Mr. Robert Herz
Chairman FASB

Sir David Tweedie
Chairman IASB

Dear Sirs

Thank you for the opportunity to comment on the Lease Exposure Draft (ED). I'm responding to the proposed changes to lease accounting. I have been in the leasing/finance industry for twenty-five years and probably the only respondent to mention the "McGregor Report" which was a catalyst for today's discussion.

I align with Warren McGregor's approach and believe the liabilities should be reflected on the balance sheet and support the Board(s) desire to;

- Bring all liabilities on balance sheet
- Eliminate/minimize financial engineering
- Provide better reporting

From reviewing the current documents posted from other respondents on the ED – I will not try to "pile on" but provide analysis to area's where the Board(s) and respondents (Lessor/Lessee) have been misguided and/or indirectly created potential impact which was not intended. I have managed leasing portfolios, supported over two hundred lessors on pricing/lease accounting systems, worked with both internal/external auditors, lessees, and have implemented changes in large software applications which support financing & leasing.

The first area to address is the **"more likely than not term".** This has serious repercussions to all involved and impacts multiple entities. If approved under the ED proposal – this would create a **"perpetual reconciliation juggernaut".**

Most personal property (equipment) leases are under operating budgets for lessees. These are managed by the various departments and may be off balance sheet (less than 20%). Going forward the CFO would likely be more involved in reporting as leases are capitalized. Based on this – the likelihood of leases carrying over past the lease term diminish greatly based on the new governance/formal reporting. Historically, renewals/extensions for equipment may occur for a few months in some situations and does not support the ability to create financial engineering.

Concern with the **more likely than not term**;

- Liability – The definition of a liability is only "met" with the base term of the contract. Renewals/extensions only meet the definition of a liability as they occur(after expiration of the base term)

  - About 15% of the portfolios with Personal Property (Equipment) leases have 1/5th of these leases enter renewals/extensions beyond the base term. The extensions are for one or more of the following reasons;
    - Awaiting new equipment to be delivered
    - Monthly rental until capital budget is approved to purchase
    - Interim capacity based on spike in demand or reserve capacity for other equipment in disrepair/refurbishment
    - Equipment in process of being returned to Lessor

- The most critical item in leasing from an accounting standpoint is the "net investment" components that drive the calculation (similar to the principle balance in a loan). The proposal in the Exposure Draft to include "more likely than not" rentals into the base period – impacts the net investment and has a severe material impact across multiple disciplines. The Board(s) needs to consider the unintended impact of this approach;

  - Additional sales, use, upfront & property tax will occur as lessors collect additional payments for the more likely than not scenario. This will launch the first step in perpetual "fire drill" reconciliation.

  - Credit Bureau reporting on payment delinquency will be incorrect. As operations try to reconcile and apply/post payments to open/modified receivables this will inevitably show accounts past due which should be current. With improper reporting – this may likely lead to lower credit grades which are priced/underwritten differently by the lessors/finance companies.

  - Cash application/reconciliation is the "Achilles Heel" of financial operations – the ED will compound this problem and impact;

    - Additional/improper late charges will be incurred from the improper accounting/management of the receivables outstanding on the base contract and renewal term. As operations try to reconcile and apply/post payments to open/modified receivables this will cause late charges to be assessed on open items – from the increased complexity of the process.

    - Buyouts/Payoffs can occur with up to thirty percent (30%) of contracts/portfolios on an annual basis. This can likely provide an overstatement of income for lessors and lead to legal issues. The Buyouts/Payoffs quoted will overstate income from the more likely than not term – which increases the net investment.

    - Finance/Interest income will be overstated/accelerated by lessors compared to the existing process.

- Improper reporting will occur for securitizations and other portfolio/pool products in the market.

- The more likely than not term – if greater than the base term will overstate income/accelerated approach for the period. Proforma reports to utilize tax payments estimates will create a permanent forecast/reconciliation issue.

- The residual becomes subject to change as - "is this based on the base term or more likely than not term?"

Another area of concern not addressed by most respondents' centers on what constitutes **"significant risk"** in order to determine the proper lease classification (Derecongiton Approach or Performance Obligation). It appears significant risk would be driven by the useful life remaining at lease expiration (not extension/renewal) and residual/salvage value. In the past the 90% bright line test was utilized for lease classification. In this situation – a similar challenge is required for the proper classification.

Without guidance, the ability to compare financial products across multiple lessors from a reporting standpoint to the market becomes challenging. It is likely each lessor will determine the components (i.e. useful life, residual/salvage position) in each lease to determine the proper classification. It may be beneficial to keep the current accounting in place from FASB for lessors – whereby leases without significant risk would be treated as capital leases and those with significant risk would align with operating leases.

As the 90% test is no longer valid – a new test will be required. Potential parameters/guidance may be utilized as outlined below – to help lessors and the accounting community. Useful life as defined by the ASA (American Society of Appraisers) and supported by USPAP (Uniform Standards of Professional Appraisal Practice);

"Useful Life of an asset is when fifty (50%) percent of the model is retired from service"

The ASA Machinery & Technical Specialties (M&TS) has researched and provided a study providing the useful life for assets. This is an independent study which aligns with USPAP standards and can be utilized as an objective basis for lessors to determine the term of the transaction against the useful life of the asset. Other studies may exist and would be applicable for various industries.

The engineering or useful life of an asset does not change based on the owner/lessor of the asset. One of the proposals in the ED was that based on the lessors business model should drive the classification of a Derecogniton Approach or Performance Obligation. Simply carving out one lease from Lessor A and placing it into another portfolio (Lessor B) should not alter the lease classification. It would be difficult to see how the lessor should have a bearing on the useful life or classification of the finacial product as outlined above, however, some lessors may take larger residual positions. A potential discussion point/guidance on “significant risk could be;

- An asset that has greater than the (X) years remaining of Useful Life compared with the guidelines (i.e. o ASA/MT&S) from applicable industry sources/studies.

Another area of concern focuses on the loss of residual accretion – that has existed since 1976. My estimate is the Board(s) indirectly impacted the accretion as this has not been characterized as an abusive approach. IAS 36, FAS 144 & FAS 13 are some of the existing standards which monitor the residual/salvage value on an annual basis. The PV of residual has several challenges as outlined in other documents provided to the Board(s). A user of financial statements would have a challenge trying to decipher what the true residual position utilized for pricing with a PV of residual – whereby the accretion of the residual would show the true economics and avoid the large spikes at expiration.

| Reference | Lessee Accounting | New Proposal | Financial Statements |
|---|---|---|---|
| | **Liabilities (Base Rents & Active Fixed Term Renewals)** | | |
| A | Base Rents - Capital Leases | Capitalize - include in Financial Statements | Yes |
| B | Base Rents - Operating Leases | Capitalize - include in Financial Statements | Yes |
| | **Contingent Liabilities** | | |
| C | Usage Based | Capitalize if > XX% of Base Rents | Yes |
| D | Market Based | Immaterial | No |
| | **Purchase Option (Estimates)** | | |
| E | Contract/Fixed - Capital Leases | Estimated Amount of Purchase | Supplemental Disclosure |
| F | Market/FMV - Operating Leases | Estimated Amount of Purchase | Supplemental Disclosure |
| | **Non - Purchase Option Liabilities** | | |
| G | Contract/Fixed - Capital Leases | Capitalize – include in Financial Statements | Yes |
| H | Market/FMV - Operating Leases | Capitalize – include in Financial Statements | Yes |
| | **Renewal/Extensions (Month to Month)** | | |
| I | Contract/Fixed - Capital Leases | Capitalize if > XX% of Base Rents/Term | Supplemental Disclosures |
| J | Market/FMV - Operating Leases | Capitalize if > XX% of Base Rents/Term | Supplemental Disclosures |

The amount of GL activity under the ED provides several considerations and an ad undo complexity to the process and hinders reporting. The approach outlined above eliminates off balance sheet reporting, reduces/mitigates financial engineering, supports better reporting and provides governance for comparing estimates with actual liabilities as they occur.

Basically – if one was to review the financial statements with these changes it provides several benefits;

- Lessees will have balance sheet/financial statement activity on components that meet the definition of a "liability" base rent.
- To improve reporting and mitigate perceived financial engineering – the lessee would account for the base rents and return costs. Non GL/Reporting would provide the details (Purchase Options, etc) to provide a better overall picture of the Lessee from supplemental disclosures for;
  - Comparing current liabilities (base rents/fixed renewal terms) and future liabilities (estimated Purchase Options) with other like entities
  - Reporting via supplemental disclosures that outline Return Costs Purchase Options to help outline perceived financial engineering
- Decreases the complexity and multiple GL entries which can be accomplished with general reporting/supplemental disclosures.

Here is a summary as aligned with the applicable chart/reference above;

**Reference A**: Like today capital leases would be on balance sheet.

**Reference B**: Current operating lease would be reported as capital leases. This provides better reporting and mitigates perceived financial engineering

**Reference C:** A few industries charge in addition to the base rent (i.e. copiers/# of copies). To mitigate perceived financial engineering – if usage amount exceeded a certain percentage (i.e. 10%) – than that amount should be reflected on the balance sheet

**Reference D**: If payments are indexed/float which could increase/decrease based on the market/LIBOR –it would seem immaterial. These rates are typically trued up on an annual basis. Lessees could provide estimate based on remaining term and increase/decrease in aggregate payment amount from forecast rate adjustments under a supplemental disclosure if required.

**Reference E**: By contract – these leases are determined and the Purchase Options is typically a fixed/nominal amount. Lessee can report these to help provide better reporting and minimize perceived financial engineering.

**Reference F**: Lessors know the FMV/Residual of the asset over the term. Lessors are required to monitor this value under various requirements (FAS 13/144), reserve allocation, PD/LGD calculations, etc. Lessors can provide this information to Lessees via a normal reporting period. To create GL activity on an option that has not been exercised and/or fluctuates – would be better served by reporting as outlined.

**Reference G/H**: If the Board is worried about financial engineering – then the Return Costs could be reported until the return option is not selected by the lessee. The Return Costs would be checked against the Purchase Option Price to validate if there is materiality to support financial engineering. The Purchase Option Price or Return costs will be incurred by the Lessee regardless, thus the accounting for the Return Costs seem reasonable to reflect this liability.

**Reference I/J**: As mentioned – in the equipment leasing industry – renewals are nominal and will continue to decline as additional governance/reporting is in place for on balance sheet requirements. If there is a perceived financial reporting abuse – than month to month renewals could be monitored/reported outside the Financial Statements – once they meet a percentage (i.e. 10%) of the base rent. To create financial statement activity on an option that has not been exercised and/or is immaterial would be better served by reporting as outlined above. Month to month renewals would be reported – but active fixed term renewals would be capitalized.

In summary, I think the approach of bringing all leases on balance sheet for lessees is prudent and should be reflected in the financial statements. Better reporting is available with supplemental disclosures in lieu of generating multiple financial statement/GL activity for proposed approaches under the ED. This should help mitigate the risk outlined in this document and align with comments from other respondents.

Sincerely,

Mark A. Belec

Advanced Portfolio & Application Services