November 21, 2000

Mr. Timothy S. Lucas
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Dear Tim:

With the subject of the G4+1 Special Report, *LEASES: Implementation of a New Approach* ("the Special Report") on the agenda of the upcoming AAA/FASB Financial Reporting Conference, I thought it was time to share in writing with you and the Board my thoughts concerning the subject of accounting for leases in general and the G4+1 proposal in particular. As you know, I have spent a significant portion of the last 30 years auditing the financial statements of leasing companies and almost as much time advising lessees concerning the application of existing lease accounting literature to their lease arrangements. During that time I have read literally thousands of agreements that convey the right to use every conceivable type of equipment and real estate for periods ranging from one day at a time to 75 years and more. Over the years, I have witnessed the rise of new lease products designed to take advantage of changes in foreign and domestic tax law, in ICC and other federal agency rules and regulations, in the rate of change in computer and telecommunications technology, in the preferences of the financial markets for various types and tenors of financing arrangements and in the lease accounting standards, themselves. I have participated actively in determining how the existing standards should be applied to these new products and changed circumstances, sometimes formally through my participation on the Working Group advising the EITF on these issues and more frequently, in consultation with representatives of the lessor community and my counterparts in the other Big 5 firms.

Several years ago, in connection with a research study conducted by Barents Group, the policy and economics consulting arm of KPMG, I had the opportunity to question representatives of AIMR, the association of financial statement users whose criticisms of the existing lease accounting standards were quoted so prominently in the Special Report, *Accounting for Leases: A New Approach* ("the McGregor Report") issued by the G4+1 in 1996. Our discussion covered not only AIMR's criticisms of the existing literature, but also their information needs and the machinations they currently must go through to convert the leasing information provided in financial statements and footnotes into information they can use to perform meaningful financial

statement analysis. In addition, since the issuance of the McGregor Report, I also have spent considerable time with a variety of the Board's constituents discussing and analyzing the proposals that now find their full expression in this Special Report. However, with no active project currently on the Board's agenda, I have not sought to develop a position on these subjects within my own firm. Therefore, what follows is solely my own observations and opinions on this important and persistent topic. I look forward to having the opportunity to discuss these ideas with you and members of the Board at the upcoming AAA/FASB conference.

In a very real sense, a workable method of reporting leases in the financial statements of lessees has been the Holy Grail of accounting standards-setters in this country for at least the last forty years. Neither the Accounting Research Committee of the AICPA nor the Accounting Principles Board was able to build a consensus for doing anything substantive with this issue. Although the newly-formed FASB took up the subject of accounting for leases as one of its first priorities and devoted nearly half of its resources to the subject during the first seven or eight years of its existence, and notwithstanding the fact that the resulting SFAS 13 clearly represented progress when compared to all previous attempts, after nine FASB amendments, six FASB Interpretations, 12 FASB Technical Bulletins and EITF consensuses too numerous to count, there is virtually universal agreement (except perhaps for a few diehards within the lessor community itself) that SFAS 13 has failed to achieve its stated objectives (i.e. that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurral of an obligation by the lessee and as a sale or financing by the lessor) and needs to be reconsidered. Unfortunately, despite the enthusiasm of the G4+1 and many of its supporters for what they believe would be a simpler and more straightforward approach, for the reasons I will develop below, I believe the adoption of new standards based upon the financial components model proposed in the Special Report, would represent a step backwards from existing practice, even with all of its shortcomings.

In this letter, I will attempt to articulate my view concerning the practical considerations and the technical accounting arguments surrounding the development of a new lease accounting standard. However, as background to those discussions, I think it would be worthwhile at the outset to reflect on the reasons why lessors and leasing transactions exist.

The Economic Role of Leasing and Implications for Accounting Standards

I believe the principal *economic* reasons why leasing companies exist in a market economy include (1) to intermediate the risks associated with owning property; (2) to finance the

acquisition of property; (3) to intermediate credit risk between sub-prime credits and traditional lending institutions; (4) to intermediate the transfer of income tax benefits associated with owning property from low marginal-rate taxpayers into the tax returns of taxpayers with higher marginal income tax rates; and to enable users of property (5) to outsource significant activities related to the maintenance and administration of that property to specialists; and (6) to conserve working capital as compared with more conventional financing arrangements. The risks associated with owning property in a market economy include not only risks associated with fluctuating used equipment prices reflecting changes in technology or supply and demand (including the risks associated with purchasing a long-lived asset to satisfy a relatively short-term need), but also risks associated with having to own more property than one needs (e.g. having to own an entire high-rise office building in order to have a downtown address when an enterprise needs only one floor) and risks associated with having revenue-generating equipment that is required to meet peak demand for a company's products or services sit idle when such demand slackens.

In addition to the *economic* reasons for leasing, the volume of leases employed in our economy primarily to take advantage of perceived financial reporting benefits associated with the use of off-balance-sheet accounting has increased significantly each year since the adoption of Statement 13 as lessors engineer and promote new structures to meet the demand of their customers for such products. For example, although the so-called *synthetic lease* structure has existed among users of vehicle fleets at least since 1977 (when the Board issued FASB Interpretation No. 19), the successful adaptation of this structure to the off-balance-sheet financing of large, newly-constructed real estate facilities is a relatively recent phenomenon that has spawned geometric growth in the volume of these transactions over the last ten years.

In my opinion, any new lease accounting standard that does not reduce the volume of lease contracts transacted solely or primarily to take advantage of the perceived benefits of off-balance-sheet accounting will not be worth the time and effort required to develop and maintain it. Yet measured against this criterion alone, I believe a new standard based upon the financial components approach proposed in the Special Report would be found wanting. If the proposals in the Special Report are adopted in their conceptually pure form, as described in the document, the leasing landscape will change; but the financial components approach will only put more variables in play. As a result, I believe the opportunities to structure within the reconfigured landscape of the new standard to achieve perceived accounting advantage will increase not decrease. If the opportunities are there, experience tells us that lessees and lessors will find and use them. And if I am correct in my assessment, our experience with SFAS 13 suggests that

standards setters and regulators will find it necessary to spend virtually unlimited hours attempting to fashion increasingly arbitrary rules with little or no underlying theoretical basis in order to curb what they perceive to be accounting abuses and to stem the migration of even more assets and related financing obligations off of corporate balance sheets.

Practical Considerations Concerning the Proposed New Approach

Although SFAS 13 claims to be based upon an analysis of who holds the major portion of the risks and benefits associated with the ownership of property, it is clear that the actual accounting produced by this Statement is not faithful to that claim in many instances. Such results should not be surprising to anyone - considering, for example, that in Interpretation No. 19, the Board chose to focus on *theoretical* risk and to ignore the actual *economic* risk with respect to a lessee's guarantee of the lessor's residual value. However, the financial components approach proposed in the Special Report would go even farther, essentially ignoring the risks and benefits of ownership entirely. Given the prominent role of risk intermediation in the origins and *economic* purpose of the leasing industry, it seems unlikely to me that such an approach would be able to achieve a significant improvement in transparency with respect to financial reporting for leases; indeed, I believe it would not. Let me explain.

SFAS 13 requires that a lessee classify a lease at its inception and account for it over its term in accordance with that classification. Leaving aside those relatively few leases that transfer ownership outright or include a bargain purchase option such that eventual purchase of the asset is presumed, the first steps that a lessee classifying a lease under SFAS 13 must perform are (1) to determine the *term* of the lease for classification purposes (which often differs from the stated term in the agreement) and (2) to determine the *minimum lease payments* that the lessee is expected or can be required to make during the lease *term*. Statement 13, as amended and interpreted, provides a set of rules (often criticized as overly-complex but relatively simple compared to the provisions of recent standards based on the financial components paradigm such as Statements 133 and 140) that address when and how renewal options, cancellation rights, financial and economic penalties and financial and residual value guarantees should affect the determination of lease *term*. Once the lease *term* has been determined, SFAS 13 also prescribes which direct and contingent payment obligations should be included in *minimum lease payments*, both for purposes of classifying the lease and for purposes of accounting for it based upon its classification.

The initial text and the subsequent amendments and interpretations of SFAS 13 reflect the Board's attempt to resolve issues concerning the *term* of a lease and the *minimum lease payments* due under a lease by focusing on the extent to which the various option and guarantee provisions of a lease contract transfer economic risks associated with ownership of the leased property to the lessee. Provisions that are deemed to transfer such risks to the lessee are included in the lease *term* and/or *minimum lease payments* and those that do not are excluded. While some the Board's guidance on this subject has proved to be relatively effective in capturing the underlying economic reality of lease option and guarantee provisions, other guidance has been ineffective (some has outright failed). The resulting disconnect between theory and practice has led to the well-justified criticism that we account for leases under Statement 13 based primarily on their form rather than their substance, notwithstanding the stated objectives of SFAS 13.

Differences in the effectiveness of various provisions of SFAS 13 relating to the determination of lease *term* and *minimum lease payments* are well-understood by those representatives of the national accounting firms that you have given the tongue-in-cheek label, "the secret society of lease accountants." However, more importantly for the transparency of financial reporting, those differences in effectiveness are well-known to lease transaction engineers operating within the lessee and lessor communities who are constantly looking for ways to exploit the ineffective provisions of the lease accounting literature to create new accounting-friendly product offerings for themselves, their customers or their prospective customers. Warren McGregor's conclusion that the major deficiency in current lease accounting standards is "that they do not provide for recognition in lessee's balance sheets of material assets and liabilities arising from operating leases" reflects the widespread belief among standard-setters, academics and some elements of the user community that many if not most operating leases are simply disguised financing transactions that belong on lessee's balance sheets. In my opinion, this exploitation of the weaknesses in SFAS 13 with respect to the treatment of options, penalties and guarantees in order to finesse the "risks and benefits of ownership" analysis upon which current lease accounting purports to be based is a principal source of the criticisms directed at Statement 13.

However, lease agreements are designed to carve up risks and benefits of ownership between lessee and lessor and such agreements frequently include options to renew, rights to cancel, penalties for cancellation or failure to renew, and guarantees of lessor indebtedness and residual values. As a result, the authors of the Special Report could not avoid addressing how these provisions should affect the determination of the *term* of a lease and, thus, the amount of the *minimum payments required by the lease*. The cornerstone of the proposal articulated in the McGregor Report and fleshed out in the G4+1 Special Report is to require lessees to record their

rights and obligations arising from lease contracts as assets and liabilities measured as the present value of "the minimum payments required by the lease." Consistent with this financial components approach, the proposal, generally, would be to view each of these provisions as giving rise to a separate asset or liability to be measured initially at its fair value (when that value can be determined reliably). With few exceptions, the authors of the Special Report would ignore the extent to which renewal options and residual value guarantees result in the transfer of economic risk between lessees and lessors, notwithstanding the central role of risk-intermediation in the existence of the leasing industry and notwithstanding the central role of risk-transfer considerations in the negotiations that precede the execution of all but the most trivial lease contracts.

In the hands of creative transaction engineers, I predict the G4+1's proposals quickly will provide lessees with the opportunity to select their accounting for financing the acquisition of property, plant and equipment from a smorgasbord of transaction structures that economically are substantially identical with respect to who holds the risks and benefits of ownership. I also predict these proposals will result in a general *shortening* of lease terms (to reduce the amount of recorded assets and liabilities) while *increasing* the transfer of risks of ownership to lessees as a result of an increased use of residual value guarantees (whose recorded fair values will be nominal in relation to the assets being acquired). Finally, I predict that the perceived abuses resulting from the effects described in my first two predictions will cause the standards-setters and/or regulators to reintroduce rules that, if they have any conceptual underpinnings at all, will be based upon the very risks and rewards analyses that the advocates of the financial components model criticize as being out of step with modern accounting theory and the Board's conceptual framework. Let me illustrate the basis for these three predictions using examples from the Special Report itself.

Prediction: The proposals would result in what amounts to "free choice" accounting by requiring different accounting for transactions that are economically the same.

Consider Examples 4 and 5 from Chapter 5 of the Special Report and contrast them with a simple purchase, financed 100 percent with debt:

Example 4

A lessee enters a lease to hire equipment for three years at an annual rental of 5,000. In addition, the lessee is required to pay a fee of 3,000 for the residual value. The equipment will be sold at the end of the lease at fair value, and all the sale proceeds will be paid to the lessee. (Note: A footnote to the example indicates that except for time-value-of-money considerations, it is not relevant when the fee is paid. Therefore, to promote comparability among the examples, assume the payment is due at the end of the lease.)

Example 5

A lessee enters a lease to hire equipment for three years at an annual rental of 5,000. The equipment will be sold at the end of the lease at fair value. If the proceeds are more than 3,000, the lessor will pay the whole of the surplus to the lessee. If the proceeds are less than 3,000, the lessee will pay the shortfall to the lessor.

Debt Example

A company purchases equipment that it intends to sell at the end of three years. It pays the manufacturer for the equipment using the proceeds of a three-year loan. The loan requires annual payments of 5,000. At the end of three years, the outstanding principal balance of the loan will be 3,000.

The lessors in both lease examples and the lender in the debt example are entitled to receive three payments of 5,000 each over the term of the agreement and 3,000 at the end of three years. In each example, if the user decides at the end of year three to keep the asset, it can do so without further involvement of the lessor or lender by paying the lessor/lender 3,000. If the user chooses not to continue to use the asset it will pay or receive the difference between 3,000 and whatever it can realize from selling the equipment to a third party.

I submit that economically, all of these transactions are identical and they all should be accounted for as such. (Ironically, under existing lease accounting literature, they all would be treated as purchases of the equipment in exchange for a liability equal to the present value of 18,000.) Yet the authors of the Special Report would account for the lease in Example 5 differently. Under the financial components approach, they argue that the lessee's rights and obligations under Example 5 are different in ways that should be significant to the accounting.

Specifically, they would record an initial asset and liability in equal amounts, measured as the present value of the three annual payments of 5,000 and the value of the residual value guarantee (if it is practical to quantify it). Recognizing that a guarantee that equipment expected to have a value of 3,000 in three years will, in fact, have a value of 3,000 at that time is likely to have only a nominal value (if it can be determined at all); for all practical purposes we can assume that the lessee would record an asset and liability equal to the present value of 15,000.

Paragraph 5.52 of the Special Report attempts to articulate the differences that justify this different accounting:

> "The substantive difference between Examples 4 and 5 is that the lease contract in Example 4 specifies separate cash outflows and inflows for the lessee relating to the sale of the equipment. In Example 4 the lessee has an obligation to make an additional payment of 3,000 to the lessor and has a right to receive the full residual value proceeds from the lessor, which gives rise to separate asset and liability amounts. In Example 5 the lessee has obtained the right to use the equipment for the lease term and the right/obligation to receive any surplus proceeds from the lessor or to pay any deficit, which do not give rise to separate asset and liability amounts in respect of the equipment's residual value. The fact that there are different accounting outcomes in the two examples is not surprising, since they reflect what the lessee would pay for the rights it has acquired in each case."

I respectfully disagree with the proposed accounting and with the arguments that would support such accounting. From a risks and benefits of ownership standpoint, there are no substantive differences between Examples 4 and 5 or between those examples and my debt example. Furthermore, lessors and lenders readily will agree to any one of these structures with a given customer, leaving companies free to choose how much of the cost of acquiring and financing their physical plant will appear on their balance sheet. In my opinion, accounting that produces significantly different results for these two transactions, in the absence of significant differences in the underlying economics of the transactions, is neither relevant nor reliable as those terms are used in the Board's conceptual framework.

Prediction: The proposals would result in a general shortening of stated lease terms and in an increased use of residual value guarantees.

It should be apparent that the differences in assets and liabilities that would be recorded for Examples 4 and 5 above under the accounting proposed in the Special Report will invite the very

lease transaction engineering that Warren McGregor and the G4+1 have so roundly criticized with respect to SFAS 13. This outcome is particularly likely when even the authors of the Special Report acknowledge that the *fair value* of a guarantee that a future residual value will be worth what everyone already expects it to be worth will be seen to be nominal in relation to the asset itself. Instead of a three-year lease that necessitates recording an asset and liability equal to the present value of 15,000, why not a two-year lease with an option to renew and an additional guarantee of the residual value at the end of year two if renewal does not occur? Why not a one-year lease with a series of renewal options and residual value guarantees?

In my experience, lenders who are comfortable with a borrower's credit worthiness for purposes of making a loan can become equally comfortable with a lease arrangement that provides them the same expected cash flow stream with no exposure to the residual value of the asset at the end of the financing arrangement. Therefore, I believe that even companies that currently purchase most of their fixed assets will find irresistible the temptation to lease under arrangements that will allow them to record substantially less than the entire cost of those assets on their balance sheets if they can do so without paying a risk premium for that privilege. The accounting proposed in the Special Report would permit such companies to provide a 100 percent residual value guarantee while recording only a nominal liability for that guarantee, thus affording them that opportunity.

Actually, I believe we can expect to see one exception to this trend toward shorter lease terms, supported by residual value guarantees. Whereas rental expense associated with operating leases is included in EBITDA and similar alternative measures of performance, amortization expense associated with capital leases is excluded from such measures. As a result, recently, I have observed an increased interest on the part of management of companies operating in certain industries to have leases capitalized on their balance sheets. While this trend, if it continues, would appear to run counter to my second prediction, the ability of these companies to achieve their desired accounting without changing the underlying economic risk/benefit profile of their transactions will only serve to demonstrate the accuracy of my first prediction.

Prediction: Regulators and/or standards-setters will find it necessary to curb perceived abuses associated with the accounting proposed in the Special Report by reintroducing rules based upon risks and rewards analyses.

The authors of the Special Report appear to have anticipated the increased use of renewal options and residual value guarantees to shorten lease terms in order to reduce the level of assets

and liabilities recorded on the balance sheets of lessee. In fact, they illustrate and analyze such a transaction structure in paragraphs 5.62 to 5.65 of the Special Report as follows:

> "5.62 Where the lessee provides a residual value guarantee at the end of the lease term, it is proposed that the assets and liabilities initially recognized should be measured to reflect the fair value of the guarantee rather than the gross amount of the residual value that is guaranteed. The recognized asset would be characterized as the right to use the property for the term of the lease only, not the whole of the property (that is, not including the guaranteed residual value). The recognized liability represents the minimum payments required by the lease and the (net) exposure under the guarantee. Such characterization is consistent with the treatment of guarantees generally.
>
> "5.63 Consider the following example:

Example 7

> An airline has the right to lease an aircraft for 15 years at a rent of 5 million per year. However, the lessee has an obligation only to lease the aircraft for one year at a time: at each anniversary, the lessee can choose either to extend the lease for a further year at the 5 million rental or to break the lease and return the aircraft to the lessor. The lessee has also given an undertaking that, if it decides to break the lease, it will guarantee a predetermined residual value to the lessor. The guaranteed amount is specified for each renewal date and ensures that the lessor will recover its investment in the lease (including interest up to the break up date) if the lessee decides not to renew.
>
> At the beginning of the lease term, should the lessee recognize an asset and liability for (the present value of):
>
> (a) 5 million plus the value of the guarantee (the value of the guarantee could, in fact, be quite small if the expected residual value was not significantly different from the guaranteed amount)? Or
> (b) 75 million (5 million x 15)?

> "5.64 In addressing this issue it is assumed that the renewal option is genuine and

> there is no constraint that prevents exercise (for example, the asset in question is not unique and essential to the lessee's operations). The Group believes that application of the proposed principles discussed in this chapter and Chapter 4 results in the initial recognition of assets and liabilities comprising the minimum payments required by the lease for the noncancellable period (5 million) and the value of the guarantee: these reflect the fair value of the right to use the aircraft for the noncancellable period and the value of the renewal option.
>
> "5.65 In the Group's view, if a lease is negotiated with a short minimum term, renewal options and residual value guarantees for each renewal date, it indicates that both parties have much comfort relying on the value of an asset that has a ready market. Furthermore, if the option is indeed genuine, it would be expected to have an observable effect on the pricing of the lease. Hence, the lessee is paying a real price for financial flexibility and the accounting should reflect that flexibility. The price paid may also include breakage fees and other termination costs as well as the cost of honoring the residual value guarantee: these would need to be provided for. The Group does not believe that the concurrent existence of these two features in a lease should give rise to recognition of additional assets and liabilities (that is, by anticipating the exercise of renewal options)."

Example 7 describes what currently is referred to in the U.S. as a synthetic lease. (Although current lease classification rules limit the amount of the residual value guarantee permitted in order to classify such leases as operating leases, the authors of the Special Report would remove this limitation and permit lessees to guarantee 100 percent of the residual value.) As with the previous examples, I believe the economic relationship between the parties to the transaction described in Example 7 is substantively identical to the relationship that would exist if the airline purchased the asset with the proceeds of a 100 percent, 15-year loan that (1) is due on sale of the airplane and can be prepaid without penalty at the end of each year, (2) includes principal repayments each period such that the unpaid principal balance at each prepayment date coincides with the residual value guarantee amount at that date under the lease and (3) has a balloon payment due at the end of 15 years equal to the final residual value amount guaranteed under the lease.

Even with the limitations on residual value guarantees imposed by current lease accounting standards, these transactions are nothing but loans that do not have to be accounted for on the balance sheet. Indeed, in the current market they are priced as loans and at least one major financial institution even has marketed them as "Off-Balance-Sheet Loans." More importantly,

however, contrary to the assumptions about rights and obligations that underlie the entire financial components approach, attorneys knowledgeable in such matters have advised me that transactions such as Example 7 are designed so that a court would conclude that the rights and obligations of a lessee in these transactions are those of an owner/borrower while the rights and obligations of the lessor are those of a secured lender. (Interestingly enough, I understand that this legal determination rests on an analysis of which party holds the predominant burdens and benefits of ownership, irrespective of the fact that the lessor holds title, as nominal owner of the property.) In reality, at least as far as so-called synthetic leases and the courts are concerned, what the authors of the Special Report describe in paragraph 5.65 as "financial flexibility" is simply *accounting flexibility*.

In the long run, I do not believe regulators and standards-setters will be comfortable permitting such *accounting flexibility* to continue in the absence of substantive differences in the underlying economics of these transactions. However, if this problem is not recognized and addressed in a meaningful way in the development of a new lease accounting standard, I believe we will face yet again the prospect of an endless succession of amendments, interpretations and implementation guidance in what I believe will be a futile attempt to make the new lease accounting standard operational. Already we can see the beginnings of that process in an alternative view to Example 7 ("the Alternative View") articulated in paragraph 5.66 of the Special Report as follows:

> "An alternative view is that residual value guarantees (and other residual value participation agreements) that operate in connection with renewal options are similar to mechanisms for arriving at the termination sum if a lease is cancelled early and should be treated as such. Under this view such leases do not give the lessee any significantly greater financial flexibility (**or expose the lessor to any significantly different risks**) than equivalent leases that are specified to be noncancellable for a longer term. Those who support this view regard it as more useful to characterize the lessee's assets and liabilities as relating to the period for which the lessee has the right to use the property. They are also concerned that such structures may become more widespread, and have the effect of reducing the amounts of assets and liabilities that would be recognized in lessees' financial statements." (emphasis added)

I found this paragraph interesting for several reasons. First, supporters of the Alternative View have concluded in this instance that exercise of the renewal options should be assumed for purposes of measuring the assets and liabilities arising from this lease. In effect, they already are

prepared to abandon the separate financial components model in favor of what can only be described within that conceptual approach as a form of synthetic alteration accounting. I submit that their concerns, while legitimate, represent nothing but a reincarnation of the age-old problems related to determining what lease *term* and *minimum lease payments* are relevant for accounting purposes.

Similar concerns by supporters of the Special Report's majority view appear to be reflected in the assumptions stated in the first sentence of paragraph 5.64 quoted above. What distinguishes a renewal option that is "genuine" from one that is not? When is an asset "unique" or "essential to the lessee's operations" and what is the accounting implication if it is not? If, as the language seems to suggest, the members of the G4+1 are prepared to require that periods covered by options that are not genuine and periods during which assets are essential to a lessee's operations be included in the initial measurement of assets and liabilities, someone will need to provide guidance as to how those determinations are to be made. Thus, I do not believe the old questions are likely to go away as a result of adopting a financial components approach to accounting for leases. However, I suggest that once the regulators and/or standards-setters start down this path of recharacterization and synthetic alteration, they will find themselves on a slippery slope that has no bottom.

Second, I find it interesting that the language in paragraph 5.66 suggests that those who hold the Alternative View would rely on an analysis of the lessor's exposure to risks in order to address their concerns about the proposed accounting. I suspect that is because at bottom, their concerns are risks and rewards concerns, notwithstanding the alleged superiority of the financial components model for reporting the assets and liabilities arising from lease contracts. Furthermore, this statement serves to confirm my belief that once they start on the slippery slope of recharacterizing lease provisions, they will find it necessary to abandon their conceptual framework and rely on arbitrary rules and/or risks and rewards of ownership constructs to resolve their concerns in ways that produce results they will find acceptable.

And finally, the last sentence of paragraph 5.66 suggests that the concerns of those who support the Alternative View derive from some a priori expectation concerning what magnitude of assets and liabilities *should* be recognized in a lessee's financial statements. Such apparent bias is unbecoming in a group of standard-setters whose conceptual framework calls for neutrality in the development of accounting standards. If, as Warren McGregor and the authors of the Special Report maintain, this new approach is necessary to account for the rights and obligations created by the individual provisions of lease contracts in conformity with the conceptual framework definitions of assets and liabilities, I would have thought the members of the G4+1

would be more comfortable with the results of applying that model than some appear to be and I would not have expected them to resort to the discredited risks and benefits model of existing lease accounting standards so quickly to address their discomfort. On the other hand, I share their apparent concern that unless the Board is prepared to introduce substantial modifications and exceptions into the basic model designed to account for individual rights and obligations arising from lease contracts under a financial components approach, companies will have virtually unlimited opportunities to manage both their balance sheet and income statement accounting related to the acquisition and financing of fixed assets, without substantively changing the underlying economics of their financing arrangements.

Technical Accounting Arguments Concerning the Proposed New Approach

Warren McGregor asserted that the current lease accounting standards, based as they are upon an analysis of who holds the *risks and rewards of ownership* of the leased property are at variance with the conceptual frameworks of the FASB and other G4+1 participants because rights and obligations associated with operating leases are not recorded as assets and liabilities in the balance sheets of lessees even though they meet the definitions of assets and liabilities found in those conceptual frameworks. Messrs. Nailor and Lennard, the authors of the current G4+1 Special Report, appear to have accepted this assertion as established fact and have undertaken to develop an accounting model requiring that each of these rights and obligations be accounted for independently at its assumed fair value. In essence, they propose to apply the financial components model, originally developed to account for transfers of financial instruments, to contracts used to finance the acquisition of tangible property, plant and equipment. In the process, they would fragment these tangible assets into intangible rights and obligations and distribute the resulting components between the balance sheets of the lessee and the lessor.

Even if one accepts the underlying premise that the current SFAS 13 distinction between operating and capital leases is at variance with the Board's conceptual framework, it does not follow that the Board's definitions of "assets" and "liabilities" necessitate the adoption of a financial components approach to account for leases. On the contrary, I believe the definitions of *assets* and *liabilities* in FASB Statements of Financial Accounting Concepts No. 6 ("CON 6") are sufficiently general to permit the Board to identify the *assets* and *liabilities* arising out of lease contracts using either of two basic approaches without harming the conceptual integrity or purity of those definitions.

Furthermore, I believe that the Board, for purely practical or cost/benefit reasons could, and probably should, decide that certain assets and liabilities relating to lease commitments that do

not exceed some arbitrary threshold need not be recognized in lessee's balance sheets. Daily or weekly auto rental contracts outstanding on the balance sheet date would appear to be a fairly obvious example of contracts that should be excluded. Warren McGregor proposed to exclude contracts with firm terms less than one year. The authors of the Special Report suggest excluding leases that are not material, whatever that means. In my view, this is an issue that the Board must address in developing any new lease accounting standard, regardless of which approach the Board chooses for identifying the assets and liabilities arising out of lease contracts.

Recognizing that there are two possible interpretations under the Board's conceptual framework of what constitute the assets and liabilities arising out of lease contracts, the question remains, which one is better and how should the Board choose. (The Special Report devotes one paragraph out of approximately 140 pages to explaining the G4+1's reasons for rejecting one of the alternatives.) I suggest that the Board should evaluate the results produced by the two alternatives using the guidance in its own conceptual framework, specifically, the guidance in FASB Statement of Financial Accounting Concepts No. 2 ("CON 2") concerning the objectives of financial reporting and the qualitative characteristics of accounting information.

I propose to explore and comment on each of these issues in greater depth below. To facilitate my discussion and better to illustrate some of my points, I have attached as an Appendix to this letter information concerning the accounting and incremental financial reporting that would result from applying the basic methodology proposed in the Special Report to the acquisition of a large commercial jet aircraft under three alternative financing scenarios: a plain-vanilla three-year lease, a plain-vanilla 18-year lease and an outright purchase financed with a 22-year loan. Also included in this Appendix is information that would result from accounting for these same three transactions using the alternative interpretation of the assets and liabilities related to lease contracts. I chose to use these examples in part because aircraft are large, discrete, frequently leased and relatively easily understood assets and in part because Warren McGregor used examples from the airline industry in his 1996 critique of the current lease accounting standards. However, there is nothing about my arguments that is unique to aircraft or the airline industry.

Lease Accounting and the Definitions of Assets and Liabilities

Paragraphs 25 and 35 of CON 6 define assets and liabilities, respectively, as follows:

- "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."

- "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."

Clearly, the Board could decide to adopt the position articulated in the Special Report that the rights and obligations arising out of a lease contract meet these definitions and develop an accounting standard based on the model proposed in the Special Report to implement that decision. However, in the process, we accountants would carve up the tangible property, plant and equipment that companies use to conduct their business in the physical world into intangible abstractions that bear little relationship to the physical realities they purport to represent. Under this financial components approach, the asset an airline uses to generate its revenue is an airplane only if it chooses to purchase the airplane. Otherwise, its flight equipment assets consist of intangible rights, measured as the amortized present value of its initial firmly-committed rents and bearing little discernable relationship to the underlying physical reality they are intended to represent.

Obviously the variety of such assets that lessees could and would report in their balance sheets is unlimited. However, I submit that such assets are meaningless abstractions that provide little in the way of decision-useful information to the users of financial statements. The problem with this approach, in my opinion, is that it would subordinate the definition of an asset to an interpretation of the definition of a liability that is biased toward recognizing only future obligations to pay cash.

Alternatively, the Board could decide that the asset an airline controls is an airplane. This application of the definition of an asset would conform what is reported as an asset in the airline's balance sheet to the tangible reality of the airline's physical plant regardless of whether it leased or purchased the airplane. However, it would necessitate including within the liability arising out of a lease contract, the lessee's obligation to return the airplane to the lessor at the end of the lease term unless it negotiates an agreement to extend the lease in exchange for additional payments of cash. (Not unlike a borrowers obligation to return the cash it borrowed on the loan maturity date unless it negotiates a renewal or extension.)

Paragraph 3.19 of the Special Report recognizes the existence of this latter alternative view; however, paragraph 3.20 indicates that the G4+1 rejected this approach because it would make the leasing of assets appear to be similar to owning assets while the Group's view is that they are different and the accounting should not make different things appear to be

alike. I believe the Group is wrong in this assessment – I would argue that throughout the duration of a lease contract, the similarities between the future economic benefits the airline controls with respect to a leased asset and an owned asset are greater than the differences. In addition, considering that most of the time airlines that are going concerns either renew their leases or return the airplane and replace it with another of equal or greater capacity, it should be clear that the financial components approach would lead to chronic under reporting of the physical plant of lessees solely on the basis of their financing decisions – a classic case of off-balance-sheet financing that, in my opinion, would increase not reduce the accounting-based incentives to lease.

These two interpretations of the assets and liabilities arising from a leasing contract represent two extremes that could be applied to all leases, even, for example, daily or weekly contracts. For example, shipping companies routinely lease cargo containers to move cargo from Point A to Point B under leases that call for daily rentals from the day the container leaves the agent's yard at Point A until it is dropped off at another agent's yard at Point B. Notwithstanding that the containers have been delivered to the shipping company and, therefore, according to the Group's view no longer are subject to an executory contract for accounting purposes, I believe efforts to quantify the assets and liabilities conveyed under such contracts are likely to be difficult if not impossible. Similar arrangements apply to agreements conveying the right to use over-the-road trailers in the trucking industry. Faced with these and similar problems, I believe it is more likely, that the Board would decide to adopt one of these approaches but only when the magnitude of the lessee's commitment related to a given asset exceeds some minimum threshold. Leases that did not rise to the level of assets and liabilities under such an approach would be treated as equally unexecuted executory contracts – i.e., operating leases.

While the Special Report suggests that such exceptions should be permitted only for short duration leases that are "immaterial," I believe an undefined *materiality* approach would lead to inconsistent application and additional structuring for perceived accounting advantage and ultimately that it would prove to be unsatisfactory in the U.S. financial reporting environment, particularly in light of the SEC staff's recent issuance of SAB 99. Furthermore, although of necessity any decision concerning where to draw the line between those leases that give rise to assets and liabilities and those that do not would be arbitrary, I believe that an approach to defining such a line that ignores the extent to which the lessee has assumed significant risks and rewards of ownership above and beyond the committed rent stream is not likely to produce a meaningful cut.

Finally, I suggest that the Board would need to consider significant cost/benefit issues associated with requiring lessees to capitalize all leases before adopting a new standard that includes such a requirement. I am not convinced that the purported marginal improvements in the transparency of financial reporting that we could expect from a requirement that companies capitalize all copier and fax-machine leases in this country would outweigh the significant marginal administrative costs required to amortize the capitalized assets and impute interest to each obligation as compared to the current practice of charging each monthly payment to rent expense as it is paid. To my knowledge, this issue has not been evaluated in any meaningful way by the members of the G4+1, but I believe it should be before any final decisions are made on a new lease accounting standard.

Lease Accounting and the Conceptual Framework

In the preceding section, I have described two very different approaches to identifying the assets and liabilities arising from a lease, both of which, in my opinion, would satisfy the Board's conceptual framework definitions of assets and liabilities. (For ease of reference throughout the remainder of this letter I will refer to the approach advocated in the Special Report as the *financial components approach* and the alternative approach as the *whole-asset approach*.) If it ever undertakes a reconsideration of lease accounting, I believe the Board will find it necessary to choose one of these approaches (or a modified variation of one or the other approach that incorporates practical and cost/benefit considerations). At that time, the challenge the Board will face will be to select the approach that is most consistent with its entire conceptual framework, particularly with the objectives of financial reporting and the qualitative characteristics of accounting information. Therefore, I have attempted to evaluate each approach against that framework in the discussion that follows.

Paragraph 32 of FASB Statement of Financial Accounting Concepts No. 2 ("CON 2") states:

> "The characteristics of information that make it a desirable commodity guide the selection of preferred accounting policies from among available alternatives. They can be viewed as a hierarchy of qualities, with usefulness for decision making of most importance…"

Paragraph 33 of CON 2 states in pertinent part that:

> "…The primary qualities [that make accounting information useful] are that accounting information shall be relevant and reliable. Relevance and reliability can be further analyzed into a number of components. To be relevant, information must be timely and

> it must have predictive value or feedback value or both. To be reliable, information must have representational faithfulness and it must be verifiable and neutral …Comparability, including consistency is a secondary quality that interacts with relevance and reliability to contribute to the usefulness of information…"

Paragraph 63 of CON 2 states with respect to representational faithfulness:

> "Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations."

And finally, paragraph 111 of CON 2 states with respect to comparability:

> "Information about an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other point in time. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark…"

Given that the Board has identified decision-usefulness of information as the most important characteristic to be considered in the selection of alternative methods of accounting I thought it might be helpful to attempt to identify the types of information that would be most decision-useful to the users of the financial statements of an enterprise that uses leasing as a means of financing the acquisition of a significant portion of its physical plant.

Users of property, plant and equipment can finance the acquisition of their physical plant in a variety of ways. Those who elect to own it outright can finance the purchase with short-term or long-term debt. Those who elect to lease it also can finance it short or long term. Decisions to finance short-term or long-term expose companies to interest-rate risks and benefits. In addition, those who purchase their fixed assets benefit when the value of such assets rises over time and suffer when the value of their assets declines. Companies that lease their fixed assets are exposed to similar risks and benefits albeit generally in different time frames and to different degrees than those who own their plant. (However, as we have seen, lessees can use residual value guarantees and renewal and purchase options to make their exposure to such risks virtually identical to those of owners.) Consistent with the risk intermediation role of lessors described at the beginning of this letter, various leasing strategies expose the lessee to varying degrees of used-property market risk.

Users of financial statements may well consider information that allows them to assess where a company has chosen to position itself on the risks and benefits continuum with respect to changing fixed asset prices and interest rates to be decision-useful information. However, I do not believe there is a single balance sheet and income statement convention that can convey that information in any reliable way. Certainly neither balance sheets and income statements prepared using the financial components approach nor those prepared using the whole asset approach provides information from which users of financial statements could draw meaningful conclusions about that subject. (And existing lease accounting standards provide no better information on this subject.) Therefore, the need to communicate this information to users of financial statements cannot serve as the basis for choosing between the financial components approach and the whole-asset approach (or for that matter as a basis for discarding the existing lease accounting model either). To the extent such information needs to be made available to users of financial reports prepared in accordance with generally accepted accounting principles, I believe it must be provided in the footnotes regardless of which approach to capitalizing leased assets and related liabilities the Board chooses to adopt.

On the other hand, it is important to bear in mind that whatever other objectives motivate lessees to lease their fixed assets, the one characteristic that is common to all leasing transactions is that they enable the lessee to finance the acquisition of property, plant and equipment. For users of financial statements that perform basic financial statement analyses (e.g. compute ratios such as debt to equity, interest coverage, current ratios, return on assets, revenue per dollar invested in fixed assets, etc.) and use such analyses to assess creditworthiness or to compare performance with prior periods or with other companies and industries, I believe a decision to require the financial components approach instead of the whole asset would have a significant effect on the relevance of the information and on the ability of users to draw meaningful and reliable inferences from their analyses.

Page 1 of the Appendix compares the incremental effects on an airline's balance sheets and income statements of its decision to lease an asset for three years and account for it under the financial components approach and the whole-asset approach. The assets and liabilities reported in a balance sheet prepared under the whole-asset approach would be significantly higher. In addition, reclassification of the obligation to return the airplane into current liabilities during the last year of the lease informs the users of financial statements that the airline must refinance this asset or surrender it and lose its ability to generate revenue. The financial components balance sheet provides no such information. However, I believe it is the effect on the income statement that is most dramatic and, perhaps, unexpected. Although the aggregate expense is identical over the three years and similar from year to year, the presentation of the components of

expenses are very different. Over the three-year period, the financial components approach would report almost 85 percent of the expense as amortization of fixed assets and the other 15 percent as interest, whereas the whole-asset approach would report only 16 percent of the aggregate expense over the three year period as amortization and 84 percent as interest expense.

The differences in balance sheet presentation clearly would impact the reporting entity's debt to equity ratio, its computed return on assets, its revenue per dollar invested in fixed assets and the denominator of its interest coverage and earnings to fixed-charges ratios. In addition, the numerator of the interest coverage ratio would increase significantly. In my opinion, it cannot be the case that such radically different numerical representations of the same event in the basic financial statements can be equally useful to the users of financial statements for purposes of making investment decisions or evaluating past performance. So which approach produces the better information?

The Concepts Statements tell us that information is useful for decision making if it is relevant and reliable. Information is relevant when it has predictive value, feedback value or both. It is reliable when it is representationally faithful, verifiable and neutral. I believe that measured against these criteria, the information presented under the whole-asset approach is unquestionably more decision-useful to users of financial statements. Let me explain.

According to the Concepts Statements, representational faithfulness is correspondence between a measure or description and the phenomenon it purports to represent. Now it is indisputable that when an airline flies passengers between New York and Los Angeles, it flies the whole airplane, not a bundle of intangible rights. And, whatever else we know or believe about lease agreements, it also is indisputable that every lease enables the lessee to finance the acquisition of an asset. If that asset is an airplane costing $100 million, we can be fairly confident that someone, in this case a lessor, is paying interest on a significant portion of the purchase price. We also can be fairly certain that the rent the lessor will agree to accept in exchange for granting the lessee the right to use the airplane will be intended to recover all of its financing costs (including a spread and a return on any of its own money invested in the airplane) plus some portion of the cost of the asset.

In my opinion, it would not be representationally faithful to the inherent financing nature of lease contracts to report what is clearly financing costs as if they were depreciation charges. Furthermore, in my opinion, it also would not be representationally faithful to have the split between the portion of rental payments reported as interest and the portion reported as amortization of property fluctuate significantly based solely upon the length of the

noncancellable lease term. Finally, before it would be possible to draw meaningful conclusions about the performance of an airline that leases a significant portion of its fleet, I believe financial analysts would find it necessary to recast the airline's balance sheets and income statements prepared under the financial components approach (just as they do today to adjust for operating leases) in an attempt to simulate the information that would be reported under the whole-asset approach.

The Concepts Statements also inform us that information gains greatly in usefulness if it can be compared with similar information about other enterprises. Page 2 of the Appendix demonstrates the differences in the amounts that three airlines would report in their balance sheets and income statements under the proposed financial components approach if they acquired the use of a $100 million airplane (1) under a three-year lease, (2) under an 18-year lease and (3) by purchasing it with the proceeds of a 22-year loan. While the differences between the 18-year lease and the purchase are not insignificant under the financial components approach, at least the reported information bears some relationship to the underlying financing nature of the transaction. However, the differences between either of these transactions and the 3-year lease would make meaningful comparisons of the performance of these three airlines impossible without again engaging in significant recasting of the short-term lessee's financial statements.

On the other hand, differences in the information prepared under the whole-asset approach can be explained readily in terms that relate to the underlying differences in the three financing strategies. (Page 3 of the Appendix illustrates the balance sheets and income statements of the same three airlines prepared using the whole-asset approach.) For example, differences in interest expense between the 3-year lease and the longer term financing structures can be explained primarily as the difference between short and long-term interest rates. Differences in the depreciation/amortization expense between the 18-year lease and the purchase can be explained as the risk premium the lessee is paying the lessor to assume the residual risk at the end of the lease term. The lower level of aggregate expense reported by the purchaser can be explained as the result of its having financed only 85 percent of the purchase price as compared to the 100 percent financing implicit in the lease arrangements.

Finally, the Concepts Statements tell us that to be reliable, information must be not only representationally faithful, it must be verifiable. The financial components approach proposed in the Special Report would require lessees to estimate and account for each separate financial component at its fair value. Lessee's would be required to estimate the fair value of residual value guarantees, renewal options and contingent rent provisions. For example, lessees of retail space under leases that require a stated percentage of sales generated from the location in excess

of a stated minimum monthly rent would be required to estimate the amount of rent that they would have to pay for their space without the contingent rent provisions and include that higher amount in the initial measurement of the asset and liability to be recorded. In many if not most situations, there will not be an observable market in which to validate the lessee's estimates of the amounts to be included for such provisions in the measurement of the liability and, accordingly, these estimates will be substantially unverifiable. On the other hand, the whole-asset approach requires only an estimate of the lessee's current borrowing rate (a readily observable rate in most instances) in order to "get the balance sheet right."

For the reasons discussed in the preceding paragraphs, I believe that measured against the criteria of the Board's own conceptual framework, the new approach described in the Special Report comes up significantly short. In fact, I would go so far as to suggest that Statement 13, amended to eliminate or revise what we all know to be its most defective provisions, would produce better information for the users of financial statements than would the current G4+1 proposal. However, if the Board decides to adopt a new lease accounting standard based on the notion that all but the most insignificant leases gives rise to assets and liabilities that should be recorded, I believe the case is overwhelming for choosing what I have described as the whole-asset approach that would include as a liability not only the cash payment obligation during the lease term but also the obligation to return the leased property at the end of the lease.

Concluding Comments

Paragraph 1.17 of the Special Report contains the following statement:

> "The Group's view is that [the financial components] approach would improve financial reporting. Marginal differences in leasing structures and in their interpretation for accounting purposes would no longer result in major differences in the reporting of financial position and financial performance for lessors and lessees and in related financial position and performance indicators such as gearing, asset-based measures of performance (for example, return on assets employed), and interest cover. Reflecting the spectrum of lessee and lessor interests under all leases would therefore make the accounting treatment more transparent and improve comparability."

I have argued throughout this letter that the Group is wrong in this view. However, the Board does not need to rely on me or my analysis to resolve this issue. Indeed, this paragraph represents the statement of an hypothesis that can be tested by empirical research. Perhaps as a result of the discussion at the upcoming AAA/FASB Financial Reporting Conference, one or more of the academics participating in the forum will become interested in taking up such a project. Although I am fairly confident of the outcome, for the reasons set forth herein, I would

welcome the opportunity to assist interested parties in designing a project to test the Group's hypothesis in the real world.

*   *   *   *

In closing, I would point out that I have confined my comments to the accounting by lessees for leases of equipment. I acknowledge that there are significant lessor accounting issues that would need to be addressed before any new accounting standard could be adopted. I also recognize that there are significant issues surrounding the accounting for leases of real estate, particularly those involving the use of part of a facility, and sale-leaseback and sublease arrangements present their own unique problems as well. However, I believe no new approach to accounting for leases can be successful unless it works for lessees first and foremost. For all of the reasons I have tried to articulate in this letter, I do not believe the current G4+1 proposal will work for lessees and in my opinion, it ought to be abandoned.

As always, I appreciate the opportunity to share my ideas with you and the Board and I look forward to a lively discussion of this subject at the conference in December. If you have any questions or would like to discuss this matter prior to the conference, feel free to give me a call.

Very truly yours,

Dennis W. Monson