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Invitation to Comment – Exposure Draft Leases

Dear Board Members,

Thank you for the opportunity to comment on the Lease Exposure Draft ("ED"). LeaseTeam provides software solutions to the equipment leasing industry which manages the entire life cycle of a lease including pricing, credit adjudication, and accounting for the lease. We have over 240 clients throughout the United States and Canada using our solution and have been active in this industry for over 20 years.

While we theoretically agree with the right-of-use model and the improved financial reporting derived from bringing all leases "on balance sheet", we are concerned with how the ED proposes to measure them and feel that the ED complicates and significantly increases the cost of accounting for leases for both lessee and lessor. We disagree with the proposed rules for including optional renewal payments and contingent rents in the calculation of the lessee liability as they do not meet the definition of a liability. The lessee’s decision to extend an equipment lease is typically made near the end of the contractual lease term, and based on economic and business conditions at the time. For example, how useful or accurate would lease term estimates made in a 2007 financial statement be today, in the midst of a significant recession?

We believe that the lease asset and liability should include payments the lessee is contractually obligated to make. We understand the concern about lease structuring that may be done in order to reduce the lessee liability. To ensure that structuring opportunities do not exist, renewal options should be included in the liability recorded by the lessee and the asset recorded by the lessor, if there is a significant contractual incentive to renew or there are significant penalties for not renewing, which make it virtually certain that the lessee will renew.
Our suggestions closely mirror the current minimum payment standards found in FAS13 and IAS17, which we believe would provide a good set of rules for measuring assets and liabilities under the right-of-use model.

Contingent rentals should not be included in measuring the lease asset or liability unless they are tied to an index or rate. Payments that are contingent upon actual usage of the underlying asset should be excluded from the lessee liability since they can be avoided by the lessee. The proposed probability weighted scenario analysis will add considerable estimation risk. We don’t believe that estimates of this nature would provide a benefit commensurate with the cost of complying. However, we do agree that rental payments tied to an index and guaranteed residuals should be included. In addition, to prevent creative accounting through structuring, the final standard should address rules for determining when the base rent is being disguised as contingent rent.

We disagree with the residual asset accounting proposed under the derecognition method because it will create an inconsistency between the true economics and the accounting. If the lessor is confident enough to price based on the estimated residual, why is it ignored under the accounting rules? We believe that residual value estimates are more reliable than estimating the lease term or contingent rents. As under current rules, we feel the lessor should be able to accrete the residual. In addition, the residual is not property, plant, or equipment, but rather should be presented with the lease receivable as an investment.

We appreciate the opportunity to respond to the changes being proposed and hope that you will carefully consider our input. We sincerely feel that the proposed rules for application of these changes create an unnecessary burden for the many companies that lease equipment, and could have a negative affect on the leasing industry which may reduce the number of finance options available in the market. We hope that you will simplify the application of the right-of-use model.

Our answers to the specific questions are included in the attached appendix. If you have any questions regarding our response, feel free to contact me at (402) 493-3445.

Sincerely,

Russel Hallberg
President
Appendix - Response to Exposure Draft Questions

Question 1: Lessees
(a) Yes. We generally agree with the proposed right-of-use model and feel that recognizing all leases on the statement of financial position provides better information. However, we disagree, with some exceptions, to the capitalization of renewal options and contingent rentals. These are discussed more fully in response to questions 8 and 9.

(b) Yes. While we are concerned about the acceleration of expense on the lessee statement of income, we feel it is consistent with the right-of-use model (i.e. lessee is financing the purchase of a right-of-use asset).

Question 2: Lessors
(a) No. We see no significant improvement to lessor financial reporting under the proposed rules. We understand the desire to maintain symmetry between lessee and lessor accounting, but we believe the costs to convert and report under the proposed rules far outweigh the benefits. As a software provider to the leasing industry, we understand conversion costs. Upgrading to a system that supports the new lease accounting rules will be the most significant system upgrade most lessors would have ever experienced. Converting to either method would be challenge enough, but adding the uncertainty of applying the measurement estimation rules being proposed would be significantly more complicated for those lessors offering more complex leases.

(b) The equipment leasing economic model matches the derecognition model much more closely than the performance obligation, and this guidance should support that classification. We recognize that the derecognition model may not be suitable for other types of leasing, in particular real estate leasing, however, the introduction of two lessor models fails on the board’s goal of creating accounting symmetry between lessees and lessors. Having two models causes more confusion than today’s lease accounting for lessors since the guidance defining when to apply which model is not sufficiently defined.

While we generally agree with the derecognition method, we believe the elimination of residual accretion is a step in the wrong direction. Fair value would give financial statement users the best information.

Question 3: Short-term leases
(a) We agree that a simplified method of accounting for short-term leases should be available and think that the proposed method achieves this goal.
Question 4: Definition of a Lease
   (a) Agree.

   (b) We disagree with the concept of separate purchase/sale for a lease. We suggest relying on the proposed revenue standard for determining whether a sale has occurred and removing the special rules for a lease. Unless title transfers at the inception of the transaction, as would occur in a purchase or sale of an underlying asset, the transaction should be accounted for as a lease under the guidance proposed in this exposure draft.

   (c) Agree.

Question 5: Scope Exclusions
   Agree.

Question 6: Contracts that contain service components and lease components
   We agree that distinct service components should be accounted for separately from the lease component, using the accounting proposed under the Revenue from Contracts with Customers exposure draft. There is some concern that the “distinct service” guidance does not clearly address operating costs under a real estate lease. Such operating costs should be considered distinct services and accounted for separately from the lease component.

   Except for the “front-end loading” of expense under the proposed lessee accounting rules (see question 1(b)), this would not be a significant issue.

Question 7: Purchase options
   We disagree and feel that a purchase option should be handled in the same manner as a renewal option. The purchase option should be included in the right-of-use asset and liability, if it is reasonably certain that the lessee will exercise the option.

Question 8: Lease term
   We don’t agree that typical lease renewal options meet the definition of a liability. We understand the concern about lease structuring in order to reduce the lessee liability. To ensure that structuring opportunities do not exist, renewal options should be included in the liability recorded by the lessee and in the asset recorded by the lessor, if there is a significant contractual incentive to renew or there are significant penalties for not renewing, which make it virtually certain that the lessee will renew.

   It is our opinion that the proposed “longest term more likely than not to occur” standard introduces unwarranted accounting complexity without a commensurate improvement in the information presented in the financial statement. It also involves estimation of dubious reliability since in the case of the lessee, it would be
based on forecasts of business conditions years in the future; and in the case of the lessor, no way to reasonably estimate the lessee’s intention.

We believe the optional lease extensions are a valuable lessee tool for managing risk and price, and fear the proposed accounting treatment may build incentives for leaving the extension options out of the lease contract, and simply re-negotiating a new agreement when the time comes.

Question 9: Lease payments
We have similar concerns with the inclusion of all contingent rentals that we have with optional lease payment. The proposed probability weighted scenario analysis adds tremendous complexity and estimation uncertainty. Unless the contingent payment represents disguised minimum lease payments, a usage-based contingent payment should be excluded from the measurement of assets and liabilities. An index/rate based contingent payment should be calculated based on the index/rate at the inception of the lease.

Question 10: Reassessment
We disagree with the requirement to remeasure assets and liabilities, if the proposed standards for estimating lease term and contingent rental are retained. Requiring remeasurement if there is a significant change to the liability means the lease estimates will have to be reviewed every time a financial statement is issued. This will require tremendous time, effort, and cost to continually remeasure, and will unfairly influence the lessee’s decision of how they finance equipment (lease vs. loan) needed for their business.

Question 11: Sale and leaseback
Agree.

Question 12: Statement of financial position
(a) Agree.

(b) We disagree with the performance obligation method of accounting for equipment leases, as stated in our response to question 2. We agree with gross reporting, inclusive of the underlying assets, rights to receive lease payments and lease liabilities, totaling to a net lease asset or liability, should the performance obligation method be retained.

(c) We feel that the lease receivable and residual should be reported at gross, totaling to a net investment in leases. We do not believe that the residual represents property, plant, or equipment. Additionally, the residual should be accreted over the lease term.

(d) Agree.
Question 13: Statement of comprehensive income
Agree.

Question 14: Statement of cash flows
Agree.

Question 15: Disclosure
Agree.

Question 16: Transition
(a) While this may provide a simplified approach, it exacerbates the front-end loading of lease expense described in response to question 1(b). The option of full retrospective application of the new rules would significantly reduce this problem.

(b) Yes, full retrospective application of the new rules should be permitted.

(c) None.

Question 17: Benefits and costs
While we theoretically agree with the right-of-use model and the improved financial reporting derived from bringing all leases “on balance sheet”, we are concerned with how the ED proposes to measure them. We feel that the ED complicates and significantly increases the cost of accounting for leases for both lessee and lessor. It is our opinion that the proposed “longest term more likely than not to occur” standard, the inclusion of estimated cash flows such as contingent rents and renewal options, and the remeasurement requirements introduce unwarranted accounting complexity and cost without a commensurate improvement in the information presented in the financial statement. In addition, the proposed model for lessor accounting does not provide a significant improvement over the current model of lessor accounting, nor does it achieve the board’s stated goal of symmetry between lessees and lessors. As a result, we don’t believe the costs that will be incurred by lessors to update their systems, change processes, and re-educate their employees in order to comply with this proposal is justified.