International Accounting Standards Board First Floor 30 Cannon Street London EC4M 6XH United Kingdom Robert Heald 12/13/2010

Financial Accounting Standards Board 401 Merritt 7, PO Box 5116 Norwalk, CT 06856 United States

## Dear Board Members:

Thank you for the opportunity to comment on the Lease Exposure Draft. I support this joint venture between the IASB and the FASB. I agree with the lessee accounting as presented in the Exposure Draft and with the derecognition approach to lessor accounting. The accounting for both the lessee and derecognition lessor methods accurately recognize assets and liabilities created as a result of the lease contract. The performance obligation method, however, does not accurately recognize assets and liabilities. I argue that the performance obligation method should be discarded and replaced with the derecognition method or a modified derecognition method.

All leases are sales. Sometimes the sale is the physical leased asset—a sales type lease under the old standard. Sometimes the sale is the expected intangible benefit the lessee will receive from the leased asset over the life of the lease. Finance professors describe this benefit as a future series of cash inflows or a reduction of future cash outflows. I will use this principle to evaluate the two lessor accounting methods—derecognition and performance obligation.

From the lessor's perspective, the discounted lease inflows the lessor will receive comprise the fair market value of the leased asset. The lessor, in effect, has an inventory of cash flows that the lessor sells to the lessee in exchange for a receivable. This inventory of cash flows represents the lessor's economic resource. Using the derecognition method, the carrying value of the underlying asset is removed by the lessor at the commencement date of the lease. This accounting treatment is correct since the lessor has converted some or all of its rights to the underlying asset into a lease receivable. Any method which allows the lessor to continue to recognize the entire underlying asset is deficient and would create a situation where two different entities get to claim asset rights on only one asset. This asset I am describing is not necessarily the physical asset. It can also be the intangible expected benefit.

The standard setters seem to believe that because the lessor may retain significant risks or benefits associated with the physical leased asset—a sale has not occurred. I believe this is a mistake. A sale has occurred, even though it may only be a partial sale of the physical underlying asset. All leased assets, except those with indefinite lives, have a finite amount of benefit. The benefit, once used by the lessee, is gone forever. The current derecognition method would correctly remove the portion of the carrying value of the leased asset from the lessor's balance

sheet associated with the expected benefit that will be used by the lessee. This is correct because the lessor has converted part of the leased asset's carrying value into a receivable. The performance obligation would not reduce the carrying value of the leased asset and this would cause the assets to be overstated on the lessor's financial statements.

With respect to the performance obligation method, this exposure drafts fixes the understatement of leased assets on lessee's balance sheet only to create the opposite problem of overstatement on the lessor's balance sheet. Nonetheless, the performance obligation method has ardent supports and I can certainly empathize with them. The performance obligation does an excellent job of matching the lessor's lease revenue with lease expense. I argue that there is a way to modify the derecognition method such that it equals the performance method in matching.

My modified derecognition method involves the use of a contra asset account. I will use the example in the exposure draft at B30 (see figure 1). At commencement, debit a discount on leased assets instead of cost of sales and credit deferred revenue instead of revenue. The discount behaves as "lease expense in waiting" while deferred revenue represents "revenue in waiting". Amortize the discount over the life of the lease using the effective rate method. Recognize the deferred revenue over the life of the lease as well. This method will match revenues and expenses as well as the performance obligation method and correctly derecognizes the underlying asset. As an added bonus, the discount also gives additional information to users since the contra asset account on the lessor's balance sheet will clearly and easily identify the rights that the lessee has over the lessor's lease inventory.

Another advantage of this modified derecognition method is that it does not utilize a lease liability on the lessor's financial statements. The lease liability as used in the performance obligation method is not a liability. The standard setters argue in BC17 that a lease liability exists because the lessor cannot lease the asset to another party during the term of the lease, "The lessor is committed to allowing the lessee to use the underlying asset for the entire lease term, even if the price or availability of similar assets changes or if there are changes in other economic factors." In a nutshell, the lessor has lost control of the asset during the lease term and is trapped by the lease contract and exposed to negative market externalities. But then in the previous paragraph, BC16, the standard setters argue the opposite point.

In BC16 the standard setters claims that "When the lessor grants the lessee the right to use the underlying asset during the lease term in exchange for a right to receive lease payments from the lessee, it does not lose control of the underlying asset and, thus, continues to recognize the underlying asset in the statement of financial position, with no adjustments." Paragraphs BC 16 and BC17 are anathema to each other. Both cannot be true. Either the lessor has lost control of the asset and it's carrying value associated with the lessee's lease rights should be derecognized or the lessor retains control over the asset. In the latter, the lessor will not be exposed to changes in economic factors because the lessor will be able to lease the asset to another party if positive economic factors occur.

The standard setters are correct to consider the opportunity cost of not being able to lease an asset that is already leased but this cost is already accounted for elsewhere in the financial statements. The opportunity cost is embedded in the lessor's incremental borrowing costs. For example, in a state of the world that the standard setters describe in BC17—one where the lease payments for a similar leased asset increase—the lessor would simply acquire another similar

asset to lease. If the lessor borrows the money to purchase or build another asset, this would have an effect on the lessor's incremental borrowing costs. These incremental borrowing costs are already incorporated into the lessor's interest expense as shown on the lessor's income statement—just as the lessee must now recognize interest expense on the lease, the lessor is already recognizing the interest expense to stay solvent.

I similarly hold that leased assets with an indefinite life—land for instance—should be treated as a reduction in net working capital. The cost of leasing assets with indefinite lives is the loss of that asset's fair market value. The lessor can either choose to lease the asset or sell it. If the lessor chooses to sell the asset, the lessor receives a lump sum payment (or an equivalent annuity) which the lessor can use to reinvest in other business activities. If the lessor chooses to lease the asset, the lessor is delaying the sale of the asset for the length of the lease. The cost of waiting is the lessor's incremental borrowing rate on the fair market value of the leased asset. This expense should be matched with the lease payments the lessor receives.

In conclusion, I believe that the performance obligation double counts asset's and creates a fantasy liability on the lessor's balance sheet. I support the current derecognition method or a modified derecognition method to account for the lessor's side of a lease contract. I again thank the Boards for their efforts and consideration.

## Figure 1

BC30 at commencement:

Dr Lease receivable CU6,710

Dr Discount on asset held for lease CU4,793

Cr. Underlying asset CU4,793

Cr. Deferred revenue CU6.710