ELFA

William G. Sutton, CAE
President and CEO

EQUIPMENT LEASING AND FINANCE ASSOCIATION
1825 K Street NW
Suite 900
Washington, DC 20006
P 202.238.3400
F 202.238.3401
www.elfaonline.org

December 13, 2010

Ms. Leslie Seidman
Acting Chairman
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Submitted via electronic mail to director@fasb.org

Re: File Reference: No. 1850-100, Exposure Draft: *Leases*

Dear Madam and Sir,

The Equipment Leasing and Finance Association welcomes the opportunity to respond to the request for comments from the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) on the proposal contained in the FASB Exposure Draft, *Proposed Accounting Standards Update: Leases Topic 840*.

The Equipment Leasing and Finance Association (ELFA) is the trade association representing over 600 financial services companies and manufacturers in the $521 billion U.S. equipment finance sector. ELFA members are the driving force behind the growth in the commercial equipment finance market and contribute to capital formation in the U.S. and abroad. Overall, business investment in equipment and software accounts for 8.0 percent of the GDP; the commercial equipment finance sector contributes about 4.5 percent to the GDP. For more information, please visit http://www.elfaonline.org.

Equipment leases provide all types of equipment to all types companies but most importantly to small and medium sized companies. The small and medium sized company sector is cited as the largest potential source of the job growth needed to

reinvigorate the economy worldwide. Access to capital and efficient use of equipment are the major drivers for leasing rather than operating lease accounting under ASC Topic 840. This statement has been supported by academic studies over the decades.

Our members provide leases and loan financing, and they are also users of financial statements. When determining whether to enter into a lease contract with a lessee, they analyze the ability of the lessee to pay its obligations according to the contractual schedule. In making the decision to extend credit and assume the risks and rewards associated with the underlying asset, lessors rely on the lessee's financial statements and in their pricing generally model the financial statement effects of the proposed lease investment. Subsequently, they place significant reliance on the lessee's financial statements in reassessing credit worthiness and in monitoring compliance with covenants. Accordingly, our comments involve the decision usefulness of the proposed accounting for leases from the perspective of both preparer and user.

Summary Comments

We support the Boards' objective of having lessees record greater amounts of lease assets and liabilities than is done today under IAS No. 17, *Leases*, and ASC Topic 840. We are, however, concerned with many of the elements of the proposed lessee and lessor accounting models, as they will increase the cost and complexity of lease accounting without significantly improving the quality and relevance of financial statements. In some cases, we believe the quality of the information presented will be impaired and the relevance of the financial statements reduced. We therefore cannot support the lease accounting model presented in the exposure draft.

In the proposed lessee model, we agree with the Boards that:

- The right of use concept provides a logical means of determining the amounts to be capitalized,
- The contract is the most practical unit of account, and
- The value of the contract asset and obligation is the present value of the liability attached to the asset.

We disagree with the exposure draft's approach to the determination of lease term and recognition of contingent rental payments, as we believe the proposal will lead to the recognition of amounts that do not meet the accounting definition of liabilities. We also believe the proposed requirements related to lease term, contingent rents, and remeasurement will cause a standard in this form to be difficult and time consuming to implement and to account for on a recurring basis. It will cause the accounting depiction

of many lease transactions to move further from the economics of leasing and reduce the relevance of the financial statements.

We further believe the lease asset and lease liability exist together and they should not be subject to separate and distinct accounting after lease commencement. The accelerated expense recognition that results from separate cost allocations for the lease asset and lease liability should not be accepted as a natural consequence of the right of use model. Leases are not simply the seller financing of an asset sale. Inherently, leases involve the separation of use and ownership. Accordingly, lessee accounting should allocate the total consideration based on usage while lessor accounting should faithfully portray the economics of the investment, including, when significant, the tax risks or rewards.

Lessor Accounting

We are pleased the Boards have recognized in the exposure draft that differences exist between leases, but we do not regard either the performance obligation or derecognition approaches as improvements over the existing lessor models. The current lessor models are either economic models – in the case of the direct finance, leveraged and sales-type lease models – or are simple and straight forward to apply – which is the case with the operating lease model. The proposed derecognition approach is an accounting model that moves direct finance, leveraged and sales-type leases away from the economic model. We therefore do not support the derecognition model as it has been proposed. The proposed performance obligation model is neither an economic model nor simple and straight forward to apply and understand. We also believe the performance obligation approach is inconsistent with the lessee model and the circumstances surrounding most equipment lease transactions. Based upon these and other observations presented later in this comment letter, we have concluded the performance obligation should not be pursued by the Boards. Given our concerns with the lessor models proposed in the exposure draft, we believe it is preferable for the Boards to remove lessor accounting from the scope of the project while the matter of lessor accounting is given additional consideration.

As equipment lessors, our membership will generally lease one asset to one lessee at a time. As lessors, they earn their return from a combination of rents, tax cash flows and residual realization. We find that of the two accounting models presented in the exposure draft the derecognition model is more consistent with the transactions we enter into, as it shares some attributes with the existing direct finance and sales type lease models. Therefore, if the Boards were deciding on one accounting model for lessors, we believe the one model should be a derecognition based model. We acknowledge the derecognition model may not be appropriate for all leases; especially, leases of a portion

of an asset, e.g. a lease of a part of a building, leases that have a relatively short lease term or leases with rents contingent upon the lessor providing a service to the lessee. For those transactions that do not fit into a derecognition model we believe it would be appropriate to follow the existing operating lease model or, if appropriate, the investment property model, rather than the performance obligation model. Given the diverse range of leasing transactions a hybrid approach to lessor accounting is appropriate.

Concluding Comments

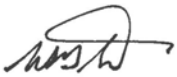
The lease model included in the exposure draft is intended to address a perceived weakness in financial reporting through the capitalization by lessees of operating lease obligations. Unfortunately, the proposed lessee model will frequently result in the capitalization of possible lease payments that do not meet the conceptual framework's definition of a liability, artificially accelerate expense recognition for lessees, is unnecessarily complex, creates a significant compliance burden for lessees and lessors, and replaces sound lessor accounting models with untried approaches that do not mirror lessor economics or the proposed lessee accounting model. We are also concerned there will be unintended consequences arising from the implementation of the proposed model and that financial reporting by both lessees and lessors will be less transparent and more difficult to understand. We therefore urge the Boards to reconsider their approaches to the determination of lease term and lease payments and to the allocation of lease contract cost. We also urge the Boards to replace the performance obligation approach to lessor accounting and reconsider elements of the derecognition model and bring it more in line with existing direct finance lease accounting.

Given the proposed changes to lessor and lessee accounting and after reflecting on the questions we have identified during our evaluation of the exposure draft, we believe an orderly and thorough evaluation of the issues will require more time than the Boards have allotted to the project. We therefore recommend the Boards review the project timeline and allow for the analysis and study a project of this significance deserves.

As a separate attachment to this cover letter, we have included our answers to Questions for Respondents.

We appreciate the opportunity to comment on the exposure draft, and we also thank the Boards for their policy of open communications during the standards setting process. We remain available to help in any way needed, and we are committed to assisting in the creation of a workable lease accounting standard, which reflects the economic substance of transactions and improves the clarity in financial reporting.

Sincerely,



William G. Sutton, CAE
President and CEO

Attachment

Attachment

Questions for Respondents

The exposure draft proposes a new accounting model for leases in which:

(a) A lessee would recognize an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraph 10 and BC5-BC12). The lessee would amortize the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.

(b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23-BC27).

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?

(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 apply?

Response

We believe the Boards have proposed an appropriate methodology for the initial recognition and measurement of right of use leases by the lessee. We note this approach is consistent with the methodologies used by some of the major rating agencies and other financial statement users. We also believe this approach is understandable and may be implemented within acceptable cost-benefit parameters.

While the right of use model treats the asset and liability as linked at lease inception, the model then treats them as independent items for subsequent accounting unless there is a remeasurement event when they are once again considered to be linked. If the unit of account is the lease contract, then the unit of account should continue to be the lease contract for purposes of all subsequent measurements. We therefore believe the amortization of the right of use asset and the liability needs to be considered as joint elements of lease accounting and considered together so that the income statement pattern of amortization and interest expense not exceed the level rental

charge associated with the lease contract. We do not believe the proposed income statement presentation provides decision useful information, and we do not believe that merely considering this to be the natural outcome of separate recognition of an asset and a liability is sufficient justification for an approach that misstates the cost of a lease transaction.

We have also observed the accounting for the lease contract is not consistent with the accounting for contracts elsewhere in the accounting literature. In many areas of accounting a contract is respected and treated as the unit of account. There is also considerable discussion when multiple contracts should be combined into one unit of account, including DIG Issue K1 (815-10) and SFAS No. 160 (810-10-65). The separation of a contract into elements is performed in the financial instrument literature when a financial components approach is followed – SFAS No. 166 (860) -- or when the cash flows in the host contract are altered – SFAS 133 (815). The draft does not contain a principle for the application of a separation approach in this circumstance, especially one that reconciles back to the accounting literature.

We believe lease obligations are not like other financial liabilities. A lease is not the same transaction as a company using a mortgage loan to purchase an asset. Financial liabilities such as mortgages may be settled separately from the asset they are financing. Once the mortgage is settled, the company owns the whole asset and the contract has no continuing affect on the use or disposition of the asset. The company also has control over the whole asset and the lender only has protective rights while the financing is in existence. These distinctions are relevant when a lease transaction is analyzed, as a lease is a two party contract for the temporary use of an asset that is separate and distinct from other transactions.

A lease is unique in that the asset and liability are linked throughout the term of the lease. They cannot be settled separately. The right of use asset ceases to exist when the lease contract ends and the last payment obligation is made, whereas, other assets financed by debt survive after the debt is paid. These issues will recur when the Boards address licensing agreements with payments over time and with leasing of intangibles where the asset and liability are linked.

The exposure draft asserts that while the value of the right-of-use asset and the liability to make lease payments are clearly linked at the inception of the lease, they are not necessarily linked subsequently because the value of the right-of-use asset can change with no corresponding change to the liability to make lease payments. We believe this is not a sufficient justification for the separation of the contract into two components. The lease contract contains an asset and an obligation to pay rent. If

there is a change in value, it is a change in the value of the total contract. The contract may be favorable or unfavorable and consideration of the value of the contract involves both the asset and liability components.

When considering the statement in the previous paragraph it is important to remember that amortization is a cost allocation exercise performed for accounting purposes. It is not a valuation. In the case of a lease there are two cost allocations to perform: the amortization of the asset and the amortization of the liability. The accounting proposed in the exposure draft calls for normal cost allocation conventions to be followed, even though, for example, the liability does not have an agreed separation of payments into principal in interest. The question that should be considered in the exposure draft is whether the cost allocations proposed in the exposure draft reflect the true cost of the arrangement; alternatively, does following the two separate accounting conventions for an asset and for a liability produce a financial statement result that reflects the flow of resources from an entity in accordance with the contract.

Under the separate amortization model proposed in the exposure draft, we believe the cost of using the asset is over allocated to the early years of a lease and under allocated in the later years. Using the straight line method of amortizing the lease asset when combined with the mortgage style amortization of the lease liability also creates an “under water” balance sheet value for the lease contract beginning in month one of the lease as the asset amortizes faster than the liability. This accounting does not reflect economic position of the lease contract. Given static markets, the value of a lease contract should always be nil (net of ROU asset and liability), absent an impairment or idling of the leased asset.

We believe an approach that considers the contract in total and that does not consider the asset and liability as separate transactions should be used to provide a faithful representation of the periodic expense allocated to the income statement. This approach would allocate costs on an equal allocation of the total consideration over the lease term. There are several ways to achieve this result, such as mortgage style amortization of the both the lease asset and lease liability

Respecting the lease contract and considering the asset and liability together has several advantages. The capitalization techniques historically used by rating agencies and other financial statement users have not involved changing the expensed amount (rent expense). Many users of financial statements expect to see rent expense in the income statement and rent paid as a deduction from operating cash flows in the cash flow statement. The alternative approach we have proposed would enable users of

financial statements to receive the information they need without causing them to adjust their financial models.

We have also observed several practice issues that arise solely due to the proposed cost allocation methodology. For example, when a lessee shortens an estimated lease term the resulting adjustment will be an accounting "gain" as expenses were recognized at a faster rate than they should have been recognized. We regard this outcome as unreasonable and potentially confusing to users of financial statements. In addition, the high to low expense pattern of lease costs are exaggerated in the case of longer lease terms and where significant contingent rents are included. In the case of contingent rents, this would result in the lessee amortizing currently a cost that may or may not occur far in the future. We do not believe this is a fair depiction of the transaction and does not present the most useful information for readers of financial statements.

Finally, we believe certain of these issues with the proposed lessee and lessor accounting exist because the Boards have not developed a sound theoretical basis for the lease accounting models. For example, we have noted the basis for lessee accounting is not clearly stated in the exposure draft. The basis for conclusions opens with a discussion of the right of use model, but the basis for conclusions does not provide an overarching theory for lease accounting other than stating that a lease contract from the lessee perspective contains an asset and an obligation. During public meetings, some board members articulated the view that a lease is the in substance purchase of an asset and the in substance incurrence of debt. The basis of conclusions, BC10(b), also notes this is the view of "some" Board members, indicating it is not a universally held view or that there is some level of debate regarding the nature of lease transactions. If the Boards are approaching lessee accounting from the perspective of an in substance purchase and debt model, this principle should be clearly stated and supported in the basis for conclusions. This approach also needs to be reconciled with the control concept articulated elsewhere in the exposure draft. Failure to explicitly conclude on these matters will make it hard for readers to interpret how the model is intended to work and what the underlying principle is they should be considering.

Question 2: lessors

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks and benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative model would you propose and why?

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

(c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

Response:

Application of the Proposed Models

We are pleased the Boards have recognized that leases represent a range of transactions. Some of these transactions between the lessor and lessee involve only lessee credit risk, some represent a mix of credit and residual risk, and others combine credit, residual and lessor performance risk. Given this range of transactions, we do not believe it will ever be possible to have one lessor accounting model that would faithfully represent the universe of lease transactions. While we appreciate the efforts the Boards have expended on developing two lessor accounting models, we do not believe either proposed model is an improvement over existing practice. The current lessor models are either grounded in lessor economics – in the case of the direct finance, leveraged and sales-type lease models – or are easy and simple to apply – which is the case with the operating lease model. The proposed derecognition approach is an accounting model that moves direct finance, leveraged and sales-type leases away from the economic model. We therefore do not support the derecognition model as it has been proposed. Lessor accounting was never cited as a financial reporting deficiency, and we do not see the need for changes in lessor accounting absent a real and notable improvement in the accounting models.

We believe direct finance lease accounting and the related sales-type lease accounting model are the methods most closely aligned with the right of use concept. It recognizes the lessor has transferred a substantial portion of the value and utility of the asset to the lessee. It reduces the value of the leased asset in recognition that the lessor no longer has the unilateral control over all of the asset's utility. Our position is that an asset is a bundle of rights and one or more of those rights may be transferred, sold or leased and should be derecognized when sold or leased. We are also of the opinion that another model, such as operating lease accounting, should be applied in circumstances where the direct finance lease model is not appropriate. For example, short term leases, leases of only a portion of the asset to the lessee – such as leases of a portion of a building -- or leases where the lessor's payment is conditional upon the lessor providing a service to the lessee would not be appropriate to account for following direct finance lease model.

We do not support the performance obligation model. By its name it implies the lessor will not receive rents from a lessee unless it performs each month. This approach is not consistent with the lessee model, which is grounded in the assumption the lessor has performed once the asset is in the possession of the lessee. It is also not consistent with the lessee's payment obligation in many leases, particularly those involving "hell or high water" lease obligations.

Recognition of Assets, Liabilities, Income and Expenses

When considering the proposals for lessor accounting, we have been struck by how much of what is being proposed harkens back to earlier debates regarding lease accounting. For example, APB Opinion No. 7, *Accounting for Leases in Financial Statements of Lessors*, had lessors include residuals for finance leases near property, plant and equipment. This approach was reconsidered in SFAS No. 13, *Leases*, as the residual was correctly considered an element of the investment in a lease. We find it ironic that the Boards are proposing to return to an accounting approach that was adopted 44 years ago and then replaced within10 years of issuance.

We are especially concerned by references in the basis of conclusion (for example, BC 106) to difficulties related to measuring the residual at fair value at lease inception without reference to this being a requirement under existing accounting standards. The fair value of the residual will be relevant to the allocation of basis, either directly or indirectly, under the derecognition approach and it is certainly an important element of lease pricing and economic evaluations for a significant population of leases and as such will be known at lease inception. In addition, it is unclear to us why if in the Boards view the estimation of residual fair value as difficult, residual values are to be accounted for at fair value during transition (paragraph 106(b)).

We believe the lessor model in SFAS No. 13 (as codified in ASC Topic 840) was closer to the economic model then the pure accounting models being proposed in the exposure draft. Existing lease accounting for finance and sales type leases requires the investment in the lease to be recognized at fair value at lease inception. Under this approach the residual asset represents an element of the lessor's investment and it should be accreted from its present value to its expected value using the implicit rate in the lease. The derecognition model fails to allow residual accretion. Applying a cost allocation approach to residual valuation, freezing the residual asset, including it in property, plant and equipment and eliminating residual asset accretion are a step backwards in the evolution of lease accounting.

With regards to sales type leases we are again troubled by the cost allocation approach in the derecognition model. This approach does not advance the accounting model. APB Opinion 7 allowed for the recognition of full manufacturer's profit. This approach was reversed six years later when APB Opinion No. 27, *Accounting for Lease Transactions by Manufacturer or Dealer Lessors*, was issued only to be reversed again four years later when SFAS 13 was issued. The move to a cost allocation approach appears to be a new development in the debate related to sales type leases, but we do not regard the proposed approach as an improvement in the accounting model.

If the Boards continue with the derecognition approach's cost allocation model as outlined in the exposure draft, we believe the residual should be accreted to the estimated fair value over the term of the lease. We believe the deferral of gross profit on the residual portion should not preclude accretion of the residual.

With regards to other elements of the proposals, we have two additional comments on lessor accounting. The Boards have proposed lessors recognize income or expense based upon the lessor's business model. We believe a simpler way of determining whether amounts should be presented gross or net would be to determine based upon a lessor's involvement in the lease at lease commencement whether revenue and expense should be recorded at lease commencement. For example, in many finance lease transactions the lessor does not take delivery of the asset at lease commencement. The asset goes directly from the manufacturer to the lessee. In these cases the lessor is an agent at that point in the transaction and gross recognition of lease revenue and expense would be inappropriate as well as being unnecessary. If the lessor has possession of the asset, then it would be functioning as a principal and should record revenue and expense. This approach would be consistent with the revenue recognition project.

Finally, we have observed that while the performance obligation approach is meant to be applied to transactions where the lessor has retained significant risks and benefits related to the underlying asset, we find it ironic the performance obligation method earnings pattern is more accelerated than either the derecognition earnings pattern or even the existing direct finance lease model. This is principally caused by the failure of the derecognition model to allow for accretion of the residual asset.

<u>Leveraged Lease Accounting</u>

We acknowledge that leveraged lease accounting is an outlier in the accounting literature, but we continue to believe it is not inconsistent with the lease model and best reflects the economics of these transactions to the lessor.

A lessor's returns on a lease investment are a function of the cash flows it receives from lease rents, residual value and tax cash flows. These factors determine the key metrics used by lessors to evaluate their returns on a lease investment: the pre tax returns, the pre tax equivalent of the after tax return and, finally the after tax return on the lease. For equipment lessors, the after tax return is the most important metric for primary return analysis. The leverage lease model aims to integrate the tax benefits associated with asset ownership into the income recognition model, rather than simply considering them to be a secondary benefit outside of the core accounting for the lease transaction.

Leveraged lease accounting was continued under SFAS No. 13 (as codified in ASC Topic 840) since the combination of a lease with nonrecourse debt allows a lessor to recover its investment early and put its funds to use for other purposes. A pre tax model that does not integrate the impact of leverage when combined with tax benefits will frequently cause a lease that has a positive after tax yield to an investor to show negative returns during the early years of a lease. This is not representationally faithful, and the accounting model should strive to be faithful to the lessor's economics. The primary issue with lease accounting is not that leveraged lease accounting is performed using after tax cash flows; rather, that other leases are not accounted for considering the impact of tax benefits.

The leveraged lease is a unique product and the basic accounting attempts to factor in the economic position of a lessor, including tax benefits and asset risk. As a result of the unique treatment billions of dollars in transportation and energy assets have been financed at lower rates than the lessee's incremental borrowing rate. It should also be noted that most of the leveraged lease investments are held by banks, and the regulatory capital treatment of leveraged leases is the same as the accounting model.

If the final standard does not provide for the continuation of leveraged lease accounting, we request that existing leveraged leases be allowed to run off and not be subject to the transition requirements of final standard.

Question 3: short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of the lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize a portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65).

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?

Response

The current operating lease model should be used for leases with terms of 12 months or less in the financial statements of both lessors and lessees. For lessors, we regard the approach as reasonable and easy to apply. For lessees, we are troubled by the complications associated with the approach proposed in the exposure draft, and we are hard pressed to construct a realistic scenario where a lessee would have a material amount of short term lease obligations. The proposed lessee short term lease model will require significant effort by preparers but will not materially improve the quality of financial reporting. We therefore recommend carrying forward the operating lease approach for leases of 12 months or less in the financial statements of lessees.

Definition of a lease

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1-B4 and BC29-BC32). This exposure draft also proposes guidance on distinguishing between a lease and a purchase or sale (paragraphs 8, B9, B10 and BC59-BC62) and on distinguishing a lease from a service contract (paragraphs B1-B4 and BC29-BC32).

Question 4

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?
(c) Do you think that the guidance in paragraphs B1-B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what alternative guidance do you think is necessary and why?

Response

Definition of a Lease

We agree with the definition of a lease contained in the exposure draft.

Lease versus Purchase or Sale

The purchase or sale versus lease criteria was added principally to address issues related to lessor accounting. While the distinction has merit and we have always believed the scope of lease accounting should be more robust, we do not recommend continuation of the criteria given what constitutes a sale or purchase under the exposure draft is not fully in agreement with the legal definitions of a purchase or sale and since current practice is reasonable.

Lease versus Service Contracts

The question of what is or is not a lease developed in accounting on a piecemeal basis over time. For example, ASC 840-10-15-6 to 15-21 (EITF Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*) was issued more to address when a transaction should not be accounted for as an energy trading item at fair value then to address a practice issue within lease accounting. Using a definition of what is a lease that was developed for this objective is effectively a change in the scope of lease accounting when the proposed model is applied.

Given the very significant difference that will exist between service contract and lease accounting if the proposed accounting model were to be adopted, we believe it is appropriate to reconsider the criteria used to identify embedded leases. This is necessary to draw an appropriate distinction between leases and all other contractual arrangements. While exposure draft criteria for separating a lease from a service contract is generally consistent with existing requirements, the altered accounting treatment will effectively represent a change in scope that should be reconsidered. There is a place in the accounting literature for executory contracts and the boundary between lease and executory arrangements needs to be respected.

Since EITF Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*, was finalized there has been much debate over the pricing tests included in the topic to assist in the separation of leases from service contracts. In particular, some companies and their auditors have interpreted the statement regarding fixed pricing very strictly, while others have allowed greater flexibility regarding the determination. Since most of the leases embedded in service arrangements have been operating leases, as the rents are often regarded as contingent or the arrangements are short term, the primary purpose of the embedded lease analysis was the determination of whether a contact was a lease or derivative contract or whether the seller of production was a variable interest or voting interest entity.

The matter of leases embedded in service arrangement highlights the concern we have with regards to the recognition and measurement of contingent payments. As it is now drafted, the exposure draft would have lessors and lessees account for fixed lease payments and variable payments that are dependent upon the production of an asset in the same manner. In order to simplify and make the proposed accounting operational, a distinction needs to be drawn between these arrangements as they are very different transactions.

We have noted in the exposure draft the basis for identification of embedded leases includes new requirements regarding the substitution of assets. Thus service contract accounting is not possible "if a lessor can substitute another asset for the underlying asset but rarely does so in practice." We believe this additional criterion should be eliminated. Paragraphs B2 and B3 also need to be conformed to agree with one another.

Scope

Question 5: scope and scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposals to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33-BC46).

Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

Response

Given the specialized nature of these topics, we agree with the exclusion of these items from the scope of lease accounting. We do believe, however, the inclusion of intangibles in the scope would bring to light the issues of the proposed

accounting. We do believe that the cost pattern of a lease of intangibles should be level as that is the pattern of economic benefits received.

Question 6: Contracts that contain both service and lease components

The exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, Revenue Recognition (Topic 605): Revenue from Contracts with Customers, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5-B8 and BC47-BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) The FASB proposes that the lessee and lessor should apply the lease accounting requirements for the combined contract.
(b) The IASB proposes that:
  i. A lessee should apply the lease accounting requirements to the combined contract.
  ii. A lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
  iii. A lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

Response

<u>Lessee Accounting</u>

We do not believe it is appropriate for a customer's accounting to be determined using a definition and criteria that were developed for the determination of whether separate performance obligations exist from the seller's perspective. If the Boards wish to integrate the proposed guidance in *Revenue from Contracts with Customers* into the proposed lease accounting standard we recommend that it be done in total and not selectively. For example, the Boards should explore whether from a customer perspective a lease liability exists for the customer-lessee when the lessor has not satisfied its performance obligation for the delivery of the output specified in service agreement that contains a lease. The leasing model should be a logical and consistent model. It should not be the mere collection of concepts taken from other accounting literature on a piecemeal basis.

Existing accounting guidance requires lessees (and lessors) to allocate payments into service and lease components and to subtract executory costs from lease payments when accounting for a lease transaction. We believe this guidance is appropriate for lessee accounting and should be continued. Certain executory costs do not fit readily into the goods and services model presented in paragraphs 20-24 of *Revenue from Contracts with Customers*, as the executory cost may or may not have separate utility. It is hard to imagine property taxes having separate utility or value, but accruing these costs as part of the lease liability or including them in the cost of the lease asset if they are paid by the lessor does not appear to be a reasonable outcome. If the separation criteria does not allow for the exclusion of these costs from lease accounting, the criteria needs to be revised. An approach that allocated items based upon whether they are part of the lease or not part of the lease is preferable to the distinct or non-distinct criteria proposed in the exposure draft.

Lessor Accounting

As with lessee accounting we believe the lessor should exclude executory costs from lease accounting, whether they are distinct or not, as the accounting for these costs should be the same whether they are paid directly by the lessee or the lessor. As with lessee accounting the separation should be performed depending first upon whether the item is part of the lease and only then whether the service element is distinct or non distinct.

If the Boards continue with the allocation basis proposed in the exposure draft for the performance obligation lease liability, it may be necessary to reconsider the amortization of the lease liability. A service that is not distinct may mean that a ratable reduction in the liability over time may not be appropriate and the reduction is more likely related to the delivery of some service.

Question 7: purchase options

The exposure draft proposes that a contract ceases to be a lease when an option to purchase the underlying asset is exercised. Thus a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for a purchase option and why?

Response

We concur with the approach in the exposure draft, as we do not believe purchase options, other than bargain purchase options, represent a liability to the lessee or a right to a lease payment for the lessor until they are exercised. Exclusion of purchase options is consistent with the accounting requirements for nonderivative forward purchase contracts.

Measurement

The exposure draft proposes that a lessee or a lessor should measure lease assets and lease liabilities arising from a lease on a basis that:

(a) assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease (paragraphs 13, 34, 51, B16-20 and BC114-BC120)

(b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease contract by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121-BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be reliably measured.

(c) is updated when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments, including expected payments under term option penalties and residual value guarantees, since the previous reporting period (paragraphs 17, 39, 56 and BC132-BC135).

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?

Response

We believe the lease term should represent the period for which the lessee is obligated to make lease payments. We do not believe renewal periods represent a liability of the lessee until the lessee makes an election. We further believe renewal rents do not meet the definition of a liability as the past event has not occurred that would create the liability. In our opinion the signing of the lease contract is *not* the obligating event for renewals and that all the lease accounting needs to factor in is the

measurement of an obligation. It is difficult for us to reconcile the proposed accounting with the treatment of other nonderivative options to acquire a right.

The Boards proposal will have a number of consequences for financial reporting and analysis regarding lease transactions. By potentially requiring a 10 year lease with a more likely than not renewal term of five years to be accounted for the same way as a 15 year lease, the exposure draft has two economically dissimilar transactions accounted for the same way. This issue is compounded if the renewal rent is at the then fair market value, as the proposal would have a lessee recognizing a lease liability at nominal value when the renewal rent would have a fair value that is close to zero. The interaction of these elements may even lead to the right of use asset being recorded at an amount that is greater than the fair value of the underlying asset. If this situation resulted in impairment of the right of use asset, the issues with the model would be readily apparent.

We realize that the Boards are concerned with financial engineering and that concern is an element of the proposed rules regarding renewal terms and uncertain payments, such as contingent rents. This concern would be more easily dealt with if the model continued the existing definitions in lease accounting and practices regarding lease term. Specifically, renewal periods should be included in the measurement of a lease liability if they are bargain renewal options or if the lessee will suffer an economic penalty by failing to renew the lease.

The estimation of lease term as has been proposed will create the significant complexity for preparers. For example, if a lease has one renewal option, the lessee will need to consider two scenarios at lease inception and at each reporting period for purposes of remeasurement. If a lease has two renewal options, three scenarios will need to be considered. If the lease involves fair market value renewal rents, rather than fixed rents, then estimates of the then fair market value rent will need to be developed and factored into each analysis. Under these circumstances one lease may quickly generate two, three or four scenarios and estimations. If a lessee has 1,000 leases – a round number that is certainly a low estimate for many lessees – then 2,000 plus cases would need to be considered at lease inception and each reporting period. A lessor may easily have in excess of 500,000 leases in its portfolio of investments. A lessee may easily have 10,000 leases. Since most equipment lease contracts have an equipment cost value of less than $25,000, the proposed approach will result in a significant burden with at best limited improvement in financial reporting, even if the premise that renewal periods are relevant is accepted.

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 contract 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 lessor 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?

Response

The lease payments included in the measurement of the lease liability should be limited to the actual accounting and economic liabilities that exist within a lease contract. As with optional renewal periods in a lease, estimated contingent rents, when the contingency is related to a future lessee event or future lessor performance, do not meet the definition of a liability. The past event has not occurred that creates the liability and the estimated payments are not a legally enforceable obligation.

We understand the Boards are concerned about financial structuring, but this concern is dealt with adequately under current accounting standards without the complications proposed in the exposure draft. Current practice is to include contingent rents when they represent an attempt to structure around the existing minimum lease payment definition. We believe this is a reasonable and principle based approach, and one that is certainly more readily applied and understood.

Question 10: reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

Response

While SFAS No. 13 (as codified in ASC Topic 840) may be faulted for only requiring reassessment when a change in the lease occurred, we believe the significant change threshold in the exposure draft is not sufficiently defined to

prove workable in practice. In order to prove that no significant change in the lease liability or the right to receive lease payments has occurred, preparers are likely to have to perform all of the reassessment work that would be required to record a transaction. As indicated in our response to Question 8, this reassessment is likely to involve thousands of scenarios each period.

Given this situation the reassessment criteria should be limited to situations when the lease agreement is modified or when the lessee determines that it will exercise a renewal or purchase option. If the Boards continue with an approach that includes contingent rents in the measurement of the lease asset and liability, we believe these estimations should not be readjusted each period. The initial measurement would serve as the lessee's best estimate of the cost of the asset and the liability incurred, with other impacts entering income as they occur.

Sale and Leaseback

This exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents a sale of the underlying asset, the leaseback also would meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66-67, B31 and BC160-167).

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose?

Response

The lessee right of use model appears to be grounded in a control concept: the lessee records assets it controls (paragraph BC6.d) and the concept of distinguishing between a purchase and a sale also is based upon a control notion. When determining when a lessee has sold an asset in a sale and leaseback transaction the exposure draft then adds risks and rewards factors into the analysis. We believe the lease model needs to be internally consistent: the lessee model is either a control model or a risks and rewards model. It should not be a combination of the two models. We therefore believe the factors added in B31 need to be eliminated for the model to be a control model.

In addition, the Boards appear to have added the criteria in B31 as a means of combining the sale contract with the lease contract. If that is the case then the Boards should address the combination of contracts on a basis that is consistent with the manner in which other contracts are addressed in the accounting literature. Introducing a consistent view of the accounting for contracts into the lease literature would allow the Boards to address the concern we have expressed regarding contract separation of lease contract in the summary and lessee sections of this comment letter.

With regards to lessor accounting, we do not understand the need to mandate performance obligation accounting for transfers that meet the conditions for lessee sale accounting. Further, we do not understand why a lessor needs to account for a transfer that does not meet the conditions for sale accounting as a receivable. Even in an unsuccessful transfer the lessor has purchased the asset and may have included a residual assumption in the transaction. The leaseback is a lease and consideration should be allocated between rents and residual.

Presentation

The exposure draft proposes that lessee and lessors present the assets and liabilities, income (or revenue), expenses and cash flows arising from lease contracts separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25-27, 42-45, 60-63 and BC142-BC159).

Question 12: statement of financial position

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease (paragraphs 25 and BC143-BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in its statement of financial position, totaling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? What alternative presentation do you propose and why?

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment

(paragraphs 80, BC154 and BC156)? Why or why not? What alternative presentation do you propose and why?

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose the information in the notes instead?

Response

Lessee Presentation

The presentation for lessee assets and obligations discussed in the exposure draft is reasonable in the context of the proposed model, but we do not believe such amounts need to presented separately on the face of the balance sheet and may be disclosed separately in the footnotes.

Lessor Presentation: Performance Obligation

If the Boards continue with the performance obligation approach, the presentation outlined in the exposure draft is reasonable, as the net investment in the lease will consider the right to receive lease payments, the lease liability and the underlying asset in combination.

Lessor Presentation: Derecognition

As indicated in Question 2, we do not believe the presentation of the residual within property, plant and equipment, represents a reasonable depiction of the lease transaction. This approach to lessor accounting was implemented in 1966 and replaced in 1976, a mere ten years after the practice was codified and accretion of residual assets was once again allowed. We do not see a reason to return to this method of presentation or to the prior method of accounting for lease residuals especially since the current accounting has served investors and companies well for over thirty years.

The residual value of the physical asset is the “unleased” value of the leased asset that the lessor can generate future benefits through a release or sale when the lease ends. That residual value is an expected future cash flow that the lessor takes into account in its pricing and its investment decisions. The residual is not a property, plant and equipment asset of the lessor; rather, it is an asset held for sale or lease when it is returned by the lessee. For lessors, property, plant and equipment are non-revenue generating assets; the buildings, office space and office equipment needed to run the

business. Including residuals in property, plant and equipment will therefore blur the distinction between revenue generating assets and administrative overhead.

Lessor Presentation: Subleases

The presentation of subleases is acceptable within the proposed model, but we do not believe that separate presentation of the asset and liability should be mandated on the face of the balance sheet

Question 13: income statement

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? Why or why not?

Response

Lessors

For lease transactions accounted for under the performance obligation model, we do not believe separate presentation should be mandated for interest income, lease income and depreciation. At this stage it is not known what presentation users of financial statements will find most meaningful when analyzing financial statements and preparers when managing their businesses. Therefore, requiring a set presentation will not allow for the development of the most appropriate presentation.

For lease transactions accounted for under the derecognition approach, we believe the exposure draft approach will produce a reasonable result but we continue to be troubled by the need for lessors who enter into what are today finance leases to record a journal entry to derecognize the leased asset. Many, if not most, finance leases do not include the lessor taking delivery of the asset. The asset generally moves from the supplier or manufacturer directly to the lessee and the lessor pays the supplier/manufacturer for the asset. In these circumstances the lessor never has an asset to derecognize and functions in a role similar to that of an agent. Mandating a journal entry only adds a step into transaction processing and is a journal entry without economic substance.

Lessees

We do not believe separate presentation of the elements of a lease transaction should be mandated as such presentation is not consistent with the accounting and disclosure requirements for other contractual arrangements, such as service contracts and secured financing arrangements.

Question 14: statement of cash flows

Do you think that cash flows arising from lease contracts should be presented on the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Response

Lessors

We do not agree with the change in cash flow statement presentation for leases. For lessors applying the derecognition method the financing component of a lease is a financing activity and should be presented with other financing transactions a lessor may enter into, including loans. The reasons for the proposed change from current accounting requirements and the difference that will now exist between lease and loan receivables has not been addressed in the exposure draft.

Lessees

We do not believe the separate disclosure of lease cash flows should be mandated. It is also unclear to us why the interest component allocated to the transaction is considered to be a financing activity while other interest charges are treated as operating activities. If the Boards are attempting to return the rental payment to the cash flow statement, this is probably best achieved through the approach we have proposed for rental charges in the income statement.

Disclosures

Question 15

Do you agree that lessee and lessors should disclose quantitative and qualitative information that:

(a) identifies and explains the amounts recognized in the financial statements arising from leases; and

(b) describes how leases may affect the amount, timing, and uncertainty of entity's future cash flows?

(paragraphs 70-86 and BC168-BC183) Why or why not? If not, how would you amend the objectives and why?

Response

In our responses to Questions 13 and 14 we have indicated our concern with regards to the highly proscribed and detailed presentation and disclosure requirements of the exposure draft. It is difficult for us to reconcile these requirements with a principles based standard on leases, and we are troubled by the differences that will exist between leases and other contractual arrangements as a result of these requirements. These concerns also exist with regards to the disclosure requirements related to quantitative and qualitative information mandated by the exposure draft.

The required quantitative and qualitative disclosure requirements are of particular concern to us. The need for this information is driven by the measurement approach to lease assets and obligations employed in the exposure draft and the need to provide users of financial statements a way to separate the fixed lease obligations from the amounts estimated for term options and contingent rents. If the lease model had not required the recognition of amounts that do not meet the accounting, operational or economic liabilities for the lessee, then several of the disclosures listed in the exposure draft would not have been required.

Transition

Question 16

(a) The exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88-96 and BC186-BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
(b) Do you think full retrospective application of these accounting requirements should be permitted? Why or why not?
(c) Are there any additional transition issues the boards need to consider? If yes, which ones and why?

Response

With one notable exception, the simplified transition approach appears to be a reasonable approach to transition, but lessees and lessors should be allowed to adopt the proposal using the full retrospective method if the Boards continue with their approach for lessee accounting and with the overall approach to lessor accounting.

Given the income statement patterns that will result from the proposed models, lessees and lessors may need the option of employing the full retrospective method in order to normalize the income statement effects of the proposed lease models.

The element of the transition guidance we do not find reasonable is the requirement for lessors using the derecognition model to account for residuals at transition at fair value. Given the delayed income recognition pattern associated with the derecognition model this approach to transition is not reasonable as it will remove an income element from recurring operations for reasons that are not clear to us.

The proposals included in the exposure draft will radically alter the accounting by lessees and lessors. The changes will require significant systems and processes to accommodate the number of lease contracts. The Boards should give due consideration to these factors when deciding upon an effective date for a final standard.

Benefits and costs

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 outweigh the cost? Why or why not?

Response

The benefits and costs section of the exposure draft does not make any direct references to the proposed changes in lessor accounting. Since there is no direct discussion of whether the proposed lessor models provide financial information that is more representationally faithful or useful in any way to management in the conduct of their business or more relevant to users of financial statements in their analysis of companies, we do not believe a case has been made for the proposed changes to lessor accounting.

Our analysis of the changes to lease accounting related to estimation of lease term and lease payments, indicates there will be substantial compliance costs associated with a standard adopted in this form. The elements of the proposed model related to the estimation of lease term and lease payments may impact the information on leases reported for a few transactions, but will do so only by placing a significant burden on lessees for the large number of small dollar transactions that make up the bulk of the equipment leasing population. The average equipment lease is a "small ticket" transaction and lessors of this

equipment provide useful financing to a great number of small to midsized businesses. We are concerned the proposals in the exposure draft will place a significant burden on these companies and on those who provide them with needed assets at a reasonable cost.

In response to Question 18 we make certain recommendations that would make the implementation of the lease accounting proposals more cost effective.

Other comments

Question 18

Do you have any other comments on the proposals?

Response

A De Minimus Exception is Needed

It has been estimated that approximately 75% of the dollars in operating lease payments reported by public companies in the United States are from real estate lease (70%) and from long term equipment leases such as aircraft (5%). The balance represents equipment leases of less than $5 million in cost and terms that average 2-5 years. Equipment leases are of short duration, growing only at the rate of GDP while real estate leases generally accumulate. Given these factors we recommend the Boards provide a de minimus or practicality exception for small dollar leases. We understand the Boards reluctance to consider a de minimus exception, and we suggest the Boards discuss this matter with users of financial statements to determine if a practical solution may be developed to the administrative burden that will arise for these leases.

It should be noted that one reason for a de minimus exception is the complexity caused by estimating the lease term and estimating contingent rents using a probability weighted average method. If those concepts were altered and the current definitions used as suggested by Mr. Stephen Cooper's alternative view, then there would be less of a need to simplifyy the rules.

We also wish to note that our proposal that the lease contract be respected for purposes of determining the periodic cost of a lease transaction and that the artificial income allocations of amortization and interest be replaced by an amount not exceeding level rent would have a significant benefit for companies seeking to reduce the compliance burden of the proposals in the exposure draft. If preparers

had the ability to determine the materiality of leases by reference to the balance sheet only, which they would if the income statement pattern of lease costs were not changed, then the materiality of the many small dollar leases could be judged against the balance sheet alone. We believe this would significantly reduce the compliance cost associated with the right of use model without any noteworthy degrading of the financial information presented.

Business Combinations and Acquired Leases

The exposure draft issued by the FASB does not contain any guidance with regards to the accounting for acquired leases and the IASB's exposure draft's guidance is not complete. It is therefore important that this area be explored further before a final standard is issued.

With regards to both lessor and lessee accounting, we note there is only one mention that lease balances need to be recorded at fair value. The one reference is to the requirement for lessors to record a lease residual at fair value. It is not possible to account for acquired leases in a reasonable manner if the fair value of the acquired lease is not considered.

In addition, we note with regards to the IASB's exposure draft:

- The performance obligation model contains no instructions as to the measurement and recognition of the underlying asset.
- The derecognition model guidance appears to require a lessor to perform derecognition for any newly acquired lease. If derecognition is appropriate, it should not be performed each time a lease changes ownership.

Lease Restructurings and Lease Impairments

There is considerable guidance under existing accounting literature related to the accounting for lease restructurings and impairments. The exposure draft provides limited guidance related to the accounting for the impairment of lease assets, rights to receive lease payments and residuals. This guidance is incomplete, as we have noted several deficiencies in lessor accounting.

In the derecognition model guidance contained in paragraph B30, it appears that an early termination of a lease results in the lessor recognizing a loss on the reversal of the lease receivable without any meaningful recognition of the lessor

gaining control over the whole of the leased asset. As a result, the model will overstate the loss a lessor might incur.

In the performance obligation model, since the right to receive lease payments amortizes more slowly than the lease liability, an early termination of a lease will always result in an accounting loss. Conversely, an early termination will always result in a gain by a lessee. Since many of the existing operating leases that would presumably be accounted for as performance obligation leases are with lessees that do not have strong credit profiles, lease terminations in the event of a default are not unusual occurrences. We are troubled by a model that always generates an accounting loss and by the timing mismatch that is likely to occur in these circumstances if the right to receive lease payments is impaired in one reporting period and the lease liability is relieved in a subsequent reporting period.

Also with regards to the performance obligation model, we are uncertain how to apply cash flows for purposes of measuring impairment. The model appears to imply that lease cash flows need to be applied twice: in the impairment testing of the lease receivable and the underlying asset. We find the use of one set of cash flows to support two assets intellectually challenging.

Incremental Borrowing Rate

The lessee's incremental borrowing rate concept is essentially carried forward from existing guidance, but the existing guidance did not have to consider rents with uncertainties and there is a risk that use of this rate may incorrectly state a lessee's obligation if uncertainty is not considered. For example, if a lease with fixed base term rents contains a fair market value renewal option, the renewal rents are subject to adjustment based upon the fair value of the leased asset and the credit standing of the lessee at the date of renewal. As a result, the lessee may be able to determine an incremental borrowing rate for the base term, but in situations where the lease term for accounting purposes includes the renewal period it would have to determine its incremental borrowing rate considering a forward starting option to borrow at the renewal date at market terms. In other words, the incremental borrowing rate is not simply a matter of considering the impact of increasing lease term on borrowing costs.

Derecognition Formula

The formula to be applied when derecognizing a portion of leased asset is as follows:

Derecognized Amount = Book Value of Asset X [Fair Value of Lease Receivable/Fair Value of Asset]

Lease transactions are priced considering all cash flows in a lease: rents, tax benefits and residual flows. Due to the lessor being the tax owner of a lease in many circumstances, it is possible the lease payments will be lower than a comparable loan rate. When this situation exists the fair value of the lease receivable will not provide a reasonable basis for purposes of performing derecognition. As a result, we believe the formula should be adjusted as follows:

Derecognized Amount = BV of Asset – [BV of Asset X (FV of Residual/FV of Asset)]

We recommend this approach as the fair value of the residual will not be influenced by the pricing of tax benefits into a lease and is objectively determinable.

Contingent Rents

Contingent rents based on an interest rate index such as LIBOR are common in certain segments of the equipment leasing industry. In a floating rate lease the monthly rent has a portion that is a fixed principal amortization and a variable portion based the prevailing LIBOR plus a spread. Paragraph 14 of the exposure draft requires the lessee to determine the expected lease payments using readily available forward rates or indices and requires the lessee to revise the discount rate when there are subsequent reassessments of the expected lease term or contingent rentals, if the lease payments are contingent on variable reference interest rates.

We believe these estimations will be time consuming and will not significantly improve the quality of the lease accounting balances. As a result, we believe it would be much simpler to use the spot rate at inception to calculate the estimated payments and discount them.

Lease Accounting Examples

The exposure draft includes some examples of the proposed accounting by lessors and lessees. Since the proposed models for lessor and lessee accounting represent significant changes from the existing practices, we believe the words in the exposure draft may prove to be insufficient to convey the full meaning of how the

proposals are to be implemented. We therefore recommend adding additional examples, including examples related to impairments and restructurings.

Non-public entities

Question 19

Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

Response

Although we see no reason why the principles in the exposure draft would not apply to all companies, we think that many private companies are small and medium sized enterprises. They use leasing to acquire the use of equipment to a greater extent than public companies as their access to capital is limited. They probably do not have the staff or economic resources to comply with the complexities of the exposure draft. We cannot comment on not-for-profit companies as we are not experienced in not-for-profit accounting.