | |
| 2013 | \$187,000 | \$185,000 | \$174,000 | \$168,000 | \$162,000 | \$3,227,000 | \$4,103,000 |
| 2003 | \$245,000 | \$216,000 | \$157,000 | \$146,000 | \$143,000 | \$2,950,000 | \$3,857,000 |
| Increase/(decrease) | (\$58,000) | (\$31,000) | \$17,000 | \$22,000 | \$19,000 | \$277,000 | \$246,000 |

| Years | cumulative lost capital | | |
|-------|-------------------------|-------------|----------|
| | 2003 | 2013 | increase |
| 1 | (\$50,415) | (\$55,237) | \$4,822 |
| 2 | (\$94,615) | (\$107,024) | \$12,409 |
| 3 | (\$137,828) | (\$156,177) | \$18,349 |
| 4 | (\$179,432) | (\$202,902) | \$23,470 |
| 5 | (\$219,072) | (\$247,565) | \$28,493 |
| 6 | (\$258,850) | (\$290,107) | \$31,257 |
| 7 | (\$296,254) | (\$329,731) | \$33,477 |
| 8 | (\$331,116) | (\$366,231) | \$35,115 |
| 9 | (\$363,260) | (\$399,391) | \$36,131 |
| 10 | (\$392,494) | (\$428,974) | \$36,480 |
| 11 | (\$418,615) | (\$454,732) | \$36,117 |
| 12 | (\$441,405) | (\$476,396) | \$34,990 |
| 13 | (\$460,631) | (\$493,679) | \$33,048 |
| 14 | (\$476,044) | (\$506,276) | \$30,232 |
| 15 | (\$487,376) | (\$513,858) | \$26,482 |