



December 14, 2010

Ms. Leslie Seidman
Acting Chairman
Financial Accounting Standards Board

Sir David Tweedie
Chairman
International Accounting Standards Board

FASB/IASB Exposure Draft – Leases (August, 2010)

Dear Madam and Sir:

Donlen respectfully submits this response to your invitation to comment on the exposure draft, *Leases*. Donlen provides leasing and management services to automobile and truck fleets, primarily in the United States and Canada. The majority of our leases are open-ended, with lease payments determined by a floating interest rate adjusted monthly based on index rates. Accordingly, our comments are directed at the application of the proposed standard to our sector of the leasing industry and not necessarily to all leasing transactions. We appreciate the intention of the Boards to provide consistency in accounting and reporting between U.S. and international standards, and to increase the transparency of various financing arrangements to users of financial statements. However, we have concerns that the standard as drafted encompasses so much complexity and uncertainty that the users of financial statements would enjoy less insight than the current standards provide. Our comments fall into the following categories:

- 1) Lessee Accounting
 - A. Recognition of assets and liabilities
 - B. Lease valuation – interest rate
 - C. Lease valuation – lease term
 - D. Lease valuation – future lease payments
 - E. Recognition of expenses arising from leases
 - F. Complexity and cost to implement
- 2) Lessor Accounting

1. Lessee Accounting

A. Recognition of Assets and Liabilities

Question 1: Lessees

(a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

The Boards' broad-brush determination that all leases are the same is not consistent with the reality of how lessees, lessors, and investors evaluate leasing. In theory, leases that provide financing for strategic assets used in the core functions of a business should be recognized on the balance sheet of the lessee, and factored into the financial analysis performed by financial statement users. However, our customers do not apply this singular view of leases and do not consider themselves owners of these assets. Rather than looking at leases as a means of acquiring and financing assets, our customers use fleet leasing as a means to achieve their operational goals by providing:



- *Flexibility:* Open-ended leases, common to fleet leasing, allow companies to expand or contract the number and type of vehicles quickly and at low cost. Vehicles, as well as other equipment such as computers, are viewed by management not as assets but as operating expenses. The term of our leases becomes essentially however long the company desires to use the asset. This type of lease more closely resembles a cancellable service contract rather than the financing of a long term asset.
- *Risk Mitigation:* Our customers use operating leases to avoid the risk of ownership of non-core assets. Ownership risk includes the residual value of the asset, as companies do not want to manage acquisitions and disposals of tactical assets based on gains and losses. The risk of ownership of non-core assets includes the ease of entry and liquidity of the aftermarket, as well as the effort required to remarket the asset. Companies use leases to avoid these risks and focus on core business risk.
- *Cost Containment:* Companies use leases of tactical assets as a means to shift costs associated with ownership to the lessor. Costs of ownership include sales and use taxes, registration and licensing, and administrative tasks that are performed by the lessor. Additionally, companies look to lessors of non-core assets to provide favorable pricing that the companies could not realize as owners / purchasers of assets.

The Boards need to give separate consideration to leases that are entered into with the goal of operational efficiency, apart from acquisition and financing of strategic assets. We agree with the Boards that the “bright line” tests for capital versus operating leases in U.S. GAAP need to be replaced by a principles-based approach. We disagree with the Boards’ broad brush determination of all leases as identical. Donlen advocates separate treatment of leases that provide operational tools to support a business from leases that represent investment in strategic assets. The Boards have commented that users of financial statements do not separate leases of core versus tactical assets. In our experience, both lessees and investors make decisions on these assets using entirely different criteria. Accordingly, providing a means to separate their treatment provides superior financial information.

B. Lease Valuation – Interest Rate

The Boards’ determination to use the lessee’s incremental borrowing rate does not match the underlying economics of leasing of non-core assets. The incremental rate is based on the business risk of the lessee as a whole. Lease rates of specific assets are determined by the risk of the specific underlying asset as well as the credit risk of the lessee, and may be influenced by the lessor’s ability to utilize tax depreciation. Accordingly, there is less risk associated with a specific class of assets such as vehicles, especially when the underlying assets are interchangeable and a ready aftermarket exists for these assets, relative to the overall business risk of the lessee.

While the option to use the interest rate inherent in the lease is superior to the incremental rate, its application by the Boards is flawed with respect to floating or adjustable rate leases. The proposed standard forces lessees to lock into a fixed rate, namely the forward rate at the time of lease inception. This contradicts the value of floating rate leases, through which the lessee is not exposed to valuation risks. Valuing and amortizing lease liabilities at a fixed rate distorts the true valuation of floating leases.

Applying true floating rate leases to the broad-brush capitalization model proposed by the Boards would require lessees to revalue leased asset and liability balances for each change in the reference interest rate. This situation results in additional cost and effort by lessees, fluctuation in asset and liability balances, and no better financial information presented to users. Donlen advocates a separate model for leases that are not capital investments by lessees but rather a flexible program for the rental of non-core business assets.

C. Lease Valuation – Lease Term

Question 3: Short-term leases

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

Question 8: Lease term



Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

The Boards' proposal to include renewal periods becomes more untenable as longer term and more uncertain leases are considered. Leases of fleet vehicles, while often open-ended, present a relatively consistent pattern of time that the underlying asset is used by the lessee, typically 3-4 years for vehicles. Valuation based on uncertain lease terms is valid only when there is a reliable means of estimating the term, based on consistent behavior or clear intentions of management. The inclusion of option periods when the exercise of the option may not be determined for years introduces a high degree of subjectivity and variability which current standards do not have.

The shelter offered by the Boards for short term leases is not sufficient. In our experience, very few leases have a maximum term less than a year. As a result, the proposal generates very little value in terms of reducing the cost and complexity of implementation or avoiding financial statement fluctuation.

If the Boards determine, against our counsel, that all leases require capitalization, the lease term used in the valuation should not include periods where the execution of options is uncertain. The only lease periods that should be included in the valuation are those to which the lessee is contractually bound, the terms of the lease make extension a certainty, or management has determined with certainty that the extension will be exercised.

D. Lease Valuation – Future Lease Payments

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured? Why or why not?

The proposed standard is flawed both conceptually and in its implementation. Recognizing a liability for payments to be based on uncertain events in the future does not meet the conceptual definition of a liability. The treatment is similar to accruing a liability in 2010 for heating costs to be incurred if we anticipate the winter of 2015 is to be colder than normal. The model as proposed forces recognition of a liability when no obligation exists on the part of the lessee.

Using a probability array of potential outcomes as a basis for calculations, in the absence of historical patterns or reliable means of determination, results in valuations that are almost certain to be wrong. The development of such a valuation model is costly, complex, and subject to an unwieldy level of speculation and manipulation.

We recommend disclosure of a range of outcomes of uncertain lease payments for a forward-looking period of five years. The factors used to derive the range (percent of sales, units of output) should be included in the disclosure. The disclosure of contingent lease payments should only include leases of assets that are core to the business strategies of the company, and should not include rentals of operational assets.

Fortunately our customers are spared the cost and complexity of this provision, as the pattern of payments inherent in our leases is stable and predictable, with the exception of the interest rate component discussed earlier and represents a small portion of the lease payment. Additionally, we are able to easily separate true rental payments from administration, management, and other services we provide.



E. Recognition of Expenses Arising From Leases

Question 1: Lessees

(b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

The proposed standard results in an acceleration of expenses in the initial periods of a lease. The recognition of higher expenses related to leasing in the early periods distorts the economics of the lease. The proposed standard also results in right of use assets valued at less than their payment liabilities for the early periods of the lease. If the Boards determine that a capitalization and amortization model must apply to all leases, the amortization should be structured to balance the recognition of expense over the term, and to ensure that lease assets and liabilities are in balance in the absence of impairment.

In addition to higher volatility, the proposed standard decreases the visibility of leasing expenses relative to the current operating lease model. The current operating lease expense reflects the “pay as you go” economics for many operational assets. The proposed standard separates expenses into an amortization component and an interest component, occupying separate areas of the income statement. Users of financial statements will likely need to make proforma adjustments to bring lease expenses into operating cash flow and EBITA.

The proposed expense recognition model creates internal control and accountability challenges for many companies, who budget and report operating lease expense within the accountability center that controls the use of the asset. Many companies do not account for amortization and interest at the operational level, resulting in a loss of accountability and control over lease expenses. A division manager is more likely to manage the deployment of leased assets when the division budget bears the expense than when amortization and interest is charged to a corporate budget.

F. Complexity and Cost to Implement

Question 17

Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

We believe the proposed standard imposes excessive cost and complexity on lessees. Broad brush treatment of all leases results in extensive cost and analysis required to predict future lease payments, when the underlying lease is structured as a pay as you go model by lessor and lessee. The minimal proforma adjustments made by some financial statement users are readily calculated by the information presented under current standards. These same users will have to perform more extensive adjustments to financial statements to reflect lease expenses as operating expenses, and to adjust asset and liability balances to align.

There is a greater risk than the hard cost of implementation. Banks and other financial institutions will need to adjust lending and capital covenants to reflect the changes wrought by the standard. There will likely be a significant slowdown of lending and investing activity while these adjustments are working their way through capital markets. Leases of non-core assets with a much lower risk, and accordingly a lower cost, will become commingled with capital acquisitions with a much higher risk and capital cost.

2. Lessor Accounting

The issues raised in this letter regarding lessee accounting apply to proposed lessor accounting as well. The performance obligation model does not properly reflect the risk of ownership of the residual asset. It is difficult to fathom how leasing an asset creates a performance liability on the part of a lessor.

The derecognition method is conceptually unsound as well. For Donlen, the standard results in a vehicle that is not on the balance sheet of either the lessee or lessor.



Mr. Bosco's comment letter appropriately addresses the major issues with lessor accounting. Donlen urges the Boards to completely reconsider the lessor accounting provisions of the proposed standard. Lessor accounting needs to be deferred until lessee accounting is finalized. Lessor accounting can then be developed in a manner that provides consistency between lessee and lessor financial reporting.

Conclusion

Leasing encompasses a vast array of activity, from financing of real estate capital assets at the core of a business, to short term rentals of ancillary items needed to support operations. Current accounting standards rely on bright line tests to determine whether a lease represents a de facto purchase of an asset. The result of the bright line test is that the balance sheet of an airline may not reflect aircraft assets, as members of the Boards have pointed out. Donlen supports the adoption of a principle-based standard that reflects the rights, risks, and obligations that a lease agreement creates. We urge the Boards to recognize that leases are not all identical, and modify the standard to reflect the operational versus capital characteristics of certain types of leases. We believe the standard as proposed distorts the true economics of the leases that comprise our business, and impose an undue burden on our customers. We ask the Boards to consider if the same airline financial statements are enhanced by capitalization of luggage carts as well as aircraft, as each requires identical analysis, remeasurement, and disclosure.

Respectfully Submitted,

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