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To the FASB and IASB:

Financial Computer Systems has been providing lease accounting services and software to corporations throughout the United States and Canada since the promulgation of FAS 13 in 1976. We have focused on assisting lessees with their reporting requirements (with limited work for lessors, primarily those that are also lessees). We have been concerned for many years about the structuring many lessees do to avoid reporting substantial transactions on the balance sheet, and we applaud the boards for finally taking the steps needed to correct this situation.

Our clients range from small organizations with fewer than 10 leases to multinational corporations with thousands, both capital and operating, covering all types of assets including equipment, vehicles, communications tower space, and real estate. Based on our experience with our clients, and with developing software to meet the requirements of FAS 13, we offer the following comments on the Exposure Draft for the proposed new lease accounting standard. We are not, however, speaking on behalf of any of our clients, but as observers of the leasing scene and implementers of both the current and future standards.

We are glad that the boards are taking this opportunity to harmonize the lease accounting standard. We believe companies and investors will be better served by having a consistent standard worldwide. We note with regret that there are a few areas where outside differences between US GAAP and IFRS mean that some aspects of lease accounting will be inconsistent between reporting regimes (such as the existence of IAS 40 for investment property and the right to revalue a right-of-use asset at fair value), but we understand that not everything can be harmonized immediately.

We are in agreement with the boards on the importance of putting leases on the balance sheet. We believe this more accurately reflects the resources and responsibilities of lessees and lessors; we agree with the idea that an airline that shows no airplanes on its books is not reflecting economic reality. The same is true of a retail chain that shows no stores. Clearly leases represent assets and liabilities, and need to be accounted for as such.

However, we disagree on both a conceptual and a practical level with the boards' move from minimum lease payments (under the current FAS 13/IAS 17 regime) to expected lease payments. We consider it incorrect to view a lease option (aside from bargain rents or other economic compulsion) as a liability. The payment of rents in the option period is not based on a past event, as the definition of a liability requires, but on the future event of exercising the option, and accordingly does not represent a present obligation but a potential future obligation. The ED proposal to include these in the lease term if exercise is judged "more likely than not" means the addition of an equal asset and liability for the extended term. This depresses financial ratios and increases reported interest expense, an outcome that increases in intensity with the length of the available options. This gives the perverse result that a lessee is worse off financially if he has an option than if he does not, when the real world result is that he is never worse off (since he can always decline the option) and may have a substantial benefit (which is, however, often difficult to quantify, particularly at lease inception).

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At the same time, lessors potentially could be far overstating interest income by anticipating more options exercised than proves to be the case. Because of the nature of interest method amortization, interest is front-end loaded, and the impact of this increases with the length of the lease. A 5-year lease at a 5% interest rate recognizes less than 15% of the rent as interest income; a 25-year lease at the same rate recognizes more than 65% of the rent for the first 5 years as interest income, and the total of interest plus performance obligation amortization is nearly 25% more than the rent. If options are assumed to renew, a lessor may recognize large up-front profits through both interest and recognition of sales-type profit; nonrenewal would then result in large charges. This creates a potential for aggressive accounting and the risk of unreliable earnings numbers, which further argues against this methodology.

We understand that the boards are concerned about entities structuring leases to evade the new standards, as has been the case in the past. However, a lease that has a one-year term with 14 one-year renewal options is qualitatively different from a 15-year lease. Even if the lessee intends at inception to stay for 15 years, the fact remains that it has the right to discontinue the lease with no penalty for any reason on a yearly basis. That right has both legal and financial significance (to both the lessee and the lessor) which the proposed standard would almost completely ignore.

Making the determination of what is “more likely than not” will often be an exercise in crystal ball-gazing and arbitrary choices. We have retail chain clients with as many as 40 years of options following an initial 10- or 20-year term. No one can possibly know what the business conditions, either for the lessee or externally, will be 50 years into the future. The attempt to quantify an inherently uncertain situation provides a venue for accusations of financial engineering, as well as requiring resources to be spent in review and estimation that are ultimately unproductive.

The same is true of estimating contingent rentals. Except where contingent rentals are effectively base rent payments, we see little benefit, and great burden, in estimating and capitalizing contingent rentals. We again do not agree that contingent rentals, in most cases, fit the definition of a liability. Certainly rentals based on usage do not, as they are totally within the control of the lessee and dependent on the lessee’s future actions (i.e., the past event of signing the lease contract is not sufficient to trigger an obligation to pay, but simply sets out the price schedule if the lessee chooses to use the asset to a certain level of activity, much like a master lease agreement, which FAS 13 notes incurs no obligations until an asset is actually ordered). Likewise, rentals based on a percentage of sales are not liabilities before the sales occur, any more than a commission agreement with a sales representative is.

We would agree with including contingent rentals that are based on an index or rate, such as leases that have an interest component based on LIBOR; those are, we believe, more typically and properly considered part of the base rent of the lease. However, we believe the requirement to constantly adjust the asset and liability to reflect subsequent changes in such an index or rate will be burdensome for limited benefit. Therefore, we believe the best approach would be that currently used in FAS 13, which is to project future rents based on the index or rate in existence at lease inception, with differences (positive or negative) in actual payments expensed as incurred and no change made to the future rent estimates.

We would note that if our suggested avenue is pursued, we believe better guidance is needed regarding the treatment of CPI increases. The CPI (at least in the U.S.) is technically an index

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(the level of prices on a particular date), yet most discussion of it focuses on the rate of change in the CPI. We are aware of a variance in current practice regarding CPI-based rent changes because of this. Some companies currently treat the CPI as an index, and thus all inflation adjustments as contingent rent (setting up a lease using its initial rent as the minimum rent for the entire life of the lease). Others treat it as a rate and estimate that the current inflation rate will continue through the life of the lease, treating the increases based on the current rate as part of the minimum lease payments, with only the difference (positive or negative) between that estimate and the eventual actual rent treated as contingent rent. We recommend that the boards clarify whether an inflation adjustment in rent should be estimated based on the current rate or should be ignored until incurred.

Overall, we are very concerned about the burden introduced in complying with the proposed standard. We do not believe the proposal meets the chairman of the FASB's stated intention, as reported in the press release announcing the release of the ED, to "decrease [lease accounting's] current complexity." There is, to be sure, a certain reduction in complexity from having a single methodology for all lessee leases, and going from three methods (under US GAAP) to two for lessors. But the conceptual change from minimum to expected lease payments, with the connected requirement to make ongoing revisions, is an increase in complexity that dwarfs the other reduction. The technical challenge in providing for the myriad of ways in which future rents will need to be estimated, with the probability-weighted estimates adjusted to actual payments and further adjustments of current and future values made throughout the life of the lease, will be substantial. (Modeling multiple changes to contingent rents and options may seem relatively insignificant in Excel with a single lease, but when the volume reaches the thousands, with dozens or hundreds of different ways that changes are being made, and a clear audit trail maintained reflecting the numerous ongoing alterations, the development work to create and maintain the models in Excel or a programming language is enormous.) The maintenance obligation, particularly for companies with hundreds or thousands of leases, will be a significant burden on staff resources. We strongly doubt that the benefit merits the expenditure, even aside from the questionable conceptual basis.

We recognize that there is a benefit to investors of having a sense of management expectations, and that there is a concern of gaming the system when options are excluded. But we believe the attempted solution goes beyond what is reasonable or necessary. Expectations are not commitments, and the balance sheet should reflect only actual, enforceable commitments. Renewal options should not be considered liabilities any more than future utility bills are; paying utilities is necessary for any ongoing concern, but there is no commitment to pay until the usage is incurred, and similarly a lease option entails no commitment until the option is exercised.

If it is seen as crucial to provide information on options, we suggest a footnote disclosure of the undiscounted value of future rents in unexercised option periods (by year for 5 years, then the remainder combined, or perhaps in 5-year groups for the remaining lives). This would allow financial statement users concerned with potential renewals to get a sense of the possibilities without weighing down the balance sheet, risking loan covenant defaults and otherwise depressing the financial status of a company.

We are aware that some wish to maintain operating leases off balance sheet because of the financial implications of capitalization. We firmly disagree; operating lease accounting understates the liabilities of a company, and capitalization provides a needed truer picture. Current disclosure is insufficient to provide this. But we understand a major objective of lease

accounting to be improved comparability with other types of transactions (particularly, the purchase of assets). The capitalization of expected but not required payments overshoots that objective and penalizes those who are trying to increase their flexibility. Therefore, we urge a return to a minimum lease payments approach, while still capitalizing (virtually) all leases.

Responding to the individual questions posed by the boards:

- 1a. Yes. A lease provides an asset and incurs a liability to pay rent.
- 1b. Yes. This is consistent with purchase accounting, which is a conceptually similar method of acquiring an asset.

We appreciate, though, that the switch from rent expense, which is generally level over the life of a lease, to amortization and interest expenses, the latter of which is front-end loaded, can produce a mismatch between expenses and associated income (which would not be expected in most cases to decline over time), and this has implications for both reported profit and expense reimbursement where entities claim recovery of their costs from other entities. We would not be averse to amortizing the asset in amounts equal to the reduction in liability, so that for each reporting period the amortization plus interest expense would equal the rent payment. This would, however, raise potential complications in cases of negative principal amortization, which we believe should be explicitly addressed if this route is followed.

- 2a. A performance obligation seems like an accounting fiction forced on the transaction to balance the accounts. However, we see no better way to handle leases that cover only a small portion of an asset's economic life, as a derecognition approach could too easily lead to a situation where all of an asset has been derecognized but additional leasing is undertaken because there is still value to the asset. Conceptually, derecognition seems to better represent a leasing transaction, so it is preferred where the lease structure permits it. We believe the dividing line provided is reasonable, even though drawing a dividing line means that the existing problem of similar transactions accounted for differently remains (though with a different dividing line than the current operating/capital division).
- 2b. The proposed approach is acceptable.
- 2c. We have no experience with leveraged leasing, and therefore are unprepared to comment on this.
3. We believe that leases that are cancelable without penalty with a month's notice or less (month-to-month leases) should be excluded entirely from the scope of this standard, even if they have an unlimited lease term. Again, these do not fit the definition of a liability, and it is inappropriate to require capitalization of an utterly arbitrary length of rents for such an agreement. We do not believe there is a meaningful risk of structuring to take advantage of such a scope exception; lessors will not accept the risk of termination, without a commensurate increase in price that will make such a choice uneconomic for lessees that truly want an extended lease. We agree with the proposal for other short-term leases.
- 4a.-c. We agree with these.
5. We agree with excluding intangible assets at the present time. We would not be opposed to considering them for addition to scope at a later date. We agree with the boards' judgment

that the specialized characteristics of leases of biological assets and minerals are better dealt with in specialized standards.

6. We are surprised that the boards have eliminated the concept of “executory costs” as recognized in FAS 13. “Service components” seem to be a subset of executory costs, but do not clearly include pass-through costs such as taxes that are excluded from capitalization under the current standard. It is not clear if this is an oversight, a misunderstanding because “service components” are not defined, or an intentional requirement to capitalize what has previously been considered a noncapitalized expense, because it is not part of the cost recovery of the underlying asset. Perhaps this can be resolved by simply providing a clear definition of “service components.”

We disagree that service components that are “not distinct” should be capitalized. We believe this penalizes lessees who are not in a position to demand a detailed accounting from their lessors, and decreases comparability between leases and purchases. We understand a major goal of lease accounting to be providing comparability of reporting between entities which acquire assets via purchase and those which acquire assets via lease; capitalizing service components (and other executory costs, if any) overstates the balance sheet for lessees. We believe that lessees should have the right to estimate these costs as they can under FAS 13, removing such costs, which are not related to the cost recovery on the underlying asset, from capitalization.

Whatever the case, we urge the boards to agree on a common standard. We consider convergence a major benefit of the new standard.

7. Since the standard separately calls for bargain purchase options to be considered evidence of a purchase/sale, this question clearly speaks only to fair value purchase options. We agree that such options should only be accounted for when exercised. There is no compulsion before exercise that meets the definition of a liability.
8. As stated in our opening discussion, we disagree with including options that are not economically compelled in the lease term. We do not believe they meet the definition of a liability, and we believe that estimation will be onerous, unreliable, and of limited value. We believe the current FAS 13 standard for determining the lease term should be retained. Guidance on determining the lease term should perhaps be expanded to note that the existence of long-lived leasehold improvements would normally be an indication of economic compulsion to exercise options.
9. As stated in our opening discussion, we disagree that contingent rentals generally should be included in the measurement of assets and liabilities. We do not believe they meet the definition of a liability, and we believe that estimation will be onerous, unreliable, and of limited value. We believe only contingent rentals that are effectively base rent payments should be capitalized. This would include rentals triggered in their entirety by a minimal level of activity, contingent rentals on leases that have only minimal base rent, and rentals that are based on an index or rate, which should be capitalized using the index or rate in effect at lease inception.

We agree that expected payments under term option penalties and residual value guarantees should be included, as we believe they do meet the definition of a liability; we concur with adding the “if they can be measured reliably” proviso for lessors.

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10. Since we disagree with capitalizing contingent rentals, this question would be much less significant. If our preferred methodology is used, we would recommend the FAS 13 practice of recognizing the difference between the estimate on those contingent rentals that are capitalized solely as an addition to or reduction of expense in the period incurred, with no adjustment to the asset and liability.

We believe that the proposed reassessment procedure is appropriate for remaining cases when changes in facts or circumstances indicate a significant change to the lease payments, such as major leasehold improvements that newly compel the exercise of options, or the actual exercise of an option.

If the boards maintain their tentative decision to include expected payments, we accept the proposed reassessment procedure as necessary.

11. We agree.
- 12a. We agree.
- 12b. We agree. We believe it is important that the performance obligation be netted with the underlying asset to avoid double-counting of assets and liabilities with the attendant harmful consequences to financial ratios.
- 12c. We agree.
- 12d. We agree. We consider a sublease meaningfully different from a primary lessor lease, and appropriately recognized separately.
13. We agree.
14. We agree.
15. We generally believe that disclosure is helpful, but we are concerned that information that in principle is helpful will become overwhelming when applied to hundreds or thousands of leases. Further, disclosure about such things as deciding which options to include in and exclude from the lease term is likely to either be so general as to be meaningless, or force disclosure of strategic planning in a way that could harm a company's competitive position. Disclosure of discrete elements such as residual value guarantees (both maximum and expected actual cost) and initial direct costs is less problematic. We also agree that, if the misguided plan to include noncompelled renewal options and contingent rentals is implemented, it is important to have a separate record of contingent and expected payments from the base rent, as currently proposed; we further believe noncompelled option period rents should be separated from base rents for the contractually obligated period, because there is otherwise no way to distinguish what is truly required from what is merely expected. It is not clear if paragraph 85 intends to separate out option period rents from contractual minimums; this should be spelled out.
- 16a. We are concerned about the burden required by setting the date of initial application to the beginning of the first comparative period. While this enhances comparability to prior years, it means that companies may have to reconstruct data for years prior to the enactment of the standard (if implementation is required for 2013 and a company provides three prior comparative years, the standard would be applied effective January 1, 2010, 18 months before the standard is expected to be promulgated). We question the value of the work involved for those with substantial leasing activity.

We propose that reporting entities have the option either to apply as of the beginning of the first comparative period, or the beginning of the year prior to the current year (if more than one comparative period is provided). In the latter case, they would provide a footnote disclosure showing both the originally reported financial statements and the restated amounts for the prior year, to facilitate year to year comparisons.

16b. We do not favor permitting full retrospective application, because it will reduce comparability between entities and invites choosing whichever method improves reported results.

16c. None that we are aware of.

17. It is unquestionable that the new reporting model is considerably more complex. For lessees with all but the simplest leases, far more time will be required in gathering and updating information needed to properly account for their leases. Any lease with contingent rentals or renewal options will require a much more detailed setup, as forecasts potentially decades into the future must be prepared, justified, and documented, even though such forecasts by their nature can have only a loose attachment to reality. Leases with contingent rentals will require continual reviews, with the requirement to determine when the changes are significant enough to recalculate a lease (and then to undertake the adjustments required).

All of this could be justifiable if the result would be more accurate accounting for an entity's assets, liabilities, expenses, and income. But much of it detracts from, rather than enhances, accurate accounting. The inclusion of expected but not required payments overstates assets and liabilities, forcing a mischaracterization of expenses and income plus a depression of financial ratios for lessees. For lessors, it can create an overly rosy picture of a company's future revenue stream, ignoring the uncertainty that options create. An unexpected non-renewal could result in a large write-off, potentially reversing years of reported interest income on a lease.

We believe that for the capitalization of all leases, the benefits do strongly outweigh the costs. Off-balance-sheet financing (through leasing and other methods) has proven itself to be a source of substantial hidden damage to many companies in recent years; capitalizing all leases is an important step in cleaning up this serious problem. The pleas of some to keep operating lease accounting because some companies will look worse financially is nothing more than a plea to avoid truthful accounting.

However, there is little benefit and great cost to capitalizing non-required payments. Therefore we oppose that aspect of this proposed standard, and urge the boards to retain a minimum lease payments reporting structure similar to that currently in use. This methodology is well-known and we believe has worked well.

18. It is 34 years since the release of FAS 13, and 14 years since the publication of "Accounting for Leases: A New Approach." The problems with operating lease accounting have been visible for a long time, and we applaud the boards for finally taking the steps needed to eliminate this black hole of corporate obligations. We are disappointed that the enthusiasm to make transactions visible has led to an overcorrection, with the proposal to capitalize expectations rather than obligations. We believe that capitalizing minimum lease payments will provide substantial benefit to users of financial statements without unnecessary

burdens, either financial or logistical, to reporting entities. If more time is required to adjust the standard to correct this error, we believe that will be time well spent.

19. We are concerned that this may prove overly burdensome to small, private companies or not-for-profit organizations that have no trained accountants on staff. We suggest that the short-term lease methodology (capitalization with no present valuing) be permitted on all lessee leases (and any subleases) for them, though we're not sure how to define who should be permitted to use this method. However, this method has its own penalty, since it increases the reported liabilities, which would probably discourage use by those who have the resources to follow the regular rules. Certainly once an entity chooses regular reporting, it should not be permitted to switch to the simplified method under this scenario. While this would reduce comparability, we don't think such organizations are regularly being compared with larger entities, and the administrative burden would be considerably reduced and simplified. We see no need for such an alternative methodology for lessors, since for them leasing is generally fundamental to their business and they can be expected to be fully aware of the appropriate standards.

Thank you for allowing us to present our thoughts on this important topic. We look forward to assisting companies in meeting the new standard, whatever final form it takes.

Sincerely,

A handwritten signature in black ink that reads "Kelvin Smith". The signature is written in a cursive, flowing style.

Kelvin Smith
Vice President