Questions and Answers

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Part I - Introduction and scope

Question 1:

Chapter 1 sets out the deficiencies of existing accounting standards for leases and the problems associated with an arbitrary distinction between different types of leases. Do you agree that standard-setters should aim to develop a single accounting method that is applied to leases of all kinds?

No! Certain leases convey all or substantially all the risks and benefits of ownership of an asset. These leases should be accounted for as though the lessee owned the asset. Where the lessee does not enjoy all or substantially all the economic benefits of the asset, the lease should be accounted for as an operating lease. This risk / reward approach gives the reader of financial statements a better understanding of the assets of the organization. Adequate footnote disclosures allow analysts to evaluate future commitments under operating leases. No single accounting method can capture this true economic substance.

Question 2:

Chapter 2 discusses the scope of any revised accounting standards for leases. It distinguishes contracts that would fall within the scope of leases and other contracts, in particular executory contracts that would not.

(a) Do you agree that the distinction has been made appropriately in Chapter 2? If not, what other factors do you think are particularly relevant?

No, the need to go to great lengths in Chapter 2 to distinguish leases from other executory contracts reflects a basic flaw in The New Approach. The rights and obligations under a lease do not necessarily end with delivery of goods. The lessor's delivery of the asset does not complete his execution. The failure to pay rent negates the lessee's rights to quiet enjoyment and the asset can be easily repossessed by the lessor. In addition, in the U.S., in forty percent (40%) of these cases where a residual value is booked, the equipment comes back to the lessor. In the remainder of the leases there is uncertainty of final disposition and the equipment must be monitored. There is a valuation problem under The New Approach. By treating the obligations and rights as being fixed at delivery, many uncertainties can be ignored. They should not be ignored nor should executory contracts be excluded.

(b) *Do you agree that leases of intangible assets (including agreements to explore for or use natural resources) should not in principle be excluded from the scope of revised standards?*

Yes.

What practical problems might arise if the proposals were applied to leases of intangible assets?

Valuation uncertainties.

(c) *Do you agree that no specific exemption should be proposed for short leases and that reliance should instead be placed on the principle of materiality?*

The principle and definition of materiality is critical. At the same time it is one of the major practical problems with implementing The New Approach. The complexity and difficulty of reporting on the components of many different leased assets will be a burden. Under recently enacted guidance of the SEC, Staff Accounting Bulletin 99, intentional failure to follow GAAP properly is itself, material. Under this definition of materiality, if the accounting is so obviously correct, any failure to apply it would appear to be material by definition. Under this definition of materiality, lessees and lessors in the U.S. would have to account in this way for every lease no matter how small or short term.

Question 3:

Do you agree that leases of land and buildings, as accounted for by lessees, should not be excluded from the scope of revised standards (see Chapter 13)?

Yes. All leases should be included in the scope regardless of the asset type.

Part II - Leases in the financial statements of lessees

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Question 4:

Do you agree with the Group's recommendations related to lessee accounting in Chapter 3 that:

(a) assets and liabilities should be recognised by a lessee in relation to the rights and obligations conveyed by a lease when the lessor has substantially performed its obligation to provide the lessee with access to the leased property for the lease term?

No!

(b) the objective should be to record, at the beginning of the lease term, the fair value of the rights and obligations that are conveyed by the lease? (c)the fair value of the rights obtained by a lessee cannot be less than the present value of the minimum payments required by the

lease (assuming that the lease is negotiated on an arm's length basis)?

For a), b), and c) above there is a presumption that the asset / liability method best captures the economic substance of a transaction. We believe that is a flawed premise and that the current risk / rewards framework best allows the reporting of economic substance in a transaction.

Question 5:

Chapter 4 discusses the treatment of optional features of leases and contingent rentals. It proposes that the rights that are reflected in the initial lease asset (and liability) that is recorded by the lessee will comprise the rights to use the property and also options, for example to extend the lease, to purchase additional usage of the property in exchange for usage-related rentals, or to purchase the property itself (in those cases where such options can be measured reliably).

(a) Do you agree with the proposal that leases containing lessee options to renew or cancel leases should not be accounted for on the basis that renewal options will be exercised, even if that is thought to be the probable outcome?

Yes. Probable events should not be measured and valued. To attempt to include them would simply highlight the inadequacies of The New Approach. Bargain renewals and bargain options should be treated as minimum lease payments because they can be measured.

(b) Do you agree that, except in those circumstances where it can be demonstrated that an option has significant value (and assuming its value can be ascertained with sufficient reliability), the payments required by the lease should be deemed to relate to the right to use the property for the lease term?

Valuation will be a problem. Comparable leases will be difficult to obtain, as there are many terms that can differ from lease to lease and lessee credit affects pricing.

Question 6:

Chapter 4 discusses (paragraphs 65-77) the treatment of contingent rentals that are a proportion of the lessee's revenues or profits derived from the leased property.

The Group's view as reflected in the Paper is that if the minimum payments required by the lease are clearly unrepresentative of the value of the property rights conveyed by the lease, assets and liabilities of a greater amount, reflecting the fair value of such rights, should be recognised. The fair value of the property rights conveyed by a lease might be determined by having regard to the payments required by a similar lease that had no provision for contingent rentals.

An alternative view is that the initial asset and liability should reflect only the present value of the minimum payments required by the lease.

Which of the two approaches do you support, and why?

The basic problem with the group's view is determining whether or not the minimum payments are clearly unrepresentative of the value of the property rights. This is a subjective decision dependent on the ability to properly value the rights and obligations. Valuing contingent rents will be subject to wide interpretation, in practice. Unfortunately, in many cases, particularly for retail leases, there are no "similar leases" available to the lessee or his accountant with which to make this comparison. If comparability and consistency are essential, then only the minimum payments should be capitalized. These problems do not exist under the present lease accounting framework.

Question 7:

Chapter 4 discusses (paragraphs 78-88) the treatment of contingent rentals that vary in line with prices.

The Group's view as reflected in the Paper is that estimates of future price changes should be reflected in the amount of assets and liabilities recorded at the beginning of the lease.

An alternative view is that only the existing level of rentals should be reflected in the amount of assets and liabilities recorded at the beginning of the lease.

Which of the two views do you support, and why?

The alternative view is appropriate under the asset / liability method. As with several of the issues, a minimalist approach is the only approach that will fit within the theoretical structure of The New Approach. Different lessees will clearly have different views as to the direction and level of prices, just as economists today rarely agree on the direction and level of price changes and may often vary widely in their estimates. Consequently there would be little consistency or comparability. Again, the limitations of The New Approach in practice are revealed.

Question 8:

Chapter 5 discusses various arrangements where the lessee has rights and obligations relating to the residual value of the leased asset, such as those arising from a residual value guarantee.

The Group's view as reflected in the Paper is that an asset and liability should be recognized at the beginning of the lease term measured at the present value of the payments the lessee is required to make during the lease term and the fair value of guarantees or other residual value agreements (if it is practical to quantify them).

An alternative view is that in circumstances where in substance the lessee has exposure to risk on substantially all of the property's value, it should record an asset and liability at the beginning of the lease reflecting the full fair value of the property, regardless of the cash flows that are specified in the lease contract. (Those who hold this view believe that Examples 4 and 5 in Chapter 5 are economically similar and therefore the accounting treatment should be similar.)

Which of the two views do you support? If you support the alternative view, how would you define the circumstances in which gross asset and liability amounts should be reported?

ELA supports the alternative view in circumstances where the lease transfers all or substantially all the risks and rewards of ownership. Since we support the risks and rewards method, we would suggest capitalization tests like in FAS 13 and IAS 17.

Question 9:

Chapter 5 (paragraphs 35-39) also discusses the accounting treatment of subsequent changes in the value of the lessee's obligations in relation to residual value guarantees.

The Group's preferred view is that the carrying amount of both the lease liability and the lease asset should be increased or decreased (subject to the carrying amount of the asset not being increased above a value that would cause an impairment write-off), and that the asset's revised carrying amount should be depreciated over the remainder of the lease term.

An alternative view is that the difference between the remeasured liability and its previous carrying amount should be recognised immediately as a loss or gain in income.

Which of the two treatments do you support?

Theoretically under The New Approach, the gain or loss should be recognized over the remaining lease term as the lessee is getting the benefit over a period of time. However, this complexity is only the result of attempting to apply The New Approach. This whole area of valuing residual guarantees is problematic due to judgment involved and lack of readily available information on estimated future value of assets. Consistency and comparability will suffer.

Question 10:

Chapter 5 (paragraphs 61-66) discusses the accounting where a renewal option is accompanied by a residual value guarantee. The Group's view as reflected in the Paper is that the concurrent existence of these two features in a lease should not give rise to the recognition of additional assets and liabilities (i.e. by anticipating the exercise of renewal options). An alternative view is that additional assets and liabilities should be recognised. What is your view?

To be consistent under The New Approach, assets and liabilities associated with renewal options should be recognized only if there is compulsion to renew or if the renewal represents a bargain. Residual guarantees are problematic under the asset / liability method. If the approach is to only record the value of the guarantee, it creates the problem of valuation of future values of assets with no ready published valuation source (e.g. a "blue book" of values). If you record the guarantee as a minimum lease payment, you are back to a risks and rewards type approach.

Question 11:

Do you agree with the recommendation in Chapter 6 relating to the discount rate that should be applied to the rental payments?

Yes. The lessee's incremental borrowing rate should be the discount rate except where there is an automatic transfer of the asset at expiry, a bargain purchase option, a compulsion to exercise a purchase option or where the implicit rate is known to the lessee. In those cases, the implicit rate in the lease should be the discount rate.

Question 12:

Chapter 7 discusses two approaches to accounting for sale and leaseback transactions. Do you agree with the Group's view as reflected in the Paper that a sale and leaseback should be accounted for as one transaction, with any gain restricted to that which relates to the rights that have not been retained by the lessee?

Yes.

Part III - Leases in the financial statements of lessors

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Question 13:

Do you agree with the general principle (Chapter 8) that a gain should be recognised at the beginning of the lease term if (a) there is evidence that the value of the lessor's assets (less its liabilities) has increased as a result of its performance in entering into the lease contract, and (b) the increase can be measured reliably?

Yes, as long as the lessor's cost or carrying value is less than the lessor's assets that result from entering the lease, a gain should be recognized at lease inception.

Question 14:

Do you believe that accounting standards should specifically restrict the recognition of a gain by a lessor at the beginning of a lease to the two circumstances described in paragraph 18 of Chapter 8?

Yes. Also, there should be no restrictions on who the lessor is. That is, the lessor does not have to be a manufacturer or a dealer.

Question 15:

Do you have any comments on the recommendations in Chapter 9 relating to disclosure of separate components of the lessor's assets?

Guaranteed residuals, whether guaranteed by the lessee, the seller or a third party should be considered a financial asset and included along with the rent receivable when presented on the balance sheet. The Group has a different view, but a guaranteed residual is a minimum lease payment as it is a financial obligation. This is the economic reality as the capital markets treat guaranteed residuals as rent receivables - they analyze the risk by studying the credit of the obligor, not the value of the leased asset.

Question 16:

What practical problems, if any, do you foresee with the recommendations in Chapter 10 relating to the initial measurement of receivable and residual interest assets?

Under The New Approach, either the cost or the fair market value should be the amount recorded on the lessor's balance sheet. If the fair market value is higher than the cost basis, a gain on sale should be recorded at inception. The implicit rate in the lease should be the rate to accrue earnings.

Question 17:

Chapter 11 discusses the treatment of optional features of leases and contingent rentals from the lessor's perspective. The Group's view is that it should be presumed that if a lease contract gives rise to a liability for the lessee (as discussed in Chapter 4) it will give rise to a corresponding receivable asset for the lessor.

(a) Where contingent rentals are a proportion of the lessee's revenues or profits derived from the leased property, the Group's view as reflected in the Paper is that if the minimum payments required by the lease are clearly unrepresentative of the value of the property rights conveyed by the lease, the lessor's initial receivable asset (corresponding to the asset and liability that is recognised by the lessee) should be a greater amount, reflecting the fair value of such rights.

An alternative view (corresponding to the alternative view of the appropriate lessee accounting noted in Question 6) is that the lessor should recognise a receivable asset of only the present value of the minimum payments required by the lease.

Which of the alternative approaches do you support, and why?

Under The New Approach, the alternate view is appropriate, as the contingent rents based on profits are unpredictable. Recording an estimate seems inconsistent with the Group's view that one should not assume an option would be exercised

(b) *Where contingent rentals vary in line with prices, the Group's view as reflected in the Paper is that estimates of future price changes should be reflected in the receivable asset recognised by the lessor.*

An alternative view (corresponding to the alternative view of the appropriate lessee accounting noted in Question 7) is that only the existing level of rentals should be reflected in the receivable asset that is recognised by the lessor at the beginning of the lease.

Which of the alternative approaches do you support, and why?

Under The New Approach, the alternate view is appropriate, as future prices are unpredictable. Recording an estimate seems inconsistent with the Group's view that one should not assume an option would be exercised

Question 18:

Chapter 12 discusses three alternative views on how a lessor's residual interest asset should be measured and accounted for during the lease term. Do you agree with the Group's view as reflected in the Paper that the initial carrying amount (measured at the present value of the estimated residual value at the end of the lease) should be accreted over the lease term by 'unwinding' the discount?

Yes. In practice, lessors record a conservative residual value, considering the risk of decline in value as well as the cost to sell the asset. The accretion rate should be the implicit rate in the lease.

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Part IV - Other issues

Question 19:

Do you agree with the recommendation in Chapter 13 that lessors of land and buildings should report as separate assets in their balance sheets the amount of their investment that represents lease receivables, and that which represents their interest in the residual value of the property, and that the finance income for the lease receivables and changes in the interest in the residual value should be reported separately? If not, what alternative treatment would you favour and why? Do you agree that information on fair values should be preserved?

Although the ELA membership is comprised of companies engaged primarily in equipment leasing, a number of our members also invest in real estate rental properties. It appears to ELA that attempts to impose the New Approach on lessors of multi-tenant properties (e.g., high rise office buildings and shopping centers) would create a nightmarish bookkeeping problem while providing no more useful information than is currently available in such lessor's financial statements and footnotes.

Virtually every lease other than the first leases of a newly acquired property will include a holding period profit or loss element that would have to be estimated and reported. Quite apart from the difficulty of making reliable estimates of the future value of a single floor or portion of a floor in a larger property, the estimates of retained and "sold" residual interests at fair value for numerous tenants leasing portions of the facility for different terms beginning and ending at different points in time will produce reported balance sheet and income statement amounts that are arbitrary, substantially unverifiable and of dubious usefulness for any sort of rational analysis or decision making by users of the financial statements.

Lessors of real property in transactions that are not essentially financing arrangements should record the asset with or near property, plant and equipment as they are now. Leases that are essentially financing arrangements should be reflected in balance sheets as such. For the latter class of transactions, the balance sheet classification should combine rent receivables with guaranteed residuals. Any unguaranteed residual should be reported separately. Any write up or write down of residual values should be reported as a separate item on the income statement.

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