



Pricing INTELLIGENCE at Work

December 14, 2010

Technical Director  
File Reference No. 1850-100  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

RE: Exposure Draft Proposed Accounting Standards Update for Leases (Topic 840)

Dear Board Members,

Ivory Consulting Corporation (“Ivory”) appreciates the opportunity to provide comments on the August 17, 2010 Exposure Draft Proposed Accounting Standards Update for Leases (Topic 840) (“Exposure Draft”). Ivory has been providing lease pricing and accounting software to the leasing industry since 1983. Our clients include most of the major equipment leasing companies in the U.S. whose transactions range from extremely complex leveraged leases to hundreds of thousands of small ticket leases.

Based on 27 years of developing lease pricing and lease accounting software, Ivory is uniquely qualified to understand the economics of lease pricing and analysis and the impact of accounting rules thereon. For the last several years, we have been helping our clients implement risk-based pricing. Fully understanding the *risk* associated with a deal at any point in time over the life of a lease involves examining factors beyond the transaction’s cash flows in order to comprehend the underlying *reality* of the transaction. An accounting model should have the same goal – to go beyond the cash flows and present the *reality* of a lease transaction on the financial statements. While the Exposure Draft is a step in that direction, we believe that it must be significantly modified so that lessors and lessees can accurately present the reality of a lease transaction in their financial statements.

Using the Exposure Draft proposed rules, we have updated our software to model both *Partial Derecognition* and *Performance Obligation* leases for single transactions for both lessors and lessees, and for portfolios of transactions for lessors. This work has helped us understand the effects of the proposed rules on the financial position of both lessors and lessees.

Our comments pertain to the following six concepts contained within the Exposure Draft:

- Principles versus Rules
- Renewals
- Contingent Rents
- Straight-lining Lease Expenses
- A Single Asset Becoming Two Under Lessor Accounting
- Residual Accretion

### ***Principles versus Rules***

It is very clear from the Exposure Draft and the study prepared by the Securities and Exchange Commission under Section 108(d) of the Sarbanes-Oxley Act of 2002 that standards should be based on principles or objectives with a minimum number of rules. We agree that this is an important step in helping to prevent “gaming” of the rules.

However, we believe the Financial Accounting Standards Board may be “throwing the baby out with the bathwater” by setting up a false dichotomy. There is no reason why the standards must be rules-based to the exclusion of principles, or vice-versa. It seems almost self-evident that the best standards will provide rules that are firmly grounded on principles. Dispensing with the principles allows companies to adhere to the rules while violating the intent of the principles. Conversely, dispensing with the rules creates a situation where every company can interpret the principles differently. For example, it is difficult to imagine how the users of financial statements will benefit from these changes if companies are all picking different cut-off points when deciding whether the risks and rewards on a lease are *trivial* or *significant*. Such a situation will lead to a serious lack of comparability among financial statements. We believe that if users of financial statements such as investors, bankers or analysts were asked if they would prefer standards based on *principles*, *rules*, or *both*, the answer would be *both* every time.

### ***Recommendation #1***

Add specific rules to reinforce the principles contained in the Exposure Draft. For example, create rules that explicitly define the terms “trivial” and “significant” as used throughout the Exposure Draft.

### ***Renewals***

Certain lessees will be negatively and unfairly impacted by the lease renewal requirements of the Exposure Draft.

For example, two similar companies have each negotiated a five-year lease on a property with identical payment schedules. Company A has also negotiated a renewal option at the same amount for five additional years while Company B’s five-year lease has no such option.

With its renewal option, Company A has greater operational flexibility over the long term than Company B. If rental rates are significantly higher at the end of the original lease term, then Company A can exercise its renewal option to good advantage. If rental rates decrease, both companies can find rental space at a lower price. Company A is in no way obligated to exercise its renewal option. However, under the proposed standards, the operational flexibility provided by the renewal option will require Company A to show a larger obligation on its balance sheet and higher expenses on its income statement for the first several years thus making it look inferior on the balance sheet and income statement to Company B. Therefore, the Exposure Draft renewal requirements do not provide users of Company A's financial statements an accurate picture of Company A.

## ***Recommendation #2***

Eliminate the requirement that non-compulsive renewal *options* for lessees be treated as renewal *obligations*.

## ***Contingent Rents***

Just as with renewal options, the accounting requirements of the Exposure Draft for contingent rents can penalize lessees for making good operational decisions.

For this example we have three similar companies that need to make copies:

- Company A buys a copier and incurs an additional cost of 5 cents per copy
- Company B leases a copier and pays 10 cents per copy to the lessor
- Company C outsources copying and pays 20 cents per copy to the outsourcer

Company B has determined that its printing needs are likely to increase in a few years so has decided to lease a copier for three years. They have also determined, based on the number of copies that they make each month, that by leasing a copier they will be saving money over outsourcing their printing needs. Under these circumstances, Company B has made an intelligent business decision.

However, under the proposed rules, Company B will be required to book an "obligation to make copies" at the inception of the lease although neither Company A nor Company C is required to book such an obligation. Even though there is no stated obligation in the lease contract executed by Company B to make any copies, Company B is required to book its estimated copying needs at lease inception as an obligation simply because it executed a lease. Doing so presents Company B as having an obligation that is neither shared by nor disclosed by either Company A or Company C, even though all three companies plan to make copies in the future. Such accounting will portray Company B to be weaker than either Company A or Company C in its financial statements.

### ***Recommendation #3***

Remove the rule that contingent rents must be booked as obligations. Replace this rule with a principle that true rents should not be disguised as contingent rents. This is an example of where we believe a principle is better than a rule.

### ***Straight-lining Lease Expenses***

The requirements of the Exposure Draft can result in lessees booking several months of losses before showing a profit even though this does not reflect operational reality.

For example, a company determines that it can lease a truck for two years at \$10,000 per month and produce monthly revenue of \$11,000. Under the current lease accounting rules, the company records an income of \$1,000 per month from the first month because it can straight-line the rent expense. The proposed standards would not achieve the same result because the rent expense cannot be straight-lined. Instead, the expense should be allocated proportionally to consumption of the benefit or, otherwise, straight-line. Although we agree that the obligation to pay rents should show up on the balance sheet, the income statement should immediately start to show a net profit of \$1,000 per month in this example.

### ***Recommendation #4***

Allow rent expense to be straight-lined over the lease term.

### ***A Single Asset Becoming Two Under Lessor Accounting***

The partial derecognition approach to leasing demonstrates an underlying problem with the performance obligation approach.

Partial derecognition correctly recognizes that if the right to receive lease payments is to be treated as an asset, then it should replace the underlying asset. The performance obligation approach, on the other hand, has a flaw in its double recognition of assets.

If a company buys a piece of equipment, that ownership confers on them the right to lease it out. The ability to lease it out and receive payments is an intrinsic benefit of ownership. It doesn't make sense to show this piece of equipment as an asset on the books and then have the right to use that same piece of equipment shown as an additional asset. The right to receive lease payments is a right of ownership that should not be reflected on the balance sheet as an additional asset. If a right to receive lease payments is going to be put on the books, it should replace the underlying asset.

## ***Recommendation #5***

Eliminate the performance obligation approach and retain operating lease accounting for lessors in cases where “the lessor retains exposure to significant risks or benefits associated with the underlying asset” (Exposure Draft Paragraph 28). This is also consistent with Recommendation #4 that lessees straight-line their rental expense.

## ***Residual Accretion***

The partial derecognition approach recognizes that leasing an asset to a lessee essentially transfers the “ownership” of the asset to the lessee in exchange for a right to receive lease payments. Inasmuch as the lessor is more than likely to dispose of the equipment at the end of the lease, it makes sense to put the present value of the future cash flows (including the residual estimate) on the books as an investment.

However, the exclusion of residual accretion causes this “investment asset” to be of lower value and less consistent with its true value over the life of the lease. While residual accretion may be “inconsistent with the cost-based approach” (BC106), it is consistent with the actual cash flows and investment balance in a lease. For example, nine years into a ten-year lease, the *real value* of the impending residual cash flow should be much closer to the expected fair value than it is to the present value which was calculated nine years previously. Throughout the lease, the real value of the impending residual should be its current present value. The income on a finance lease should match a loan with a balloon. In fact, the contractual termination values in the lease are based on the investment balance including residual. Partial Derecognition, as it is currently laid out in the exposure draft, can seriously distort a company’s true financial position.

## ***Recommendation #6***

Allow lessors to accrete residual income in partial derecognition leases. This would present a much more accurate picture of a lessor’s true financial position.

## ***In Conclusion***

Our comments support the overarching goal of sound accounting, which is to ensure that users of financial statements obtain a fair understanding of a particular company’s financial position.

Further, our comments about renewals, contingent rents, and lessee expenses are specifically focused on preventing financial misrepresentation. If two companies are essentially identical, but one company has an economic or functional advantage over the other, the company with the advantage should not appear to be at a disadvantage on its balance sheet and income statement. The proposed regulations will introduce inaccuracies in financial reporting and hamper comparability.

We believe the FASB should modify the Exposure Draft in the following six ways:

1. Add specific rules to reinforce the principles contained in the Exposure Draft defining such terms as “significant” and “trivial”.
2. Eliminate the requirement that non-compulsive renewal *options* for lessees be treated as renewal *obligations*.
3. Remove the rule that contingent rents must be booked as obligations. Replace this rule with a principle that true rents should not be disguised as contingent rents.
4. Allow rent expense to be straight-lined over the lease term.
5. Eliminate the performance obligation approach and retain operating lease accounting in cases where “the lessor retains exposure to significant risks or benefits associated with the underlying asset”.
6. Allow lessors to accrete residual income in partial derecognition leases.

Thank you for considering our comments.

Sincerely,



Chief Executive Officer

MSH:np