EQUIPMENT LEASING & FINANCE FOUNDATION
Your Eye On The Future

FASB

Changes to Lease Accounting:

Rules, Reactions and Realities

The Foundation is the only research organization dedicated solely to the equipment finance industry.

The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

The Foundation research is independent, predictive and peer-reviewed by industry experts. The Foundation is funded solely through contributions. Contributions to the Foundation are tax deductible.

Equipment Leasing & Finance Foundation
1825 K Street • Suite 900
Washington, DC 20006
www.leasefoundation.org
202-238-3400

Foreword

The equipment leasing and finance industry has lived with the specter of new lease accounting rules for many years, with some wondering if they actually ever would occur. That question was definitively answered in mind-numbing fashion when, in August 2010, the Financial Accounting Standards Board issued its Exposure Draft on lease accounting.

The question as to why these proposed lease accounting rules are needed still remains unanswered in the minds of many, as they reduce existing guidance and transparency and introduce new levels of estimation and interpretation. One lessee that Alta surveyed summed up this concern well when he said “My biggest issue is that it is a lot of additional accounting work without any true benefit to the investment community.”

Lessors also are concerned with the changes as they expect, not unreasonably, a reduction in the level of equipment leasing. The reporting results under the new rules also have raised concerns, as there is a disconnect between the economics of the transaction and the accounting, such as with the elimination of residual accretion. Additionally, the lease income under the new rules can be front-loaded or back-loaded, depending on the lease.

The fact remains, however, that the rules are changing, which means that lessors must understand the changes, how they work, and the effect of the rules on their business. This Study is intended to assist in this process. As you read the Study, however, it is important to recognize the changes in the lease accounting rules for what they are – changes to the financial reporting, and not the economics of leasing.

Still, these changes impact more than just the accounting for the leases. They also have wide-ranging effects on the leasing industry, thereby making it very important not to lose sight of the business side of these new rules. In Alta’s view, those lessors that are proactive, rather than reactive, in addressing the proposed changes will be rewarded in the marketplace.

John Deane
Senior Managing Director

The Alta Group℠

Problem Statement

The Equipment Leasing & Finance Foundation expects the upcoming changes to the lease accounting rules to impact both the balance sheets and operations of not only companies that utilize lease financing as a component of their equipment procurement strategies (lessees), but also providers of lease financing (lessors). And, while the full extent of how the new rules will affect the equipment leasing and finance industry is still uncertain, it is expected that they will result in changes to how users of equipment view the lease alternative and how lessors approach the market.

In this respect, the Foundation is concerned with how the lease accounting changes will:

- Affect customers' propensity to lease
- Alter the attractiveness of lease financing.
- Modify customers' approach to lease transactions
- Change how lessors develop and market financial products
- Impact lessor and lessee business processes and related portfolio management systems.
- Influence lessor business models and ownership structures
- Affect equipment leasing and finance providers' decisions to remain in the market or encourage new entrants to replace them

The Foundation believes the most appropriate way to address these concerns and issues is through a study that incorporates a combination of research, analysis, constituent contact, and strategic thought leadership. This study will aid the readers by helping them understand the changes to the lease accounting rules, recognize the market impact of the changes, and identifying the challenges and opportunities they represent.

Table of Contents

Executive Summary

The Exposure Draft (ED) addresses both lessee and lessor accounting but excludes transactions that are considered in-substance purchases. There are no exclusions for small-ticket leases or noncore assets, however. Lessees must capitalize all leases at the present value of the payments, based on estimates of the most likely term and contingent rents.

This capitalization will impact lessee financial statements and performance metrics, resulting in a decline in leasing for those customers that focus solely on off balance sheet financing. The requirement to assess the most likely lease term could result in additional declines in volume, although lessee responses to this rule indicate otherwise, meaning that lessors must continue to emphasize the many other benefits of leasing. Lessors must educate their sales forces on the accounting changes so they can answer questions, address customer concerns, and identify opportunities, such as those for lessees that emphasize EBITDA.

The lessor accounting products of FAS 13 are replaced by performance obligation leases and derecognition leases. The distinction between the two leases is based on whether the lessor retains exposure to significant risks or benefits in the leased asset. Lease income under the new rules is either more uneven, volatile, front-loaded, or back-loaded than under the current rules, depending on the lease type and transaction. This economic/accounting divergence is evident not only in income recognition, but also in other areas, such as residual management. Residual accretion is no longer allowed, but sales-type revenue recognition is available in derecognition leases.

The operational burden faced by lessors increases under the proposed rules, emphasizing the importance of the lessor's software applications and associated vendor support. New capabilities also will have to be created and integrated. In this regard, lessors will have to determine whether the enhancements required by the new rules represent system maintenance, or if they are additional costs.

Since the proposed changes require estimates and interpretations to book the lease, the lessor's ability to utilize workflows, flexible configuration, and rules engines will be an important element of conforming the lease management system to the new rules. Lessors will need to maintain open communications and dialogue with their lease system providers in order to avoid these problems.

The proposed changes are not the knockout punch that many expected, as lessees will continue to focus on the many other benefits of leasing. Lessors will have to act proactively, however, if they are to remain competitive in the new environment.

Project Background

The new lease accounting proposals certainly represent a change in direction for lease accounting, but the notion that changes to lease accounting are a new phenomenon is far from the truth. The approach to lease accounting, which has vexed standard setters for decades, has changed several times over the years. Although the issuance of the Exposure Draft for Leases (ED) in August of 2010 is seen by many as a new stage in the process, it is, in reality, just one more step in what has been a long and arduous slog over the best way to account for leases.

Past Lease Accounting

Lessees traditionally treated most of their leases as operating. As the nature and breadth of lease products changed, however, accounting theorists postulated that operating lease accounting was not appropriate for long-term leases that were, economically, financing agreements. Their position was codified in 1949 in Accounting Research Bulletin No. 38, *Disclosure of Long-term Leases in Financial Statements of Lessors*, which required financing leases to be recorded by the lessor as long-term receivables. Consistency in application then required the lessee to recognize a leased asset and a long-term liability.

Although many found this approach to be conceptually sound, relatively few entities accounted for leases in this manner. Because capitalization was not required by GAAP, lessees continued to take advantage of off balance sheet reporting, resulting in an increasing amount of footnote disclosure about lease terms and obligations during this period. The result was what is known in the accounting industry as widespread diversity in practice.

The substantial increase in leasing, driven by the rapid growth of tax-oriented, true leases in the 1960s and early 1970s further accentuated the wide array of accounting alternatives used by both lessees and lessors. In response to this diversity, the Accounting Principles Board (APB) issued Opinion No. 5, *Reporting of Leases in Financial Statements of Lessees* (1964). This pronouncement was followed shortly thereafter by Opinion No.7, *Accounting for Leases in Financial Statements of Lessors* in 1966).

Each of these opinions specified conditions under which a lease should be accounted for as a financing. Opinion No. 5, for instance, required a lessee to capitalize a lease if it contained a nominal purchase option, much like FAS 13 and the ED. Accounting for leases still was not uniform or consistent, however, as both Opinions 5 and 7 used different criteria for identifying financing leases of lessees and lessors.

Other pronouncements subsequently were promulgated in attempts to further clarify accounting for lease transactions, including one on accounting for leases by manufacturer or dealer lessors (1972), and another on the disclosure of lease commitments by lessees (1973). Although these opinions represented a significant move in the direction of theoretical precision in accounting for leases, they still, for a variety of reasons, presented a number of practical problems.

The SEC brought the matter to a head in 1973 by bringing pressure on the newly formed Financial Accounting Standards Board (FASB) to establish comprehensive lessee and lessor accounting rules. After issuing several exposure drafts and considering a multitude of comment letters, position papers, and oral presentations from interested parties, the FASB issued Statement of Financial Accounting Standards No. 13, *Accounting for Leases* (FAS 13) in 1976.

FAS 13 substantially changed the accounting treatment of lease commitments. At the time they were issued, the new rules of FAS 13 were viewed not only as quite a drastic step, but also as the final chapter in properly accounting for lease transactions.

The Lease Accounting Project

FAS 13 has been amended multiple times since 1976, however, and is one of the most complex accounting standards. The primary complaint against the FAS 13 model has been that operating lease accounting does not provide investors with a true picture of an entity's financial obligations. It is this perceived off balance sheet "loophole" that once more opened up the debate as to whether the current lease accounting rules are adequate.

This concern came to a head in 1996 with the issuance of *Accounting for Leases: A New Approach – Recognition by Lessees of Assets and Liabilities under Lease Contracts* (the McGregor Report). The McGregor Report, which espoused capitalization of all leases, created quite a stir at the time, and also planted the seeds that led to the decision of both the FASB and the International Accounting Standards Board (IASB) to reconsider the existing standards for lease accounting.

This decision was given additional impetus due to the FASB/IASB joint undertaking to converge US accounting rules with the international accounting standards. After embracing the 'new' approach, the IASB, in conjunction with the FASB, issued a Discussion Paper in 2009 proposing that lessees capitalize all leases on their balance sheets.

The ED, which represents the Boards' view of what the final lease accounting standard should look like, subsequently was distributed for public comment in August of 2010. Public comments can be made by anyone. The Equipment Leasing and Finance Association (ELFA) provides details on this process, along with extensive topic resources, at http://www.elfaonline.org/ind/topics/Acctg/ for those interested in responding to the FASB regarding the content of the ED.

Exposure Draft Elements

Most of the concerns associated with the existing lease accounting model relate to the financial statement treatment of operating leases by lessees and the bright-line tests used to classify them. The ED, however, addresses both lessee accounting and lessor accounting, as the FASB believes that keeping the existing lessor guidance would be not only inconsistent with the proposed lessee accounting and the FASB's approach to revenue recognition.

The basic premise of the ED is that lessees and lessors are to apply a right-of-use model to account for all leases within its scope. Under this model, the lease contract is the unit of account and lessors and lessees account for the rights and obligations created by that contract. Although, the proposed requirements are intended to standardize the lease accounting process, they will add more complexity and processes to both lessor and lessee accounting. They also take a widely recognized industry, tax, and legal concept (the lease) and segment it into three potential accounting distinctions, as illustrated in **Figure One.**

Figure One
Lease Segmentation

Each of these designations will be subject to different accounting rules. Furthermore, the distinction between product classifications will be based primarily on individual company interpretations and circumstances. This focus on individual company circumstances is a paradigm shift for US accounting standards that, in the past, have outlined specific rules and accounting guidance.

This is not the case with international accounting standards, however. Whereas, US generally accepted accounting principles are very detailed in their guidance, as is shown in **Figure Two**, the international standards tend to provide only a general framework on how to account for transactions. It is interesting to note, that, in spite of the FASB's discomfort with the FAS 13 classification tests, all the tests are retained in one form or another in the ED.

Scope

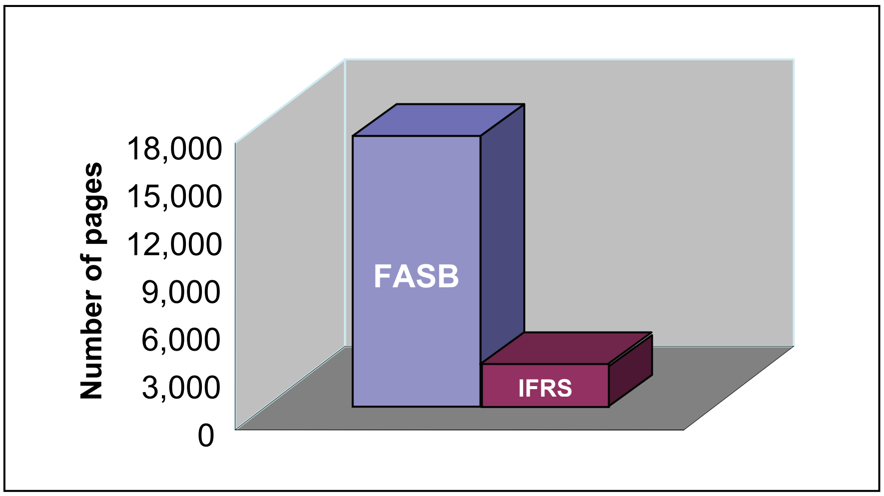
The ED applies to leases of property, plant and equipment, but specifically excludes:

- Leases of intangible assets

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
- Leases of biological assets.

Although the possibility of excluding noncore assets from the new requirements was discussed during the deliberative process, they are subject to the leasing rules under the ED.[i] Leases that represent financed purchases, however, are excluded from the scope of the proposed standard, which means that, although the four criteria of FAS 13 have been eliminated, both lessors and lessees still must run similar tests to determine if the transaction even qualifies for lease accounting.

Figure Two
FASB/IFRS Guidelines Comparison



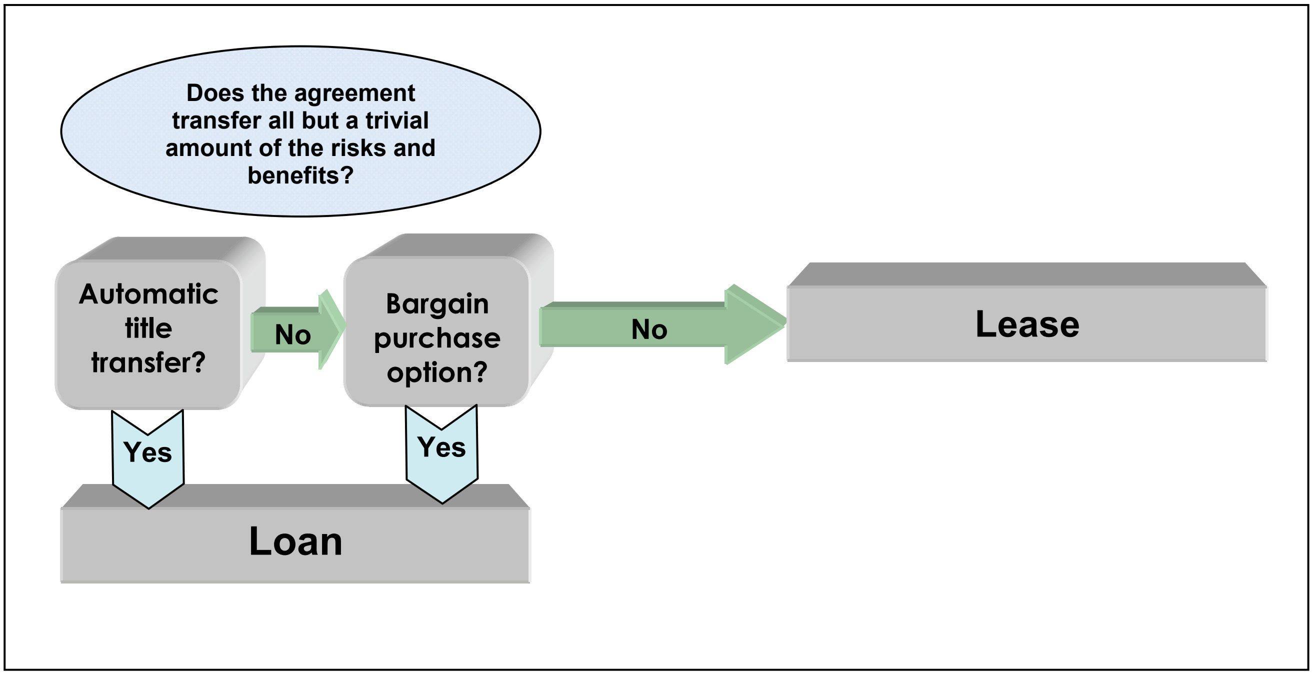
If, for example, the agreement transfers all but a trivial amount of the risks and benefits associated with the underlying asset, it is not a lease and, therefore is not subject to the lease accounting rules. Generally, an agreement transfers control of the asset if there is an automatic transfer of title or a bargain purchase option, as illustrated in **Figure Three**.

The service component of a bundled leasing arrangement is not subject to the lease accounting rules either, if the service component is distinct. If the service component is not distinct, then the entire payment is subject to the leasing rules and will be capitalized by the lessee or shown as a right to receive payments by the lessor.

Lessees

The proposals require all leases to be capitalized on the lessee's balance sheet as a right-of-use asset (representing the lessee's right to use the leased asset) and a corresponding liability (representing its obligation to pay rents). The right-of-use asset is considered an intangible asset. For purposes of the Study, the lessee accounting rules are presented in three segments – initial measurement, subsequent measurement, and reassessment.

Figure Three
Lease/Loan Decision



Initial measurement

A lessee must book a right-of-use asset, along with a corresponding liability when it enters into a lease. The liability, or obligation to pay rents, is recorded at the present value of the lease payments over the most likely term. The rents are discounted at the lessee's incremental borrowing rate or the rate the lessor charges the lessee, if it can be determined. This process is similar to booking a capital lease under FAS 13. Requiring the lessee to use the most likely lease term to capitalize the lease, however, is a new concept.

The right-of-use asset is booked at the amount of the liability to make lease payments, plus any initial direct costs. Lessee capitalization of initial direct costs is another wrinkle introduced by the ED. The lessee must make two determinations when computing the present value of the lease payments:

- The longest lease term most likely to occur
- The probability-weighted, expected payments.

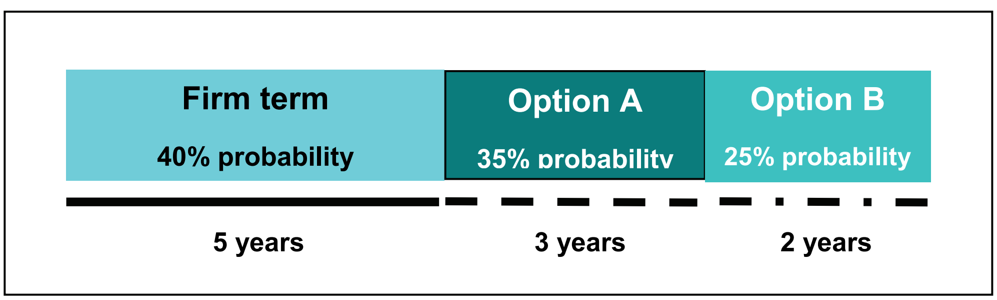
Lease term – The lessee determines the lease term by estimating the probability of occurrence for each possible term. Judgment and estimates are required to determine the term if the lease contains any options to extend or renew the lease, including automatic, or month-to-month, renewal provisions. All options must be considered and evaluated as to their likelihood of occurrence, which means the more options there are, the more effort is required to measure the term.

As part of estimating the lease term, a lessee must consider contractual factors such as the level of payments in the renewal periods (e.g., bargain or fair market value), any contingent rents, option penalties, residual value guarantees, and the costs associated with returning the equipment in a specified condition or to a specified location.

The lessee also must take into account noncontractual factors. These factors include things such as local evergreen rent regulations, significant leasehold improvements, relocation costs, costs of lost production, and tax consequences. Business factors, the lessee's intentions, and its past practices also should be considered.

When assessing the longest possible term more likely than not to occur, the lessee must consider the cumulative probability of the possible terms occurring. Once that cumulative probability exceeds 51%, the sum of those possible terms is considered the term for booking the lease. The example in **Figure Four** is used to illustrate this concept.

Figure Four
Lease Term Analysis



Based on contractual and noncontractual factors, business issues, and the lessee's past practices and intent, the lessee has assigned appropriate probabilities of occurrence for each of the potential terms. An analysis of Figure Four shows that there only is a 40% chance the term will be five years.

There is a cumulative probability of 75%, however, that the term will be eight years (the 5-year firm term plus the 3-year Option A term). This 75% probability represents the firm term probability of 40% plus the Option A probability of 35%. Since this cumulative probability is greater than 51%, the lease term in this example is eight years, as this is the longest possible term more likely than not to occur.

Lease payments – The payments anticipated over the estimated lease term will constitute the rents for determining the present value of the lease payments in most cases. There are situations, however, when, a lessee may have other potential obligations outside of those associated directly with the lease term. Such obligations include, for example, contingent rents, term option penalties, restocking fees, and residual value guarantees.

The lessee must include the expected outcome of these other potential payments, in addition to the rents over the estimated term, when present valuing the payments. The expected outcome is the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes (i.e., not every outcome must be considered). **Table One** is an example of a hypothetical analysis of the expected outcome of payments.

Table One

Expected Outcome Analysis

Outcome	Uses	Cost	Probability	Weighted outcome
1	5,000	$ 0.06	15%	45
2	7,500	0.06	25%	113
3	10,000	0.08	35%	280
4	12,500	0.10	10%	125
5	15,000	0.10	15%	225
			Expected payment	**788**

The expected payments are then present valued. If the contingent rents depend on an index or a rate, the lessee is expected to consider forward rates or indices in determining the rents. If forward rates or indices are not readily available, the lessee uses prevailing rates or indices. Residual value guarantees provided by an unrelated third party are not lease payments, nor are the exercise prices of purchase options.

Subsequent measurement

Once the right-of-use asset and obligation are capitalized, the lessee must amortize the asset and obligation over the estimated term of the lease, which, again, is very similar to the capital lease treatment of FAS 13. Since the right-of-use asset is considered an intangible asset, however, it will be amortized, rather than depreciated, over the estimated term. The obligation is amortized to interest and principal over the estimated term, using the interest method.

Assume the payment for the firm term illustrated in Figure Four is $200, and the payment for renewal option A is $100. Given an incremental borrowing rate of 8%, the present value of the obligation to make payments over the 8-year term would be $973.93. The right-to-use asset and obligation in this example would be amortized as shown in **Table Two**.

Table Two

Asset/Liability Amortizations				
Year	**Right-of-use Asset**		**Obligation to Pay Rent**	
	Amortization	*Balance*	*Interest*	*Balance*
0		973.93		973.93
1	121.74	852.19	77.91	851.85
2	121.74	730.45	68.15	720.00
3	121.74	608.71	57.60	577.60
4	121.74	486.97	46.21	423.81
5	121.74	365.23	33.90	257.71
6	121.74	243.48	20.62	178.33
7	121.74	121.74	14.27	92.59
8	121.74	0.00	7.41	0.00

Lessees are to present the liabilities to make lease payments separately from other financial liabilities in the balance sheet. They also are to present the right-of-use assets as if they were tangible assets within property, plant, and equipment. The lessee's right-of-use assets must be shown separately from the assets that it does not lease, however.

Similarly, the amortization expense related to the right-of-use asset and interest expense on the liability to make lease payments must be presented separately from other amortization and interest expense, either in the income statement or in the footnotes to the financial statements. The lessee must classify cash payments for leases as financing activities in the statement of cash flows and present them separately from other financing cash flows.

Reassessment

The lessee determines its initial obligation to make payments by estimating the most likely lease term and assessing the probability of making other payments, such as contingent rents. This obligation may be required to be adjusted in subsequent periods under the proposed rules. In this regard, if, based on new facts or circumstances that indicate there would be a significant change in the liability to make lease payments, the lessee is required to reassess, at each reporting date, which outcome it considers most likely to occur.

Lessors and lessees may have different information on the likelihood of an option being exercised, or future contingent rents becoming due, particularly as the lease progresses. As a result, they may reach different conclusions about what is the most likely outcome at that point in time. If there has been a change to the estimated term or expected rents, the liability must be adjusted.

The original discount rate in the transaction is used to present value the new expected lease payments. Changes to the lease obligation due to revised estimates of the lease term are reflected in the right-of-use asset. Those changes arising from updated expectations about contingent rents or residual value guarantees, however, may flow through profit or loss depending on whether they relate to current, past, or future periods.

Using the example of Table Two as the base case, further assume that, at the end of the second year, the lessee determines it will not exercise the renewal option at the end of the 5-year firm term, due to a significant change in its market. Since this change in the lessee's liability to make payments is the result of a change in term, it is reflected in the right-to-use asset, as shown in **Table Three.**

The ED requires the lessee to assess the right-of-use asset for impairment each period. How this is to be accomplished is very unclear at this time, however. For example, paragraph 24 of the ED states that the lessee should test for impairment using the guidance for intangibles, whereas the FASB, in the Basis for Conclusions section of the ED, suggests that impairment should be measured using the guidance for long-lived assets. To further complicate the matter, one also could argue for using the impairment tests that are outlined in the business combination guidance.

Table Three

Reassessment – Lessee			
	Present value of remaining 4 payments	**Balance (end of year one)**	**Required adjustment**
Obligation to pay rent	662	(852)	(190)
Journal Entry			
		Debit	*Credit*
Obligation to pay rent		190	
	Right-of-use asset		190

Lessors

The proposals completely revamp lessor accounting by eliminating the direct financing, operating, and sales-type lease designations, although they remain in concept. Leveraged leases, on the other hand, are completely eliminated from the lease accounting literature. The ED replaces these familiar accounting products with two new concepts – performance obligation leases and derecognition leases.[ii]

Although they do not match up exactly, **Table Four** provides a general correlation between the proposed product designations and those of FAS 13. The proposed lessor accounting rules are presented in four segments for purposes of the Study – recognition, initial measurement, subsequent measurement, and reassessment.

Recognition

The ED requires lessors to classify the lease as either a performance obligation lease or a derecognition lease. Performance obligation accounting is required for leases in which the lessor retains exposure to significant risks or benefits associated with the leased asset. These risks or benefits can occur (1) during the expected term of the lease, or (2) after the expected term of the lease, if the lessor has the expectation or ability to generate significant returns by re-leasing or selling the leased asset.

Table Four

Lessor Product Correlation	
ED product	**FAS 13 product**
Performance obligation lease	Blend of: - direct financing lease - operating lease
Derecognition lease	Direct financing lease Sales-type lease
Short term lease	Operating lease
Not retained	Leveraged lease

Figure Five illustrates the decision process whether the lease is classified as a performance obligation lease, based on whether the lessor retains significant risks and benefits of the asset. The lessor applies the derecognition approach to the lease if it does not retain any significant risks or benefits associated with the leased asset. This classification does not change after the inception of the lease.

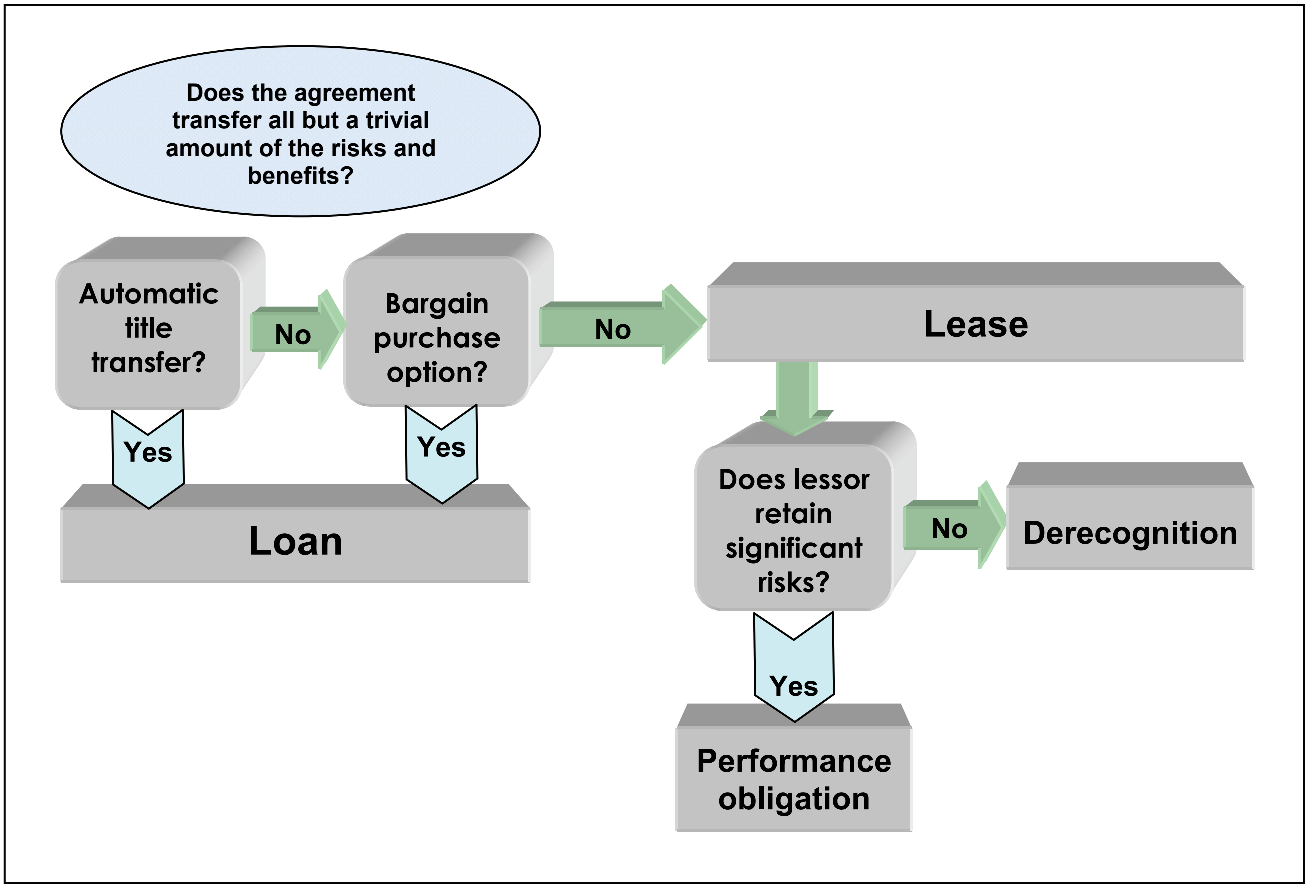
Factors that may indicate the lessor retains significant risk during the term of the lease include significant contingent rentals during the lease term that are based on the use or performance of the asset, options to extend or terminate the lease, and material non-distinct services provided under the current lease.

The following factors are considered when determining exposure to significant risks and benefits after the expected term of the lease:

- ♦ Whether the duration of the lease term is significant in relation to the remaining useful life of the underlying asset (on a conceptual basis, think of the 75% test of FAS 13).
- ♦ Whether a significant change in the value of the leased asset at the end of the term is expected. In making that assessment, lessors should consider the present value of the residual (on a conceptual basis, think of the 90% test of FAS 13).

The ED points out that the existence of one or more indicators is not conclusive in determining whether the lessor retains significant risks or benefits, and that the credit risk of the lessee is not to be considered when determining risks for purposes of classifying the lease.

Figure Five
Lease Classification



Initial measurement

How the lease is booked by the lessor will depend on whether it is classified as a performance obligation lease or a derecognition lease.

Performance obligation leases – Under performance obligation accounting, the lessor records a right to receive payments, plus any initial direct costs that it incurs. The right to receive payments is equal to the present value of the lease payments, discounted at the rate the lessor charges the lessee, which may be, for example, the lessee's incremental borrowing rate, the rate implicit in the lease or, for property leases, the yield on the property. The underlying leased asset remains on the balance sheet.

Although a residual is recorded with the right to receive payments in a direct financing lease, there is no separate residual value in a performance obligation lease. The lessor also records a liability at the amount of the right to receive payments in a performance obligation lease.

This liability, which is another new lease accounting concept, represents the lessor's obligation to perform under the lease. Although not specifically addressed, ***it is assumed that any gross margin in manufacturer and dealer performance obligation leases will be spread over the expected term of the lease.*** The balance sheet components of a hypothetical performance obligation lease at the inception date are shown in **Table Five.**[iii]

Table Five

Hypothetical Balance Sheet			
Assets		**Liabilities**	
Leased asset	$100	Debt	$88
Right to receive payments	90	Equity	12
Performance obligation	(90)		
Total assets	$100	Total debt and equity	$100

The lessor must make two determinations when computing the present value of the lease payments, just the same as the lessee. These two determinations are:

- The longest lease term most likely to occur
- The probability-weighted expected payments.

The lessor determines the lease term by estimating the probability of occurrence for each possible term. Judgment and estimates are required to determine the term if the lease agreement contains any options to extend or renew the lease. All options must be considered and evaluated as to their likelihood of occurrence.

As part of estimating the lease term, a lessor must consider contractual factors such as the level of lease payments in any renewal period, contingent rents, term option penalties, return provisions, and residual value guarantees. Noncontractual factors, such as local evergreen rent regulations, economic compulsion, tax consequences, and the lessee's past practices also should be considered.

Assume, for example, that a lessor enters into a 48-month lease**.** Based on the lessee's past practices, the lessor determines that it is more likely than not that the lessee will pay an additional three months of rent under the contract's automatic renewal clause. Based on these facts, the lease term in this example is 51 months.

Derecognition leases – Derecognition accounting requires the lessor to record a right to receive payments, plus any initial direct costs incurred by the lessor. The right to receive payments is equal to the present value of the lease payments, discounted at the rate the lessor charges the lessee. A residual asset is recorded as an allocated amount of the leased asset.

The lessor offsets, or nets, the right to receive payments against the leased asset in what is called derecognition. The amount offset by the lessor is the carrying amount of the leased asset multiplied by the quotient of the present value of the right to receive lease payments and the fair value of the underlying asset at the inception of the lease.

There is no residual value in a derecognition lease, at least not in its form under FAS 13. The allocated residual asset is the net of the lessor's right to receive payments (the amount derecognized) and the book value of the leased asset. There is some indication in the ED that the residual asset may even be considered an intangible asset. ***Residual income is not accreted over the lease term in a derecognition lease,*** but, instead, remains frozen at the allocated amount over the term.

The ED proposes that up-front revenue recognition on equipment sales be allowed in a derecognition lease. The lessor recognizes lease income (the present value of the lease payments) and lease expense (the cost of the portion of the underlying asset that is derecognized) at the commencement of the lease. The lessor classifies the lease income as revenue and the lease expense as a cost of sales, if the lessor, such as a captive, also is in the business of selling equipment.

The up-front revenue recognition, and residual asset allocation, can be illustrated by a derecognition lease with payments of $1,361, in arrears, the expected term of which is 6 years. The equipment has a fair value of $7,000 and a cost of $5,000. The sales revenue in this lease is the present value of the lease payments discounted at the implicit rate of 8%. The sale revenue and cost of goods sold are shown in **Table Six.** The residual asset would be recorded at $506, and also is shown in Table Six.

Table Six

Revenue Recognition and Residual Asset		
Sales revenue	6,291	PV of lease rents
Cost of goods sold	(4,494)	([6,291÷7,000] x 5,000)
Gross margin	**1,797**	
Residual asset	**506**	(5,000 – 4,494)

Subsequent measurement

A lessor recognizes the following items in the income statement for a **performance obligation lease**:

- Interest income on the right to receive lease payments
- Lease income as the performance obligation is satisfied
- Depreciation on the leased asset.

Table Seven illustrates how the income would be allocated in a performance obligation lease, using the previous, 6-year example.

For **performance obligation leases**, lessors are to present the leased assets, rights to receive lease payments, and lease liabilities as either a net lease asset or a net lease liability in the balance sheet. The interest income on rights to receive lease payments, income from satisfaction of lease liabilities, and depreciation expense on the leased assets are to be shown separately, and in total. The cash receipts from lease payments are classified as operating activities and shown separately from other cash flows in the statement of cash flows.

The income recognized over the term in a **derecognition lease** is the interest income on the right to receive lease payments. **Table Eight** illustrates the finance income for the derecognition lease, based on the same 6-year example used for the performance obligation lease. Notice that there is no residual accretion under derecognition leases. Instead, the residual income is recognized when the residual is realized, as shown in year six of Table Eight. **Table Nine** compares the income allocation over the term of the performance obligation and derecognition leases.

Table Seven

Performance Obligation Income				
Year	Interest	Performance obligation	Depreciation	Financing margin
1	503	1,049	(979)	573
2	435	1,049	(979)	504
3	361	1,049	(979)	430
4	281	1,049	(979)	350
5	194	1,049	(979)	263
6	101	1,049	(979)	170

Table Eight

Derecognition Income			
Year	**Interest income**	**Residual income**	**Total income**
1	503	0	503
2	435	0	435
3	361	0	361
4	281	0	281
5	194	0	194
6	101	416	517

For **derecognition leases**, lessors are to present the rights to receive lease payments separately from other financial assets, and present residual assets separately within property, plant, and equipment. Any assets arising from subleases also are identified separately. The lease income and lease expense are shown in the income statement either in separate line items or net in a single line item.

Table Nine

Lease Income Comparison			
Year	**Performance obligation**	**Derecognition**	**Difference**
1	573	503	69
2	504	435	69
3	430	361	69
4	350	281	69
5	263	194	69
6	170	517	(347)
Total	2,290	2,290	0

The presentation of the income should reflect the lessor's business model. For example, manufacturers would present revenue and cost of sales, consistent with current sales-type lease treatment, along with interest income on the right to receive lease payments. Independents and bank lessors would present interest income from rights to receive lease payments as a single line item. The cash receipts from lease payments are classified as operating activities and shown separately from other cash flows in the statement of cash flows.

An intermediate lessor presents the liability to make lease payments under a head lease separately from other assets and liabilities arising from the sublease. It also presents the right-of-use assets, rights to receive lease payments, and lease liabilities as a net lease asset or a net lease liability in the balance sheet.

Reassessment

The initial measurement of performance obligation and derecognition leases is based on estimates of the lease term and the probability of payments such as contingent rents or lease option penalties. The carrying amount of these leases has to be adjusted in subsequent periods under the proposed rules if any new facts or circumstances indicate that there would be a significant change in the right to receive lease payments. The requirement forces the lessor to reassess, at each reporting date, which outcome it considers most likely to occur on the basis of those new facts.

For **performance obligation leases**, changes to the right to receive lease payments due to revised estimates of the lease term are reflected in the liability. Contingent rents and other payments are recognized in net income to the extent that the lessor has satisfied the related lease liability. If not, the change to the right to receive payments is an adjustment to the lease liability. The lessor can recognize any changes that reduce the liability below zero in net income, however. The original discount rate in the transaction is used to present value the new expected lease payments.

Assume that, at the end of the first year, the lessor in the 6-year example used throughout this section discovers new facts that indicate the most likely lease term is four years, rather than the six years it originally estimated. The current book value of the right to receive payments is $5,433, while the present value of the remaining payments is $3,507. Any long-term asset impairment is not considered in this example.

Table Ten illustrates the entry necessary to reflect the adjustment due to the change in the right to receive payments resulting from reassessing the performance obligation lease.

Table Ten

Reassessment – Performance Obligation			
	Present value of remaining 3 payments	**Balance (end of year one)**	**Required adjustment**
Right to receive rent	3,507	(5,433)	(1,926)

Journal Entry

		Debit	Credit
Performance obligation		1,926	
	Right to receive rent		1,926

The reassessment requirements for **derecognition leases** are more complex to apply. For these leases, changes to the right to receive lease payments due to revised estimates of:

- The lease term that result in changes to the residual asset are reflected in amounts derecognized, the residual asset, and, potentially, income, by incorporating the fair value allocation methodology used in the initial measurement of the lease
- Contingent rents and other payments are recognized in net income.

The 6-year example used to illustrate the performance obligation lease also can be used to show the effects of reassessment on the derecognition lease. As in the prior illustration, the lessor's review of new facts indicate that the most likely lease term is four years, rather than the six years it originally estimated. This example also assumes that the equipment's fair value at the point of reassessment is $5,850 and the residual asset is $506, as shown in Table Six.

The current book value of the lessor's right to receive payments is $5,433, while the present value of the remaining payments is $3,507. **Table Eleven** illustrates the entries necessary to reflect the adjustment due to the change in the right to receive payments resulting from the reassessment of lease term in this derecognition lease.

Table Eleven

Reassessment – Derecognition				
		Present value of remaining payments	**Balance (end of year one)**	**Required adjustment**
Right to receive rent		3,507	(5,433)	(1,926)
Journal Entry				
			Debit	*Credit*
Revenue			1,926	
Residual asset			167[A]	
	Right to receive rent			1,926
	Cost of goods sold			167
			[A] (506 x [1,926 ÷ 5,850])	

The ED requires the lessor to assess its right to receive payments for impairment each period under both the performance obligation and derecognition leases by applying Topic 310, *Receivables*. Although not explicitly proposed, it is assumed that the underlying leased asset in the performance obligation leases also will be tested for impairment under the guidance of Topic 360, *Property, Plant, and Equipment*. Any impairment losses on the leased asset are to be recognized in net income.

The ED also requires that the residual asset in derecognition leases must be evaluated for impairment. The methodology to accomplish this review is unclear at this time, however, as the ED proposes that lessors may apply either the intangible impairment tests of Topic 350 or the long-lived asset impairment tests of Topic 360 to determine whether the residual asset is impaired. Again, any impairment losses are recognized in net income.

Transition

The ED does not provide for grandfathering leases existing on the balance sheet as of the effective date of the changes. Consequently, all leases on the books as of the date of initial application must be evaluated as to estimated remaining lease term and restated. The date of initial application is the beginning of the first comparative period presented in the financial statements the first time the new rules are applied.

This means that, if the effective date is 2012, and the company is a registrant with the Securities and Exchange Commission, three years of comparative financial statements will be presented, including leases outstanding at the end of this year (2010). The effects of the restatement are to flow through each affected component of equity.

Lessees

At the date of initial application, lessees must recognize a liability to make lease payments for each outstanding lease. This liability is measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate on the transition date. The lessee also must recognize a right-of-use asset for each outstanding lease, based on the amount of the related liability to make lease payments.

Although technically required to be restated, capital leases that do not have options, contingent rentals, term option penalties, or residual value guarantees can be carried across at the existing carrying amount of the capital leased asset and liability. If there are any prepaid or accrued lease payments associated with uneven rents, the right-of-use asset is adjusted by those amounts. Any short-term leases can be recorded at the undiscounted amount of the remaining lease payments. The assets of certain sale-leaseback transactions will be put back on the balance sheet.

Lessors: performance obligation leases

At the date of initial application, the lessor must recognize a right to receive lease payments for each outstanding lease. This right is measured at the present value of the remaining lease payments, discounted using the rate charged in the lease determined at the inception date. The lease must be reviewed for impairment as part of the transition process.

The lessor also must recognize a lease liability for each outstanding lease, measured at the amount of the related right to receive lease payments and reinstate previously derecognized leased assets at depreciated cost. This net book value is determined as if the asset had never been derecognized, and, again, is subject to any adjustments required to reflect impairment.

Lessors: derecognition leases

At the date of initial application, the lessor must recognize a right to receive lease payments for each outstanding lease. This right is measured at the present value of the remaining lease payments, discounted using the rate charged in the lease at the inception of the lease. Impairment of the lease also must be considered. The lessor also must recognize a residual asset at fair value determined at the date of initial application.

"The assets of certain sale-leaseback transactions will be put back on the balance sheet."

Lessors: leveraged leases

At the date of initial application, the lessor must recognize a right to receive lease payments for each outstanding lease at the present value of the remaining lease payments. The payments are discounted using the rate charged in the lease determined at the inception of the lease. Impairment of the lease also must be considered.

The unamortized nonrecourse debt associated with the leveraged lease must be added back to the balance sheet. Depending on the classification of the transaction as either a performance obligation or derecognition lease, the lessor also must either recognize a lease liability and reinstate the previously derecognized leased assets, or recognize a residual asset.

Disclosures

The disclosure requirements of the ED are quite extensive. In general, both lessors and lessees must identify and explain the nature of their leases, including:

- A general description of those leases
- The basis and terms on which contingent rentals are determined
- The existence and terms of options, including renewal, termination, and purchase options
- Information about assumptions and judgments relating to amortization methods
- The existence and terms of residual value guarantees
- Initial direct costs
- The restrictions imposed by lease arrangements, such as those relating to dividends, additional debt, and further leasing.

Lessors and lessees are required to disclose information about significant assumptions and judgments relating to renewal options, contingent rentals, option penalties, residual value guarantees, and the discount rate used to present value the lease payments. The nature and amount of significant subleases, along with information about any short-term leases, also must be disclosed.

Beyond the general information regarding their leases, lessees specifically are required to disclose:

- A narrative about the options considered in recognizing right-of-use assets
- Information about the terms of leases that have not yet commenced if the lease creates significant rights and obligations for the lessee
- The terms and conditions of sale-leasebacks, including any gains or losses
- A reconciliation of the opening and closing balances of both the right-of-use assets and the liabilities to make lease payments
- A maturity analysis of the liabilities to make lease payments.

In addition to the general information regarding its leases, a lessor must also disclose:

- The existence and principal terms of any options for the lessee to purchase the leased asset.
- Information about the risks or benefits of leased assets used to classify leases as either performance obligation leases or derecognition leases
- Impairment losses, separately, for derecognition and performance obligation leases
- A reconciliation of the opening and closing balances for rights to receive lease payments, lease performance obligations, and residual assets
- Information about the nature and amount of each class of residual assets
- Information about the nature of significant service obligations related to the leases
- A maturity analysis of the right to receive lease payments.

Market Impact

Whenever there is a major transformation of the regulatory or compliance framework, there will be a market impact, and the current lease accounting changes will not be an exception. The question to be answered, therefore, relates to the magnitude of the impact.

This section of the Study identifies the potential consequences and challenges of the proposed lease accounting rules and examines what they mean for the equipment leasing and finance industry and its constituents. Many of the observations and conclusions drawn in this section are based on surveys and interviews of lessees, lessors, and service providers. Appendices Two through Five provide more details about this data gathering process.

Lessees

The proposed accounting changes will affect lessees in several ways, including the financial statement impact, the additional effort now associated with lease financing, and the concomitant effect on their financing decisions.

Off balance sheet financing

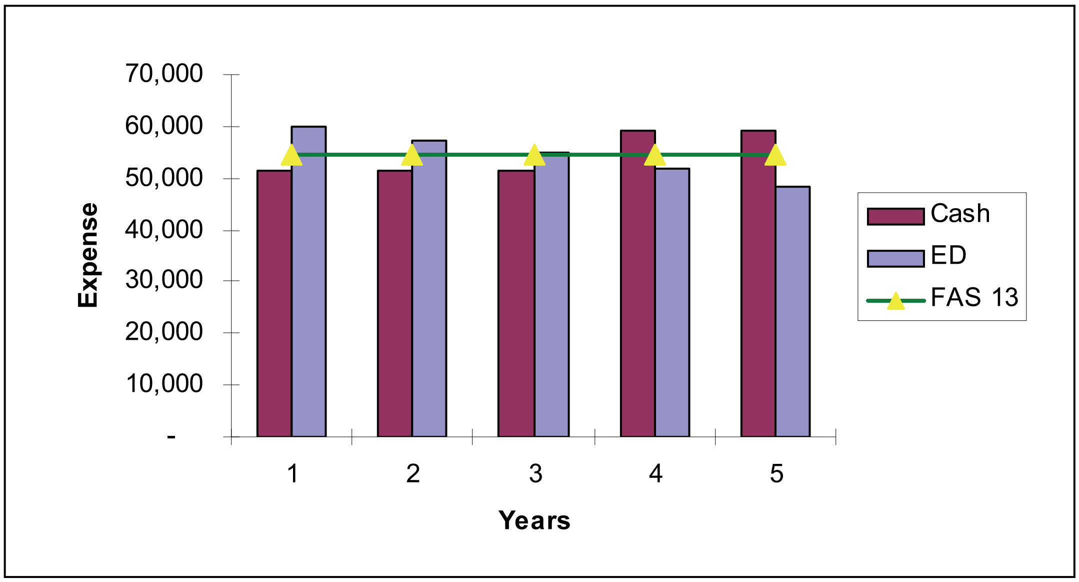
The requirement to capitalize the lessee's obligation to pay rents is the most widely recognized change in the ED. It also has been noted by the FASB as the driving force behind the overall changes. Although seen as a loss of a key leasing benefit by many, 81% of US CFOs and senior comptrollers that responded to a national survey conducted by Grant Thornton LLP,[iv] supported recognizing the obligation to pay rents in the balance sheet.

The new capitalization rules will increase the balance sheets of lessees that have operating leases. For some companies, these additional intangible and associated deferred tax assets may necessitate additional capital or create regulatory issues. The expense allocation under the new rules also is front-loaded since the cost of the lease is measured as amortization and interest expense, rather than as rent expense. **Figure Six** illustrates the differences between the cash rents paid, operating lease expense recognition, and the ED expense recognition for a 5-year forklift lease with a low-high payment structure.

The increased assets due to capitalization of rents, in combination with the requirement to recognize amortization and interest expense, will result in the deterioration in some key leverage and performance ratios. **Table Twelve** illustrates the differences between the lessee's ratios under FAS 13 and the ED. The example in Table Twelve is based on the above, 5-year lease and also assumes the lessee maintains a constant, underlying balance sheet and income statement on its other assets and activities.

Note that the EBITDA improves under the proposed rules due to the reclassification of the lease cost from rent expense to amortization and interest expense. The lease cost of amortization and interest expense now gets added back to net income in the EBITDA calculation whereas, under current rules, rent expense is not added back. ***Since EBITDA is a key valuation ratio for many companies, leasing will be viewed more favorably by this portion of the lessee market.***

Figure Six
Lease Expense Comparison



These reporting and measurement changes will occur even though the cash flows and business attributes of the transactions will not have changed. Furthermore, these measures can fluctuate between periods because of the ED's reassessment requirement. In addition to affecting overall company performance measures, the changes in these metrics also will impact bonding and loan covenants, government reimbursement policies, bonus calculations, and regulatory requirements.

Given the unfavorable financial reporting consequences of the new lease accounting rules, it is only natural to expect a reduction in the level of equipment leasing. It is interesting to note, though, that 68% of the respondents in the previously mentioned Grant Thornton survey said that a requirement to recognize lease obligations on the balance sheet would not cause them to change the way in which they finance operations.[v]

The Alta Group (Alta) also conducted a survey of lessees as part of this Study.[vi] A fairly consistent theme in the interviews was that, although the lessees had some knowledge of the accounting changes, they did not know the specifics.

And, of the information they had received, very little came from their lessors, with the majority of the information coming from accounting firms. **Table Thirteen** highlights some of the lessee survey results.

Table Twelve

Lessee Ratio Comparisons					
Return on assets		**Debt/Equity**		**EBITDA**	
FAS 13	*ED*	*FAS 13*	*ED*	*FAS 13*	*ED*
7.84%	6.35%	1.0/1	1.4/1	120,559	308,333
7.84%	6.74%	1.0/1	1.3/1	120,559	308,333
7.84%	7.18%	1.0/1	1.3/1	120,559	308,333
7.84%	7.66%	1.0/1	1.1/1	120,559	308,333
7.84%	8.24%	1.0/1	1.0/1	120,559	308,333

Since most lessees surveyed were just beginning to explore the proposed standards, there were very few that had established a plan, or even started to address the issues. Only one had determined the impact of reporting its existing leases under the new rules. Those lessees with a high percentage of real estate leases were monitoring the accounting more closely and were further along than equipment lessees in preparing to review and restate their operating leases.

Many of the lessees surveyed by Alta did not expect a material change in how their companies would be viewed if they capitalized the lease payments, since market participants already were converting operating leases into debt in their review of the financial statements. This was particularly true for lessee respondents from the construction industry.

These construction lessees, who frequently are required to be bonded for projects, did not believe the loss of off balance sheet financing would have a material impact on them. The respondents expected their operating lease commitments to be converted to liabilities as part of the bonding process.

Likewise, over 85% of the lessees contacted did not expect a material impact on their financial covenants, as most thought the rating agencies and lenders have been consistent in capitalizing operating lease rents. They did, however, expect that the new accounting rules would alter certain reporting and ratio requirements that will need to be discussed with their lenders. Those lessees with equipment and real estate leases expected any modifications to loan covenants to be made on the real estate side first, which would allow them to indirectly get up to speed on the equipment leases.

Table Thirteen

Selected Results – Lessee Survey			
	Yes	**No**	**Maybe**
The requirement to capitalize all leases will impact our leasing activities	**8%**	**92%**	**-**
The requirement to estimate the lease term and payments will change how we utilize leasing	**8**	**62**	**30**
We will seek shorter lease terms under the new rules	**46**	**31**	**23**
We expect to alter our utilization of renewal and purchase options	**46**	**23**	**31**
The requirement to reassess the lease term will change how we utilize leasing	**-**	**77**	**23**
The new rules will alter how we analyze, approve, and monitor our leases	**69**	**15**	**16**
We are prepared to implement the new rules	**8**	**92**	**-**
We have quantified the impact on our financial statements	**15**	**85**	**-**
The level of lessor communication regarding the changes has been high	**-**	**100**	**-**

Although the proposed rule changes certainly will have a negative impact on a specific segment of the equipment leasing market, ***the other key lessee motivations such as cash flow, tax issues, and flexibility still remain as significant volume drivers.*** The findings of the aforementioned studies reinforce this conclusion. Lessees in the Alta survey listed, among other factors, conservation of working capital, flexibility, and asset utilization as reasons to lease. Very few cited off balance sheet benefits as their primary motivation for leasing.

The potential decline in business associated with the proposed changes also must be viewed through the filter of overall leasing volume. What percentage of total leasing volume, for instance, does operating leasing represent? The Foundation's annual survey of leasing activity shows that, on average, operating leases account for roughly 10-11% of lessors' total volume. This number is lower than the actual volume of leases classified as operating when viewed from the lessee perspective, however, as lessors use residual value insurance to convert many of their operating leases into direct financing leases.[vii]

Additionally, partial off balance sheet financing is still available for leases in which the lessor takes a residual position. **Table Fourteen** shows the amount of the lease obligation that would be shown on the lessee's balance sheet for typical, fair market value leases of certain types of equipment. ***Lessors that offer residual-based products, therefore, will be able to create product differentiation through partial off balance sheet financing.***

Customer-focused lessors will view these changes as an opportunity to become more intimate with their customers by spending the time necessary to discern their true financing motivations. Lessors need to determine if, for example, a customer asking for an operating lease really is seeking off balance sheet financing, or is just using the term as a synonym for a fair market value or true lease.

Increased effort

Another apparent effect of the new proposals is the increased effort associated with using leasing. While the impact of the loss of off balance sheet financing applies to a very specific customer subset, the additional administrative burden of using leasing applies across the board. Furthermore, the additional effort required in the lease may shift financing decisions to other products such as loans.

This additional effort will come in the form of:

- Behavioral data capture
- Lease term estimation (both initially and subsequently)
- Associated processes and accounting policies
- Increased asset and liability tracking
- Lease management system upgrades and implementations
- Service component distinctions
- Additional internal controls
- Initial direct cost determinations
- Tax compliance

The responses to Alta's survey questions about the extra effort required to estimate the lease term was mixed. Some lessees stated that they monitored their leases closely and currently did not pay renewal or evergreen rents beyond the base lease term, making this requirement a moot issue. Others said that it would cause them to reconsider, although not necessarily avoid, using equipment leasing.

Table Fourteen

Lease Obligation			
	Loan	**Operating lease**	**New rules**
IT	100.0	0	92.7
Forklifts	100.0	0	85.4
Industrial	100.0	0	63.5
Transportation	100.0	0	54.6
	400.0	0	296.2

In terms of extra effort, the financial statement transition to the proposed standards will prove to be particularly incommodious, as the ED requires both lessees and lessors to apply the new standard to their leases existing at the date of initial application. Consequently, lessees not only will have to accumulate data on all of their leases, but also assess estimated lease terms and the expected outcome of contingent rents, etc. This effort, for many, will be monumental, as leases, even at larger companies, oftentimes are tracked on Excel spreadsheets across many different locations.

Other consequences

The shift to the proposed standard also will have other consequences, although of lesser magnitude than those just discussed. Several of these relate to lessee market behavior, as 69% of the lessees surveyed indicated that the new rules will change how they analyze and approve equipment leases. These changes will include shifts in the level of decision making and approval, decreased end-of-term options, shortened lease terms, modified lease documentation, and changes in sale-leaseback activity. Lessees also will have to begin assessing and capturing initial direct costs, and conducting impairment reviews on their right-of-use assets.

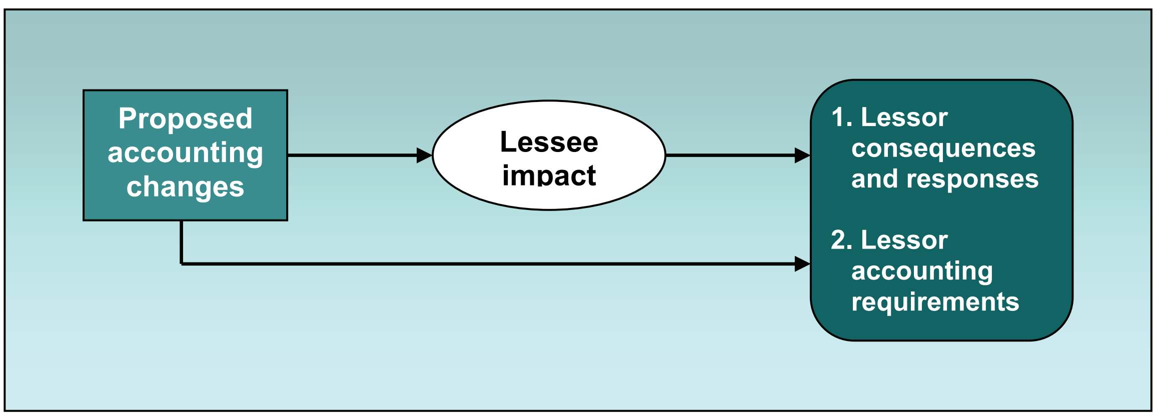
Some of the potential market behavior shifts that lessees may consider making will have to be assessed in terms of economic costs and benefits. Choosing to enter into a shorter term lease to minimize the balance sheet impact, for example, will increase the economic cost, both in terms of lessor risk and renewal costs.

Whatever the total operating lease volume turns out to be, opportunities for lessors still remain. Note that, in Table Twelve, EBITDA is improved under the new rules. This improvement, along with increased transparency, will create new opportunities for lessors, as customers that have shunned leasing in the past now may view leasing more favorably.

Lessors

The proposed accounting changes will affect lessors in two ways, as is depicted in **Figure Seven**. One of these effects relates to the changes in lessee behavior and market forces, and how lessors subsequently adjust and respond to them. The other effect relates to the lessor's adoption of, and compliance with, the new lease accounting provisions themselves.

Figure Seven
Lessor Impact



Market response

The requirement for lessees to capitalize their obligation to pay rents will have a negative effect on overall leasing volumes. However, as has been pointed out, the off balance sheet aspect of operating leases is only one of the many benefits of leasing, and, based on past surveys, not even the most important. Furthermore, off balancing sheet financing has not been entirely eliminated, as partial off balance sheet financing opportunities remain for certain equipment types, most notably in transportation.

When the other benefits of leasing are considered with the aforementioned study results, it can be inferred that the lease accounting changes do not represent a catastrophic event for the leasing industry. This conclusion also is supported by history, which has shown that the partial elimination of one customer motivation does not mean the rest of the industry will go away.

Consider the example of tax-based leasing in the UK in the early 1980s. During this time, Inland Revenue allowed lessors to write off 100% of the asset's cost in the first year. The British government, however, passed a Budget, in 1984, that eliminated this highly beneficial provision. Amidst, and in spite of, all the howls of protest, the leasing industry continued to prosper, even under the new changes, as lessors adjusted their approach and lessees continued to take advantage of leasing's many other benefits.

Even given the unfavorable reporting consequences of the new lease accounting rules, many users of equipment leasing have said that the proposed requirements will not cause them to change the way in which they finance equipment, as has been discussed. Lessors may have to alter their product mix, perhaps, as several lessees indicated that shorter lease terms may become more attractive as a way to minimize liabilities on the balance sheet. More transaction structuring also may be required. These phenomena, however, create opportunities for lessors who are willing to take on the role of true asset managers.

"The onus will be on the lessors to market their value propositions away from off-balance sheet treatment to other benefits …."

The new rules will open up heretofore closed markets, such as with EBITDA players and those customers concerned with transparency. Product differentiation (e.g., through residual or structure), knowledge of the customer, and a value-added approach will become even more important under the new accounting rules than in the past.

It is critical, however, that lessors educate their sales forces on the accounting changes so they can communicate these attributes to their customers. Although it is not necessary to have an in-depth knowledge of the ED, salespeople must be able to answer questions, address customer concerns, and identify opportunities related to the changes.

It would seem intuitive that hiding one's head in the sand, or keeping a low profile with customers, are not viable options, yet, around half of the lessors in Alta's survey (see **Table Fifteen**) indicated that they were not contacting customers or educating their sales forces about the upcoming changes.

Potential market impacts for lessors also exist that are not directly related to lessee behavior. The newly restrictive rules on revenue recognition in derecognition leases, for example, may encourage captives to more heavily utilize third-party lessors.

Table Fifteen

Selected Results – Lessor Survey			
	Yes	**No**	**Maybe**
Our company is proactively engaging our customers regarding the changes	**50%**	**50%**	**-**
We are training/re-educating the sales force to communicate the new rules to our customers	**37**	**63**	**-**
Our company is prepared to implement the new rules	**-**	**100**	**-**
We will have to institute new processes and internal controls to comply with the new rules	**100**	**-**	**-**
We will execute the increased workload of the new rules by increasing headcount	**12**	**75**	**13**
Our company expects to alter its product mix as a result of the new rules	**-**	**88**	**12**
We expect to alter our business model as a result of the new rules	**-**	**100**	**-**
The new rules will affect our alignment with parent core objectives	**13**	**75**	**12**
We have assessed the financial statement impact of the transition	**25**	**75**	**-**
We have developed a comprehensive plan for adapting to the new rules	**-**	**100**	**-**
System provider communication and assistance regarding the changes has been adequate	**-**	**100**	**-**
The changes will increase our audit costs	**88**	**12**	

Captives will not disappear, however, as vendor financing will remain a key strategy for manufacturers, as reinforced by IDC, in its briefing paper on the May, 2010 announcement of the CIT/Lenovo financing program, saying that

> "…it believes the transition underscores the essential role customer and business partner financial solutions plays in worldwide go-to-market strategies for IT providers."

There also may be increased dealer utilization in the financing process, although this is an area in which proposed accounting guidance is sorely lacking.

Bank lessors may choose to dial back the level of their leasing activities due to leasing's deleterious effects on the bank's capital requirements. Conversely, it is possible that they also may increase their leasing volume since some transactions that formerly qualified as leases will now be subject to the more onerous fair value rules applicable to financial instruments. In spite of these potential reactions, however, the reality is that none of the lessors surveyed indicated any plans to change their business model.

Implementation

Implementing the proposed changes presents challenges to lessors on several different levels, including financial/management reporting, operations, and systems support. Lessors must establish an implementation plan that addresses these issues, although Alta's survey of lessors indicates that only a few have begun to do so.[viii] The implementation plan should include, among other things, a product analysis, process development, and systems gap analysis.

Reporting – Measuring results based on the new accounting products represents a challenge for lessors, since they expect, and not unreasonably so, the priced economics of transactions to be reflected accurately in the financial statements. ***Under the rules proposed in the ED, however, there is a disconnect between the economics of the transaction and the accounting.*** Furthermore, lease income under the new rules becomes either more lumpy, volatile, front-loaded, or back-loaded, depending on the lease type and nature of the transaction.

Pretax, economic yield data currently is accurately captured in the financial statements under the direct financing lease model. The same thing cannot be said about the performance obligation or derecognition models, however. Instead, an asymmetry is created between the economic yield and book yield in both performance obligation and derecognition leases. This difference is due to factors such as the introduction of the performance obligation and residual asset concepts.

A comparison of the pretax, economic yield to the direct financing, performance obligation, and derecognition lease yields is shown in **Table Sixteen**. This comparison is based on the 6-year example utilized to illustrate the accounting for the performance obligation and derecognition leases in Tables Seven and Eight.. As can be seen, neither the performance obligation or derecognition models track the pretax economic yield of the transaction. The yield pattern of the derecognition lease is particularly uneven due to recognition of the residual income in year 6.

Table Sixteen

Pretax Yield Comparison				
Year	Economic	Direct financing	Performance obligation	Derecognition
1	8.00%	8.00%	8.18%	7.40%
2	8.00%	8.00%	8.11%	7.32%
3	8.00%	8.00%	8.03%	7.19%
4	8.00%	8.00%	7.91%	6.99%
5	8.00%	8.00%	7.72%	6.62%
6	8.00%	8.00%	7.35%	29.26%

The economic results become particularly skewed under the revenue recognition precepts of the derecognition lease, which advocate a mathematical allocation approach to recording residuals. Although the derecognition lease tracks certain aspects of current sale-type lease accounting, its proposed revenue recognition methodology distorts the gross margin on the sale. This distortion is due to the arbitrary allocation of value to the residual asset and becomes particularly visible during reassessment events.

Table Seventeen illustrates the measurement differences that the proposed derecognition lease creates. The example reflected in Table Seventeen is based on a 6-year lease, with annual payments of $1,361, a cost and fair value of the equipment of $5,000 and $7,000, respectively, and a residual position of $1,125. The rate the lessor charges the lessee in the lease is 8%.

The lessor in this example recognizes sales revenue of $6,291 on the commencement date of this lease and creates a gross margin of $1,791. As shown in Table Seventeen, ***the gross margin under a derecognition lease is less than that of a cash sale or of a sales-type lease under FAS 13.*** This difference is attributable to a double application of the rights transferred-to-fair value allocation ratio proposed by the ED and is reflected in the residual asset.

The distortion in revenue is exacerbated if the lease is adjusted to reflect a reassessment event. Assume, for example, that, at the end of Year One, the lessor's review of new facts indicates that the most likely lease term is four years, rather than the six years it originally estimated. Also assume that the equipment's fair value at the point of reassessment is $5,850. The book value of the right to receive payments at the end of year one is $5,433, the present value of the remaining payments is $3,507, and the residual asset is $506.

Table Seventeen

Margin Comparison			
	Cash Sale	**Sales-type lease**	**Derecognition lease**
Revenue	7,000	6,291	6,291
Cost of goods	(5,000)	(4,291)	(4,494)
Margin	2,000	2,000	1,797
Residual asset		709	506

According to the proposals, the required adjustment would be as shown in **Table Eighteen**. Based on the reassessment of the lease term, the new gross margin on the sale is now $38. By contrast, if the lessor originally had estimated the lease term at the inception of the lease to be four years (the reassessed lease term), the gross margin would have been $1,642.

Table Eighteen

Reassessment Adjustment – Derecognition			
	Initial recognition	**Adjust for change in term**	**Revised recognition**
Revenue	6,291	(1,926)	4,365
Cost of goods	(4,494)	167	(4,327)
Margin	1,797	(1,759)	38
Residual asset	506	167	673

Another problem with the ED reassessment approach for derecognition leases is that, in the mechanics of the adjustment, there is no correlation between the fair value of the reduction in right to receive rents (due solely to a revised estimate of the lease term) and the fair value of the asset (potentially representing a natural decline in value and not, necessarily, an impairment).

The economic/accounting divergence of the proposals is evident not only in the income recognition patterns of the new products, but also in other areas, such as the management of residuals. For example, when an asset comes off lease under the current rules, it is put into available-for-lease inventory, where it can be monitored from both a market and risk perspective. The leased asset is a current asset at this point, not a long-term asset. This management technique is eliminated under the new proposals.

Another residual-related concern with the proposals is that the lessor's true economic residual position is not reflected in either the performance obligation or derecognition lease. The impact on other financial reporting functions that must be assessed include the allowance for lease losses, depreciation methodologies, and impairment review processes.

It also should be noted that lessors are not the only ones affected by the financial reporting consequences of the new rules. The rating agencies, for example, will be forced to review, and possibly adjust, their metrics and analyses, not only in their scrutiny and investigation of leasing companies, but in how they measure and assess lease securitizations. Investors, regulators, and lenders to the equipment leasing industry also will have to adjust how they measure and view the industry.

Operations – *The operational burden faced by lessors will increase substantially under the proposed lease accounting rules,* as 100% of the lessors surveyed expect to establish new processes and data analytics to accommodate the new requirements. For example, there will be increased analysis and tracking of customer data necessary to determine the most likely lease term, not only at inception, but also at each reporting period.

These incremental processes and procedures will alter the internal control environment and potentially increase audit costs, something that 86% of the surveyed lessors expect to see. Very few of the lessors expect to increase headcount as a result of the increased operational burden, however, as they expect to utilize system processes to minimize costs.

Other potential increases in the operational burden for lessors include:

- Changes in how sales taxes are remitted
- Increases in deferred tax tracking when estimated terms do not represent contractual or tax flows

- Renegotiations and revisions of debt covenants
- Amendments to treasury management processes and models
- Changes to regulatory requirements and reporting
- Adjustments to regulatory capital
- Alterations to reporting and budgeting processes
- Modifications to buy/sell strategies

Information systems – The proposed lease accounting rules not only will create new accounting products, but also will require additional data tracking and analytical capabilities. These new requirements emphasize the importance of the lessor's software applications and the system provider's ability to support and implement the necessary changes.

> **"… from a software perspective, the premium will be on providing transaction flexibility with an appropriate amount of controls and an ability to make mid-term changes. "**

The current lease management systems have the capability to track operating leases and finance leases. Performance obligation accounting, however, requires new capabilities that will have to be created, integrated, and then linked to the leased asset and receivables. Data on derecognized assets must be maintained for impairment and reassessment purposes. Customer history, data mining, and analytical capabilities also will be required.

The performance obligation lease also may require more asset tracking capabilities than some lease management systems currently possess. Tracking subvention income, blended income, and other subsets of income and deferred charges now will become even more complicated and difficult to implement as the number of components associated with the lease transaction increases. There also will be issues with correlating legal requirements with system results, such as with payoffs.

Most lessors and software providers have not faced such sweeping accounting changes before, and certainly not of the magnitude of those being proposed. These changes, therefore, will create additional issues beyond how the software is to be modified. For instance,

- Will lessors utilize the lease accounting changes as a catalyst to implement other changes and products?
- Should lessors enhance their existing system or migrate to a new application?
- Are the changes simple configurations or are they more system-wide?
- What are the vendors' contractual obligations relating to implementing the accounting changes?

Another hurdle to be addressed from a lease management system perspective is the increased reliance on individual lessor judgment and analysis that the proposed rules impose. This increase in lessor-specific requirements will force new levels of flexibility into the system.

As one vendor suggested:

> "While it is too soon to tell how lessors will interpret the suggested changes, it appears that, from a software perspective, the premium will be on providing transaction flexibility with an appropriate amount of controls and an ability to make mid-term changes."

Due to the nature of the changes, lessors need to be proactive in maintaining open communications and dialogue with their lease system providers. Lessors should be raising questions as to their system provider's level of knowledge with the new requirements and its preparedness to implement them. This communication currently is lacking, as most lessors surveyed expressed general dissatisfaction with the level of communication from their lease management system providers.

This communication should address both implementation and transition issues and be directed towards establishing a plan to determine system gaps and required modifications. The execution of the plan in terms of resources and costs also must be discussed. For example, will clients pay separately for the enhancements required to make their leasing application compliant with the new rules, or are they considered maintenance costs? The same question needs to be asked regarding the conversion of the existing portfolio for the transition.

Some lessors may choose to stay with their current application and update its functionality to support the new regulations, while others may decide to use the changes to migrate to a new application with functionality that supports the new proposals. Whichever course is chosen, converting the lease management system to the new rules will require more effort on the part of the lessor than just understanding the technical accounting changes.

Transition

Lessors need to establish a transition plan, in addition to an implementation plan, some aspects of which will overlap. System modifications, for example, might be necessary to effectuate the necessary analysis and restatement of the existing leases. Of major importance to the process, in addition to the planning and execution requirements, is the assessment, and timely notification of management, of the potential financial statement impact.

Lessors also may find that, during the transition exercise, certain income items, such as interim rents, may be clawed back and capitalized under the new rules.

Impairment reviews also may prove problematic, along with locating and bringing previously derecognized asset data onto the balance sheet. This latter issue may be a bigger factor for lessors with leveraged leases on their books, particularly given the long-term nature of these transactions, although the diminished returns associated with grossing up these leases will most likely be of greater concern.

Software providers

In order to gain deeper insights into the challenges lessors will face from a systems perspective, Alta surveyed vendors of leasing and finance back office/general ledger software to gain their perspective on the impact of the proposed lease accounting changes (see Appendix Two, Study Methodology, for more details about the surveys).

Market response

The vendors surveyed were asked about the challenges of implementing these new changes, the challenges of supporting them going forward (since the new rules provide less guidance), and how the new standards will impact their application. Although the survey focused on the back office, the front office applications also will be impacted by the change, albeit to a much lesser degree. Lessors will have to synchronize their efforts between the two systems in order to expose gaps and minimize risk.

There were two consistent themes that emerged from the software vendors' responses, the first of which centered around the flexibility required under the new rules. The second was addressing potential client requests for specific functionality within the application. This second theme is indirectly related to the first, as will be explained.

It is expected that many of the portfolio management activities in the future will be driven by client interpretations of the accounting changes. Consequently, the lessor's ability to utilize newer technology via workflows, flexible configuration, and rules engines was seen as critical. Many of the vendors expressed concern over the ability of legacy systems to handle changes and future flexibility.[ix]

For example, since initial estimates of lease terms will be based on certain assumptions and behaviors, business rules engines can be used to monitor the contract performance against those initial assumptions. The lessor can be notified when variances occur outside of the preset parameters, thereby allowing it to review the variance and determine if the lease term must be reassessed.

"A short term solution would be to modify existing systems to meet the upcoming lease accounting changes."

The second theme in the vendor responses to the survey concerned how to address the varied client interpretations of the accounting changes and subsequent requests for boutique functionality to meet those interpretations. Vendors will need to have an objective process for reviewing these requests and vetting them for essentiality and industry reasonableness. Most vendors, however, felt that this issue would primarily be overcome through the system flexibility, workflow, and business rule functionality previously discussed.

Implementation

One concern from the lessor's perspective is whether to approach the proposed accounting changes as an upgrade to a new application or an enhancement to the existing application. Vendors' responses were mixed in this regard. Several vendors, for instance, were in agreement that a short term, lower risk solution would be to modify existing systems to meet the upcoming lease accounting changes. They expressed concern, however, that doing so would be shortsighted, as this option does not necessarily solve the long-term issues of technological obsolescence and the increasing need for functional flexibility to meet the upcoming changes.

The vendors' responses regarding changes to existing systems were mixed. Some stated that no upgrades will be required, as the changes will be accommodated through a patch release. One vendor mentioned that any product enhancements to support the requirements would be released as part of its standard product release process. Others anticipated customers would either take enhancements or larger upgrades to take advantage of these new compliance changes.

Another implementation issue relates to the cost of migrating to the new accounting paradigm. These costs include not only those for the actual functionality to bring the system into compliance with the new rules, but also those associated with the transition/conversion of the existing portfolio to the new functionality. How they will the software vendors classify these costs?

Since this issue has likely not arisen in the past, it will require both lessors and vendors to review and determine what is covered under the existing license agreement. Vendor responses ranged widely on this issue. One vendor, for instance, stated that the required changes go beyond what it considers normal maintenance, so the upgrade would be chargeable. Another said that some of the changes could be addressed by the customer through configuration changes, so any required programming would be part of its standard maintenance agreement.

Switching gears away from the technical impact of the changes, the vendors agreed that customer service/support will likely play a larger role going forward in order to properly assist clients and provide viable solutions to the lessor community. Several planned responses in this regard included enhanced advisory services, such as qualified accounting experts to address interpretation issues, and ongoing education for employees. About one-third of the vendors mentioned training and updating staff on the new requirements as a key element of their plans.

Transition

The transition to the proposed lease accounting framework will create numerous challenges for lessors as they struggle with how to accomplish this, for some, Herculean task. One vendor mentioned the ability to provide, at no additional cost, a conversion toolkit to its customers to use in transitioning the portfolio to the new rules. Another plans to provide clients the option to run parallel portfolios, thereby allowing the same lease to coexist under both the current and new accounting rules until the transition is made.

Conclusion

There is no denying that the proposed lease accounting rules will have a dilutive effect on equipment leasing volumes. They are not, however, the knockout punch that many expected, as lessee reactions indicate a continued focus on the many other, non-balance sheet benefits of leasing. The proposals will require more effort on the part of lessors to be successful, though, as they will have to adjust sales approaches, institute new processes, and modify their leasing applications.

One can debate the wisdom and efficacy of the new rules until the cows come home, but the reality is that the rules will change. Although their exact form and application may remain unknown at this time, these changes require a proactive response from lessors in the form of assessing the potential impact, developing go-to-market strategies, and establishing transition and implementation plans. To act otherwise invites disaster.

Appendices

Appendix One
Tables and Figures

List of Tables

List of Figures

Appendix Two
Study Methodology

The Study incorporates a combination of research, analysis, constituent contact, and strategic thought leadership from both within The Alta Group and key members of the equipment leasing and finance industry, including the ELFA Financial Accounting Committee. Surveys and interviews were the techniques used to capture the reactions and thoughts of lessees, lessors, and lease management system vendors.

Lessee Survey

Alta contacted lessee CFOs and procurement officers to request their participation in this Study survey (see Appendix Three). The following companies provided valuable assistance in reaching these lessees:

- Advanced Portfolio & Application Services
- Bridgeway Capital Advisors
- Caterpillar Financial Services
- Dell Financial Services
- Ernst & Young, LLP

Alta targeted the lessee industry segments with high volume, as indicated in the Foundation's Survey of Industry Activity. These industry segments are shown in the next table. The response to Alta's requests for participation was low, as most companies indicated that they had not yet developed a sufficient understanding of the new rules, and their impact, to make meaningful comments.

Lessee Industry Analysis
Construction
Rail
Service industry
Manufacturing
Healthcare
Trucking

Lessor Survey

Alta contacted lessors in order to gauge their interest in participating in this Study survey. A mix of captives, bank lessors, and independent leasing and finance companies responded to the survey request (see Appendix Four).

Software Provider Survey

Alta surveyed eight back office/general ledger software vendors. The population of 13 potential participants in the survey was drawn from the Equipment Leasing Today Software Guide (July/August 2010), the 2010 Equipment Leasing and Finance Association Annual Convention List of Exhibitors, and past Alta Group CFO/CIO conference exhibitors.

These software providers serve all types of lessors operating in a wide range of industries, and offering multiple products and ticket sizes. The following table lists the software providers that participated in the survey, listed in the order in which they responded.

Software Provider Participation
Constellation Financing Systems Corp.
LeaseTeam, Inc.
Oracle
White Clarke Group
SAP
International Decision Systems
CHP Consulting
Odessa Technologies

Appendix Three
Lessee Survey

Lessee name:

Lessee contact:

Referring lessor:

Date:

Equipment:

Public?:

Credit grade:

Revenues:

Questions

1. How extensively do you utilize equipment leasing?

2. What is your primary reason for leasing equipment?

3. How will the new requirement to capitalize the present value of the expected lease payments impact your company's equipment leasing activities?

    a. Increase? (%)
    b. Decrease? (%)
    c. Across the board, or only in certain segments? Which ones?

4. Will the new lease accounting rules increase your company's utilization of equipment leasing?

5. Will the requirement to estimate and book the most likely lease term, payments, and contingent rents change how your company utilizes equipment leasing?

6. Do you expect to seek shorter lease terms under the new rules as a way to minimize the amount of the equipment lease liability that must be carried on the balance sheet?

7. Do you expect to alter your utilization of renewal and purchase options?

8. Will the requirement to review and rebook your equipment leases, given a significant change in assumptions has occurred, change how your company utilizes equipment leasing?

9. Will the new lease accounting rules alter how you analyze, approve, and monitor your equipment leases?

10. Will the new lease accounting rules impact how your company's internal management and performance metrics are calculated?

11. Do you believe your company is prepared to implement the new lease accounting rules? If so, has the company developed any new processes or procedures?

12. How are you preparing for the capitalization and restatement of your current operating leases? Have you quantified the impact on your financial statements?

13. How would you characterize the level of lessor communication and assistance regarding the new lease accounting changes?

14. Do you currently have a lease management application?

    a. Is it part of a fixed asset reporting system?
    b. Is it a standalone system?
    c. Is it outsourced?

15. Do you have any additional issues or concerns regarding the new lease accounting rules?

Appendix Four
Lessor Survey

Lessor name:

Lessor contact:

Date:

Type:

Focus:

Questions

Customers

1. Have your company's customers indicated how, if at all, the lease accounting changes will affect their approach to utilizing leasing?

2. Have you seen any recent changes in your company's lease/loan mix?

   a. More loans –
   b. More leases –
   c. No change –

3. Is your company proactively engaging its customers regarding the lease accounting changes through:

   a. Written communications –
   b. Presentations –
   c. Customer meetings –
   d. Other –
   e. None –

4. Have your company's customers expressed any reservations about including renewal and/or purchase options in their leases?

5. Have your company's customers expressed any interest in shorter lease terms under the new rules as a way to minimize the amount of the equipment lease liability that must be carried on the balance sheet?

6. Is your company training/re-educating the sales force to reflect the new lease accounting rules?

Operations

7. Will your company have to institute new processes and internal controls to address the requirement to estimate and book the most likely lease term, payments, and contingent rents?

8. How will your company execute any new processes and internal controls associated with the new rules?

    a. Increase headcount –
    b. Absorb the additional workload –
    c. Other –

9. Does your company expect to alter its product mix as a result of the new rules?

    a. Increase residual-based leases –
    b. Decrease residual-based leases –
    c. Shift to bundled leases or other value-added services –
    d. Other –

10. Does your company expect to alter its documentation to reflect lessee concerns over renewal and purchase options?

11. Does your company expect to change its business approach as a result of the new rules?

    a. Alter the business model –
    b. Alter the ownership model –
    c. Other –

12. Do you think the new accounting rules will affect your company in terms of::

    a. Alignment with parent core objectives –
    b. Funding access –
    c. Regulatory compliance –
    d. Other –

13. The lease accounting changes will require a transition from FAS 13 to the new rules. Has your company:

    a. Assessed the financial statement impact of the transition?
    b. Begun assessing the financial statement impact of the transition?
    c. Established a plan for assessing the financial statement impact of the transition?

14. The lease accounting changes will require a financial statement approach that is different from FAS 13. Has your company developed a comprehensive plan for adapting to the new rules?

    a. Developed a plan?
    b. Begun the process of developing the plan?
    c. Waiting for the final rules?

15. Will the new lease accounting rules impact how your company's internal management and performance metrics are calculated?

16. Does your current lease management application support the proposed new rules?

17. Has your current lease management application provider communicated to you how:

    a. The required system modifications under the proposed new rules –
    b. The provider will support the proposed new rules –
    c. The provider's plan for modifying the system –
    d. The cost of modifying the system –
    e. Other –

18. How would you characterize the level of system provider communication and assistance regarding the new lease accounting changes?

19. What is your estimate of the time and costs associated with making the change between the new rules and FAS 13?

    a. Processes and internal controls –
    b. System modifications –
    c. Portfolio transition –
    d. Other –

20. Do you anticipate an increase in audit costs as a result of the lease accounting changes?

    a. Current?
    b. Ongoing?

21. Do you have any additional issues or concerns regarding the impact of the new lease accounting rules on your business?

Appendix Five
System Provider Survey

Vendor name:

Date:

Application name(s):

Questions

1. The upcoming lease accounting changes may present an opportunity for lessors to utilize these changes as a catalyst to take their business/operations to the next level. How would you reply to clients/prospects on this potential opportunity to migrate to better processes and/or applications?

2. How do you see these changes of the lease accounting Exposure Draft impacting lessee decisions regarding leasing?

3. Changes to lessee accounting requirements may impact lessor product offerings which, in turn, will require enhancements to your software application. What are your thoughts on how this will impact vendors supporting this market?

4. If you were talking with an existing client or prospect, what would you advise (risk/reward) under the scenarios listed below:

   a. Stay with their current application and update the functionality to support the new regulations?
   b. Migrate to a new application with functionality that supports the new regulations?

5. How do you see the proposed accounting rules impacting your application/company as they apply to converting to the new accounting requirements?

6. How do you see the proposed accounting rules impacting your application/company as they apply to post-transition in the following areas?

   a. New development/enhancements
   b. Upgrades
   c. Support

7. How will the new accounting rules impact your clients as they relate to:

    a. The enhancements required to make the application compliant with the new accounting requirements. Must clients pay for these separately or is this part of the maintenance cost under the software license?
    b. The conversion of the existing portfolio to the new requirements. Is this treated similar to a conversion, whereby the clients are responsible for these costs, or is this covered under the maintenance section of the license agreement?

8. This survey focuses on back-end (GL) vendors; however, the front-end applications are connected with your products. What do you expect to be the impact to the front end process and how does this impact your application and ultimately your customer?

9. The proposed lease accounting rules provide less guidance than under FAS 13. How does your company plan on managing the potential accounting interpretations while maintaining an industry based solution in lieu of multiple one-off client driven requests?

10. Do you have any additional issues or concerns regarding the impact of the new lease accounting rules on your business?

Researchers

The Alta Group

Members of The Alta Group provided invaluable assistance and insights in the preparation of this Study. Alta is the leading provider of consulting and advisory services to the equipment leasing and finance industry worldwide, with over 200 US clients. In addition to its unparalleled industry background and perspective, Alta also bring extensive experience in similar assignments. This experience not only is with the Foundation, such as in its *Perfect Storms* engagement, but also with other clients, where Alta creates strong survey and project deliverables on a regular basis.

Alta's knowledge of the equipment finance industry is extensive from both an operational and strategic standpoint. This knowledge is augmented by the perspective gained from working on committees and in various other capacities for the Equipment Leasing and Finance Association (ELFA). With a fresh perspective on market trends and an expansive focus forward, Alta continues to assist its clients to increase revenue, control expenditures and improve productivity and profitability.

Shawn Halladay

Mr. Halladay is an internationally recognized consultant and author in the equipment leasing and financial services industry with experience across all aspects of the business. He is a principal of The Alta Group and is the Managing Principal of its Professional Development Division. Over the past 30 years, Mr. Halladay has developed significant expertise in all areas of leasing, including accounting, pricing, tax, funding, and vendor leasing. He has acted as a lessee and also has applied his knowledge on a practical basis in a small-ticket equipment leasing company.

In addition to his practical leasing experience, Mr. Halladay has taught classes on numerous leasing subjects and consulted extensively, including providing expert witness support to the US Securities Exchange Commission and Department of Justice. He has international teaching and consulting experience on leasing practices and policies, having worked in Abu Dhabi, Australia, Belgium, Brazil, Canada, China, Costa Rica, England, France, Germany, Holland, Hong Kong, India, Indonesia, Ireland, Italy, Jordan, Korea, Kuwait, Macao, Mexico, Puerto Rico, Saudi Arabia, Singapore, Sweden, and Turkey.

Mr. Halladay holds a Bachelor of Science (Accounting) degree from the University of Utah, along with a Masters of Business Administration (Finance). He is a member of the ELFA Financial Accounting Committee and also serves on the Editorial Review Board of the Journal of Equipment Leasing and Finance. His published work includes:

- Author/managing editor of the *Handbook of Equipment Leasing* - a two volume, 1,300 page book containing a detailed and exhaustive review of the equipment leasing industry
- Author/managing editor of *A Guide to Accounting for Leases*, a comprehensive treatment of lease accounting
- Co-author of *Guide to Captive Finance Company Equipment Leasing*, an in-depth examination of all facets of financing the sale of a manufacturer's equipment through leasing.
- Author/managing editor of *Lease Securitization*, an in-depth and cohesive look at the securitization of equipment leases
- Author of *A Guide to Equipment Leasing*, a self-study booklet introducing the equipment leasing industry and the various leasing products
- Author of *An Introduction to Leasing*, a self-paced learning tool exploring the fundamental practices, rules, and regulations of the equipment leasing industry
- Over 40 published articles

Mark A. Belec

Mark Belec is President of Advanced Portfolio & Application Services based in Minnesota. He has twenty five years of experience in the finance/leasing industry during which he as taken on increasing responsibilities. He has consulted and/or worked for over two hundred finance/lease clients, including PwC, Wells Fargo, Chase/Bank One, BearingPoint, Third Pillar, IDS, The Alta Group.

Mark has developed "best practices" from working with auditors, C-level executives, operations, IT, and risk/asset departments. Gerry Perham, VP of Products for IDS recently noted that "Mark's background is unique in that he has worked at leasing companies in the past, and has also supported both front-office and back-office software applications. Mark understands the whole equipment finance operation."

A few of Mark's accomplishments include:

- Developed a systematic portfolio risk process in 1989 based on legal case law precedents
- As part of a larger project, Mark had to indirectly analyze buyouts for a client (Six Sigma shop) to any gaps. In this project, Mark uncovered and

quantified that the client was losing $15MM per year based on improper buyout calculations

- Created a C-level Conference with the Alta Group to provide a “neutral approach” whereby vendors had to follow scripted transactions to show the strengths/weaknesses of their systems to attendees
- Mark was selected by the president of a large software company for an internal group that determined, based on his experience, which applications to expand and which to retire.

Mark provided a presentation to CFO’s on the economic/competitive value of structured asset data. Mark has testified in Federal Court and worked with the Treasury and Federal Bureau of Investigation on past leasing related items. In addition, Mark works with software companies and third party/service providers for integrating with lessors/finance companies to improve profitability, operations and residual/risk management.

Mr. Belec is a past chairman of the ELFA Equipment Management Committee and has spoken at ASA, ELFA, and Alta conferences, most recently on “Selecting the Correct Software” and “Challenges & Best Practices for Equipment Risk Management”. Mr. Belec holds an Associate of Arts & Bachelor of Science degree from McPherson College and attended Scottsdale University School of Law. He has RUP experience and has his certification from Pragmatic Marketing http://www.pragmaticmarketing.com/pragmatic-marketing-framework

Endnotes

[i] Although the exclusion of small-ticket leases from the scope of the project was deliberated, the ED does not provide any scope exclusions based on the cost of the lease, nor are there any reduced reporting requirements based on the dollar amount of the lease.

[ii] Short-term leases represent another accounting designation. The lessor may elect, on a lease-by-lease basis, to account for short-term leases in the same manner as operating leases under the current rules.

[iii] This presentation is for illustrative purposes only, as the components of the performance obligation lease will be netted in the financial statements.

[iv] Although this study was released in May, 2010 and was based on the treatment of lessee accounting under the 2009 Discussion Paper, there were minimal changes between its requirements for lessees and those of the ED (www.grantthornton.com/cfosurvey/).

[v] Of the 68% respondents in the Grant Thornton study that indicated they would continue to utilize lease financing, 51% would continue to use leases more or less in the same manner, and 17% would continue to use leases but, possibly, with significant changes in the provisions of the agreements

[vi] The results of these studies must be tempered by the fact that neither study asked about changes in operating lease practices specifically, but instead, addressed changes in attitudes toward the use of leasing in general.

[vii] It is helpful to analyze direct financing lease volume in this context. The volume of tax-based, direct financing and leveraged leases, which, in some cases, may be considered operating leases from the lessee's perspective, averages around 25%. Although it is difficult to determine what this percentage really is, suffice it to say that some portion of this volume also represents operating leases from the lessee's perspective.

[viii] Several of the lessors interviewed mentioned that they were waiting for the final rules to be issued before creating an implementation plan, as they expected some changes in the guidance proposed by the ED.

[ix] While this may be true, it should be considered with the caveat that almost all the vendors contacted are actively trying to displace existing applications with their own product.

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye On The Future

Future Focused Research for the Equipment Finance Industry

Presented by the Source for Independent, Unbiased and Reliable Study

The Equipment Leasing & Finance Foundation

The Equipment Leasing & Finance Foundation, established in 1989 by the Equipment Leasing Association, is dedicated to providing future-oriented, in-depth, independent research about and for the equipment finance industry. Information involving the markets, the future of the industry and the methods of successful organizations are researched to provide studies that include invaluable information for developing strategic direction within your organization.

Your Eye on the Future

The Foundation partners with corporate and individual donors, academic institutions and industry experts to develop comprehensive empirical research that brings the future into focus for industry members. The Foundation provides academic research, case studies and analyses for industry leaders, analysts and others interested in the equipment finance industry.

The Foundation's resources are available electronically at no cost to Foundation donors and for a fee to non-donors. For more information, please visit www.leasefoundation.org

An example of the resources available from the Foundation include:

- Market overview studies
- Emerging market reports
- Annual state of the industry reports
- Monthly Confidence Index(MCI) analysis
- Industry future council workbooks
- Reports on entering international markets
- Case studies, and much more

Journal of Equipment Lease Financing

Published three times per year and distributed electronically, the *Journal of Equipment Lease Financing* is the only peer-reviewed publication in the equipment finance industry. Since its debut in 1980, the Journal features detailed technical articles authored by academics and industry experts and includes Foundation-commissioned research and articles. Journal articles are available for download through the Foundation website. Subscriptions are available at www.leasefoundation.org

Web Based Seminars

Many of the Foundation studies are also presented as web seminars to allow for direct interaction, in-depth conversation and question and answer sessions with the researchers and industry experts involved in the studies. Please visit the Foundation website for details on upcoming webinars at www.leasefoundation.org

Donor Support and Awards Program

The Foundation is funded entirely through corporate and individual donations. Corporate and individual donations provide the funds necessary to develop key resources and trend analyses necessary to meet daily business challenges. Corporate and individual donors are acknowledged publicly and in print. Major giving levels participate in a distinguished awards presentation. Giving levels range from $100 to $50,000+ per year. For information on becoming a donor and to see a list of current donors, please visit, www.leasefoundation.org/donors

Stay Connected

You can connect to the Foundation in various ways:

- Subscribe to *Foundation Forecast* bimonthly newsletter
- LinkedIn: linkedin.com/groups?mostPopular=&gid=89692
- facebook: facebook.com/LeaseFoundation
- twitter: twitter.com/LeaseFoundation
- RSS: feeds2.feedburner.com/FoundationElfaOnline

1825 K Street NW • Suite 900 • Washington, DC 20006 • Phone: 202-238-3400 • Fax: 202-238-3401 • www.leasefoundation.org

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye On The Future

1825 K Street NW • Suite 900 • Washington, DC 20006
Phone: 202-238-3400 • Fax: 202-238-3401
www.leasefoundation.org