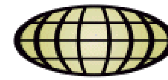


RESIDCO
Vincent A. Kolber
RESIDUAL BASED FINANCE CORPORATION
70 W. Madison, Suite 2340
Chicago, Illinois 60602
tel 312.726.0695 *fax* 312.726.3690

August 29, 2013

Technical Director
File Reference No. 2013-270

FASB
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Attn: Technical Director
RE: Reference No. 2013-270

Leases (Topic 842): Response to Leases Re-Exposure Draft ("RED")

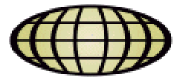
Executive Summary

We respectfully do not support the RED's proposed creation of a "right of use" asset, elimination of leveraged lease accounting, and the proposed on balance sheet reporting of operating lease obligations. The RED's inconsistent accounting treatment of Type A and Type B lease agreements suggest the Re-Exposure draft be tabled until such time as the Boards address and develop an overall conceptual framework for recognition and reporting of all types of contractual commitments.

Additionally, the RED has not demonstrated practical improvements that the stakeholder community accepts. If international reporting convergence is desired our position is similar to the alternative view presented by Marc A. Siegel, as stated in Background and Conclusions Paragraph of the RED "BC390[1]":

> "a more cost-beneficial approach would be to make only targeted improvements to current U.S. GAAP by (a) replacing the current bright-line classification criteria with one similar to IAS 17 and (b) improving

[1] FASB Proposed Accounting Standards Update *(Revised)* Leases (Topic 842), Page 319, Paragraph BC390.



disclosures for lease transactions with specific, quantitative information about renewal options, variable lease arrangements, and cash payments for operating leases to facilitate users' ability to assess the nature, timing, and amount of future cash flows.

BACKGROUND:

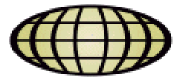
A lease agreement creates a "split interest" in a single asset. No ***one*** entity obtains all the benefit and controls all of the property rights inherent in that single asset during the term of the lease and so the lease agreement fails to meet a ***required*** essential characteristic of an asset as outlined in the FASB's own Statement of Financial Accounting Concepts No. 6[2]. We acknowledge that lease agreements do create contractual obligations, but ***do not*** create depreciable assets that should be recognized on balance sheet (unless substantially all the risks and rewards of ownership have been transferred). The RED's ***forced*** recognition of ***a "right of use" asset*** cannot be justified by reference to the FASB own Concepts Statements. Accounting is not science, but art, and further debate and study is required on how reporting of these split interest arrangements can *best satisfy the needs and conflicting interests* of the diverse stakeholders financial statements are meant to serve.

Introducing the concept of a **"right to use"** asset distorts the reporting of the economics of the operating leasing bargain and introduces unneeded complexity in financial statements. The "right to use" concept ignores the tax and legal treatment of asset ownership embedded in both the U.S. (and United Kingdom) Legal and Tax regimes. The lessee decision to lease is not the same as the decision to borrow, and leasing cannot be reported as equivalent to legal and tax ownership. The bankruptcy protection afforded a lessor is a major benefit of leasing and allows the lessor to repossess and to implicitly extend more credit (i.e. 100% financing) than a lender whose claim would be foreclosed by the automatic stay.

Accounting reporting distortions are often caused by deviations of accounting information from the underlying economics of business transactions. Accounting standards themselves can give rise to distortions which unfavorably impact the level of economic activity if they fail to properly capture economic reality.

Indiscriminate capitalization of equipment operating lease agreements modifies recognition of expense in the income statement from its current straight line operating rental treatment. The RED's capitalization treatment of only Type A operating rental agreements creates accounting distortions that do not represent the true underlying economics of such operating rental agreements. Revenues earned from operating lease expenditures are earned steadily over time. Matching operating lease rental expense equally over that same benefit period will yield an income number that is a more stable

[2] Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, Definitions of Elements, Characteristics of Assets, paragraph 26, 2008, published by the Financial Accounting Standards Board.



and meaningful measure of the lease agreement's contribution to a company's performance.

RECOMMENDATION:

We recommend classifying leases as capital ONLY when it is consistent with the economic characteristics of the lease contract (a transfer of substantially all the risks and rewards incidental to ownership). We reject the RED's indiscriminant approach in capitalizing all equipment leases greater than one year and the RED's inconsistent reporting requirements of Type A and Type B leases.

The RED's suggested changes do not provide decision useful reporting information and violate the "neutrality" concept in the FASB's Conceptual Framework by forcing an out of period recognition of reported lease rental expense.

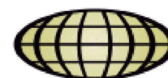
ALTERNATIVE PRESENTATION:

The alternative we suggest is to apply the following unifying logic to all types of lease agreements (whether for real property ***or*** for equipment):

1) Lease agreements that are in effect financings (which transfer substantially all the risks and rewards incident to ownership, whether for property or equipment should be treated as such. ***There should be no recognition of a "right to use" asset*** for leases that do not meet this 'financing' requirement. For those lease financing agreements that transfer substantially all the risks and rewards incident to ownership, Lessees should capitalize and record an asset and a liability; lessors record a financing receivable and remove the asset. **No "right to use asset" need be created.**

2) Operating lease agreements that are economic "rental agreements" should remain OFF BALANCE SHEET as operating rental agreements (***unless the 'term' of the rental agreement is for "substantially" all of the equipment or property's useful life***). Rents should be recognized on a straight line basis. Disclosure of contractual commitments for undiscounted future cash rent payments should be included in the footnotes to the financial statements.

Stakeholders are reporting the RED has not presented an acceptable alternative to existing US GAAP/IAS 17 and should NOT be implemented in its present state. The inconsistencies and complexities introduced, and the costs associated with changing current lease reporting requirements exceed the Board's "argument that a "benefit" results from capitalization of all operating rental agreements.



We ask that the Boards not ignore financial statement stakeholders, preparers, and users, and those who would bear the cost burden of the RED's suggested reporting revisions[3].

RESPONSES TO RE-EXPOSURE DRAFT LEASE ACCOUNTING QUESTIONS

Question 1) ***Identifying a Lease*** Do you agree with the definition of a lease and the proposed requirements in the Accounting Standards Codification paragraphs 842-10-15-2 through 15-16 for how an entity would determine whether a contract contains a lease?

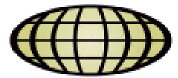
Answer: No

a. A lease is a contractual agreement entered into by a lessee for access to the availability and use of a lessor owned asset in accordance with the terms of the specific lease agreement. ***Lease agreements do not transfer asset ownership or asset ownership rights. The lessor retains both tax and legal ownership.*** A lease agreement can be likened to a split interest arrangement or bailment where placement of possession of personal property by one person, the bailor, is given into the hands of another, the bailee, for a designated purpose upon which the parties have contractually agreed. Such an arrangement is not a sale and we respectfully disagree that a "right to use" asset be recognized. A lease involves only a transfer of possession or custody, not ownership; it does not create an asset unless substantially all the risks and rewards of ownership are transferred.

The lessee's contractual obligation to pay operating lease rents are better recognized ratably as paid, not capitalized and amortized as the RED suggests. To do otherwise seriously distorts financial reporting of the economic relationship of the parties and creates unnecessary complexity in the investment analysis of financial operations[4].

Lease agreements do not allow the Lessee use "as the lessee pleases." Rather, such use is subject to significant negotiated lessor contractual limitations. Only the entity that owns the full bundle of rights can exchange the asset, use it to produce goods or services, **exact a price for other's use of it,[5] or otherwise "use it as it pleases."** (This level of control is exercised by the asset owner, ***not*** the lessee).

[3] "We are suffering from "change fatigue." Statement by Acting SEC Chief Accountant, Paul A. Beswick, December 3, 2012 from his remarks before the 201 AICPA Conference on Current SEC and PCAOB Developments.
[4] Investment Analysts have made this statement, see Minutes of the FASB Investors Technical Advisory Committee (ITAC) Committee meeting, July 24, 2012.
[5] FASB Statement of Financial Accounting Concepts No. 6, CON6-42, paragraph 184



Question 2: ***Lessee Accounting*** Do you agree that the recognition, measurement, and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset?

Answer: NO

1) The RED changes both balance sheet, income statement and cash flow recognition requirements of existing operating lease agreements to the ***economic*** ***detriment*** of the lessee.

   Capitalization of lease agreements that do not reflect the economic bargain of the lease contract is a distortion of the underlying business reality driving the agreement.

   Recommendation:

   Retain current US GAAP/IAS 17 lease accounting mechanics or, if a "change" is desired for a more "principles" based decision criteria, consider changing the "bright-line" test for capitalization criteria and on balance sheet treatment to "substantially all" of an assets remaining useful life (for *all* types of assets, whether equipment or real estate) rather than the RED's requirement of capitalizing an equipment lease "expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset."

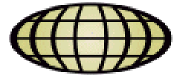
2) Even with a lease document in place, the lessor retains the "risks and rewards" of asset ownership, since the lessor retains the credit risk, maintenance risk, tax risk and residual risk.

Question 3: ***Lessor Accounting***

1) Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset?

Answer: NO

The dividing line for Lessor accounting should be based on whether the lease contract is for "substantially all of an assets remaining life" **NOT** as the RED suggests "more than an insignificant portion of the economic benefit embedded in the underlying asset,"



Question 4) ***Classification of Leases***

1) Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 842-10-25-5 through 25-8, which differ depending on whether the underlying asset is property.

Answer: NO

<u>This is a fatal deficiency of the RED</u>. Lease classification should be consistent regardless of the type of asset subject to the lease contract.

Question 5) ***Lease Term***

1) Do you agree with the proposals on lease term (842-10-25-3), including the reassessment of the lease term if there is a change in relevant factors (842-10-55-4, 5)?

Answer: Yes

Question 6) ***Variable Lease Payments***

1) Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments (842-20-55-45 to 52)?

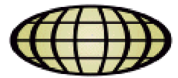
Answer: Yes

Question 7) ***Transition***

1) Subparagraphs 842-10-65-1(b) through (h) and (k) through (y) state that a lessee and a lessor would recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

2) Are there any additional transition issues the Boards should consider? If yes, what are they and why?

Answer: We do NOT agree that this RED should be implemented. We believe transition requirements further create ***significant and unneeded*** burdens on the stakeholder community, do not provide any additional information



stakeholders find cost beneficial, and in fact, distort the economic bargain inherent in operating leases.

The RED should not be implemented.

Question 8) ***Disclosure***

1) Paragraphs 842-10-50-1, 842-20-50-1 through 50-10 and 842-30-50-1 through 50-13 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analysis of undiscounted lease payments, reconciliations of amounts recognized in the statement of financial position, and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

Answer: We support the continued use of existing US GAAP/IAS 17 reporting requirements and believe enhanced footnote disclosure would be beneficial. The minor changes in existing disclosures (as referred to in Footnote 1 above) would be all that is necessary to achieve the necessary cost-benefit balance in while improving transparency regarding lease obligations, whether for a lessee or a lessor.

The RED in its current form does not reflect the economics of operating lease transactions and should not be implemented.

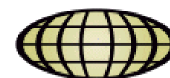
Question 9) ***Nonpublic Entities (FASB Only)***

1) To strive for a reasonable balance between the costs and benefits of information, the FASB decided to provide the following specified reliefs for nonpublic entities:

    a. To permit a nonpublic entity to make an accounting policy election to use a risk-free discount rate to measure the lease liability. If an entity elects to use a risk-free discount rate, that fact should be disclosed.
    b. To exempt a nonpublic entity from the requirement to provide a reconciliation of the opening and closing balance of the lease liability.

Will these specified reliefs for nonpublic entities help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements? If not, what changes do you propose and why?

Answer: We support the continued use of existing US GAAP reporting requirements for nonpublic entities and believe enhanced footnote disclosure



is all that is necessary to achieve the necessary cost-benefit balance to improve transparency regarding lease obligations, whether for a lessee or a lessor, public or nonpublic.

The RED in its current form does not reflect the economics of operating lease transactions and should not be implemented.

Question 10) ***Related Party Leases FASB Only***

1) Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases (for example, to require the lease to be accounted for based on the economic substance of the lease rather than the legally enforceable terms and conditions)? If not, what different recognition and measurement requirements do you propose and why?

Answer: NO

Reporting of all lease transactions should be based on the identified underlying economics of the lease contract.

Question 11) ***FASB Only***

1) Do you agree that it is not necessary to provide additional disclosures (beyond those required by Topic 850) for related party leases? If not, what additional disclosure requirements would you propose and why?

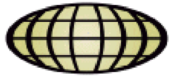
Answer: Yes

Question 12) ***Consequential Amendments to IAS 40 (IASB Only)***

1) Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? This would represent a change from the current scope of IAS 40 which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If no, what alternative would you propose and why?

Answer: No. We do not support the creation of a right of use asset as it distorts the basic economics inherent in operating lease agreements.



Respectfully submitted,

Vincent A. Kolber
RESIDCO
President
(t) 312-726-0693
www.residco.com

Respondent's Biography:
http://www.residco.com/vincent-a--kolber-team-1.php