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December 10, 2010

Financial Accounting Standards Board
of the Financial Accounting Foundation
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IFRS Foundation / IASB
30 Cannon Street
London, EC4M 6XH
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In re: Proposed Accounting Standards Update, Leases (Topic 840) of August 7, 2010

Ladies & Gentlemen,

AeroCentury Corp. (“ACY”) is a publicly traded company that provides short-term, operating lease financing of regional aircraft and engines to aircraft operators around the world. As such, the comments provided in this letter primarily address the proposed lease accounting treatment of short-term (of three to five year duration) leases of assets with substantial “residual” value at lease end and significant lessor exposure to risks and benefits associated with the asset either during the expected term of the lease or thereafter.

Summary of Accounting Methods for Operating-Type Leases: Current & Proposed

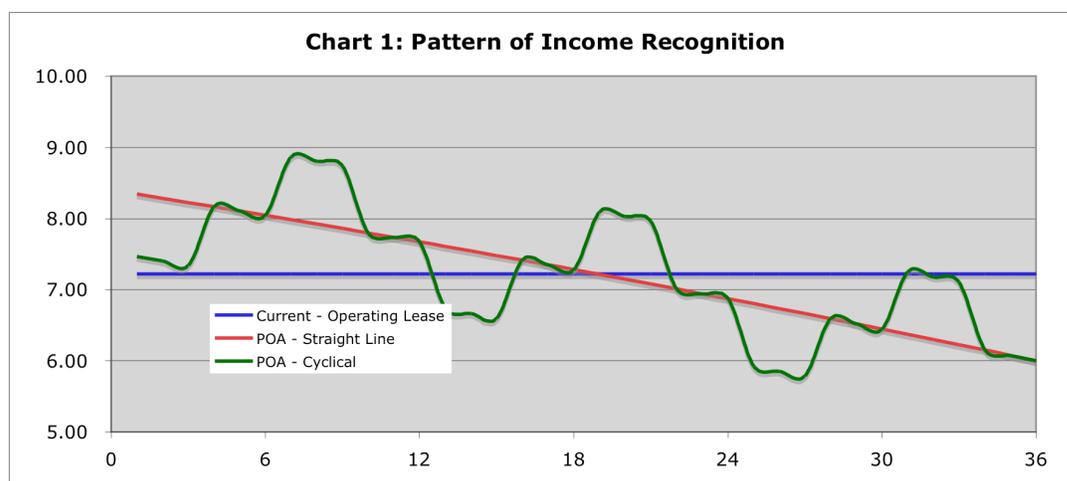
Current operating lease accounting requires that rent revenue arising from minimum lease payments be recognized on a level basis: contingent or variable payments are recognized as income when the right to receipt of such payments occurs. Leased equipment is subject to the lessor’s ordinary depreciation policies; the net book value is reported as an asset and is evaluated periodically for impairment.

The proposed treatment of such leases (using the performance obligation approach) lends proof to the adage that “a camel is a horse designed by a committee.” The performance obligation approach (“POA”) retains the leased equipment (net of depreciation and tested for impairment) on the balance sheet, but also includes the present value of future lease payments and, conversely, a “performance obligation” as a liability (which initially equals exactly the present value of future lease payments) that is not presented with other liabilities but is, instead, netted against the lease

assets. By recognizing the performance obligation as a de facto contra-asset rather than as a liability, the proposal gives voice to a theoretical recognition of a liability arising from the transfer of rights in the lessor's assets to the lessee, and then eviscerates the logical implications of that theory in its implementation by netting the liability on the asset side of the balance sheet (*where else is this permitted?*).

Unlike current rental regimes (capital and operating leases) or the proposed “derecognition approach” (which closely approximates current capital lease treatment although the standards under which it is implemented are different), the POA seems to best be described as a compromise that recognizes part of the income under an interest income approach (as required by capital or “derecognition approach” leases) and another part of the income on a different and what will probably often be a level basis (similar to current operating leases).¹

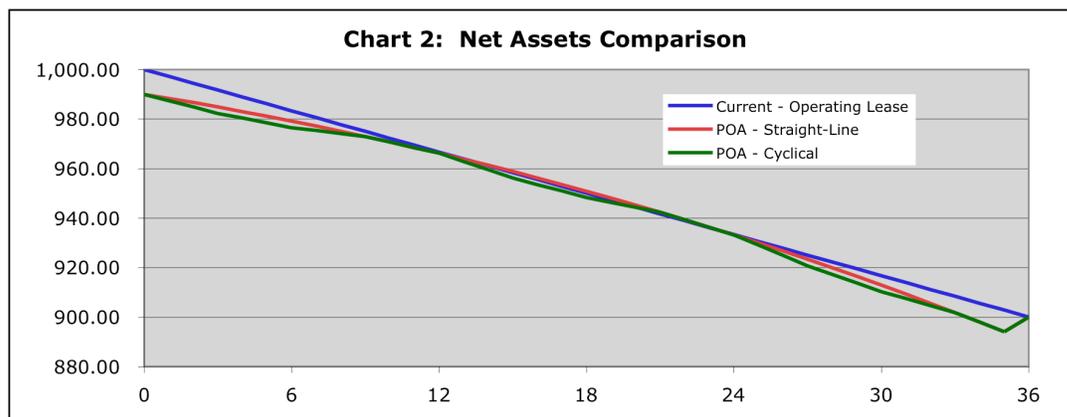
The pattern of income for a current operating lease, as well as under the proposed POA with both a straight-line or cyclical pattern of use used to amortize the performance obligation, is illustrated in Chart 1 below:²



Similarly, the net asset is presented (under POA, only the total of the depreciated equipment, receivable and performance obligation is shown) in the balance sheet illustration in Chart 2, below.

¹ Unlike current operating leases, under which minimum lease payments are recognized under a straight-line or level method, POA obligations are amortized based on the pattern of use of the asset as estimated by the lessor and presumably subject to recurring assessment and re-estimation; only where the pattern of use cannot be reliably estimated is the lessor permitted to use a straight-line or level method.

² We have assumed a lease of a \$1000 asset with a “residual value” of \$900 at the end of a thirty-six month lease, with rent payments of \$10 monthly in advance. The example assumes there are no contingent rents.



Question 2: Lessors

This series of questions asks whether the application of POA versus derecognition should be determined by whether the lessor retains significant risks associated with the asset, whether we agree that the method for income and balance sheet recognition is appropriate, and whether we think that the leveraged lease approach should be discarded.

We do believe that there is a substantial economic difference between what is essentially a pure “financing” transaction and what is a more temporary transfer of use of leased property. Where a lessee is essentially transferred virtually all of the economic rights and obligations associated with a property, it is appropriate to treat such a lease as a pure financing agreement under which the lessor derecognizes the underlying asset and recognizes a receivable effectively secured by the asset. As such, we are satisfied with the dividing line, based on retention or transfer of substantially all the risks and benefits related to the leased property, that is drawn between derecognized or not-derecognized assets under the proposed accounting changes.

The proposed accounting method for derecognized assets generally treats future receivables under the lease as an asset and amortizes it as a financial instrument using the interest rate agreed to between the parties, and we are satisfied with this general approach.

The method of dealing with not-derecognized assets is cumbersome and confusing. We see little that is gained by adding an asset and offsetting liability to the balance sheet and netting them together in presentation. There are not large changes to the net assets shown, but the components require substantial disclosure that we do not think will truly benefit users of financial statements. Knowledge of future revenue flows will be helpful; however, knowing the cumulative net present value of such payments based on estimated discount rates over a period of time is likely of less help, especially when largely offset by a difficult-to-grasp concept such as a “performance obligation” that really represents the nebulous promise to let lessees use the leased property, which “obligation” is the reason for a lessor’s ownership of, and underlying the value in, the capitalized lease property.

Investors and banks that look to the lessor's financial statements understand that the recovery of much of the value of the asset will come through rental proceeds. It is neither necessary nor even desirable to double count a lessor's assets by *also* capitalizing the present value of lease receivables. Creation of an obligation called a "performance obligation" and subsequent netting of that obligation against the over-stated assets is an inadequate redress of the problem created by duplication of recorded assets in the first place.³

We also take exception with the method of amortization of the performance obligation. Current operating leases recognize fixed payments on a straight-line (level) basis and account for contingent rents as income when earned. This concept is easily understood, and brings the lessor as far into the lessee's use of the asset and income recognition attributes as it ought to be brought. Capitalizing expected future contingent rents into a receivable, then amortizing the offsetting performance obligation in accordance with expected realization of future contingent rents is complex, involves a number of assumptions that will require frequent re-evaluation, and brings the lessor into a virtual partnership with each lessee because the lessee's pattern of use of the asset is only an important consideration for the lessor's accounting and not for its anticipated revenue stream or the future value of its assets. Accounting rules should not be designed to assign importance to theoretical concepts beyond their actual, economic importance. Unfortunately, the POA does just that.

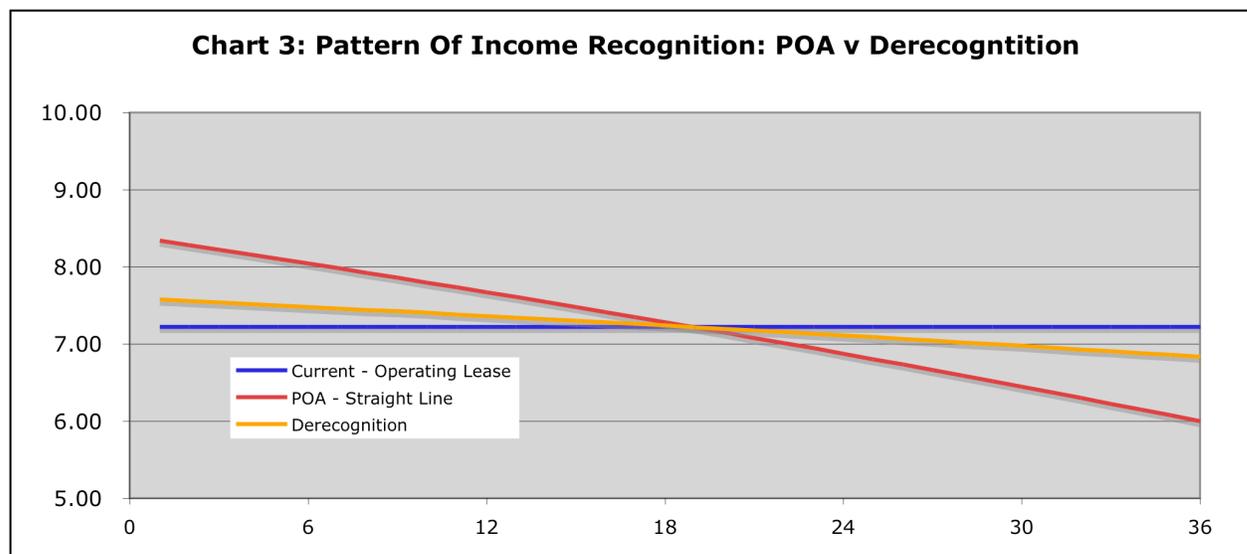
We believe that operating leases should be accounted for very much as they are today (with assets reported net of depreciation and most non-contingent rental income reported on a level basis over the lease term), with enhanced disclosure that will meet all of the needs of users of our financial statements and will be more transparent than the confusion and opacity of the proposed POA treatment, because this avoids doubling up of assets, creation of a fictitious liability in the form of the performance obligation and all of the machinations required to constantly re-evaluate and re-estimate them.

Alternatively, we believe that the Boards may wish to consider simply applying the derecognition approach to all leases. Although continuation of an operating lease model for some leases is preferable, we find at least some logic and consistency in approaching all leases similarly (which is effectively what is done with lessee accounting where something is always capitalized under the new lease accounting proposals, although what is capitalized differs based on the underlying facts).

Returning to the earlier hypothetical example in this letter, the time pattern of income recognition under current accounting and under the POA is compared to the recognition of interest income

³ Although not addressed in detail here, it should be noted that the "performance obligation" ceases to be an obligation if the receivable becomes worthless, typically through a lessee default. If it is expected that the receivable will not be collected, then the performance obligation should also be removed. In a lease where the payment terms reflect the lessor's and lessee's view of the future value of the right to use the asset, the receivable and obligation should always exactly offset, in which case there is no need to record either as they are netted against each other on the balance sheet and the amortizations would also offset. Circumstances in which there are deferred or accelerated rental payments based on credit decisions are currently accounted for by leveling minimum rents, which continues to appear to be the best way to deal with the credit as opposed to usage of asset/income issues that are blurred under the POA.

from derecognition (i.e. accounting for the present value of future lease obligations as a receivable) is shown in Chart 3, below.



It is instructive, we think, to note that income recognized under the derecognition approach is closer to the level recognition of operating leases than is the POA pattern of income. The POA pattern is a result of an artificially high interest component recognized on the amortization of the quickly declining lease receivable balance, which ignores the fact implicit in income recognition with the derecognition approach – the lessor is providing use of the entire asset to the lessee over the period of the lease, and so the amount financed is not only the rents that will be paid but also residual value of the asset to be returned to the lessor at the end of the lease.⁴

We think that the exceptions to logical accounting treatment for leveraged leases should never have been made, and agree with removing any distinction whatsoever for them in the future.

Question 7: Purchase Options

This question asks whether we agree that a lessor should only account for purchase options if exercised as provided for in the proposal. We agree with the proposed treatment, so long as an option is not a “bargain,” in which case it should (a) be treated as exercised and (b) be viewed as strong evidence that, because the lessee is likely to acquire the property outright, the derecognition approach may be appropriate.

⁴ In fact, since it is the entire asset that the lessor is really providing to (financing for) the lessee, an interest component on the entire asset value with a large “balloon” represented by the residual value will have very close to level “interest” over the term of the “loan” (lease), which means that current operating lease treatment is very close to a more theoretically “pure” finance treatment where the lease residual value is expected to be very close to the asset value at inception.

Question 8: Lease Term

This question asks whether we agree that the appropriate lease term is the longest term under the lease that is more likely than not to occur taking into effect extension or termination options under the lease.

We do not agree with this analysis. Options are included in the lease principally because a lessee is uncertain about the term it wishes to use a property. The fact is that lessees have the right to use property only for the period they are obligated to use it, and lessors should not recognize a receivable for periods and amounts for which a lessee is not obligated to continue the lease. We believe that the lessor should only include the shortest lease period under which the lessee is obligated to continue the lease *without penalty*. If a significant penalty is incurred for terminating a lease, the termination should be assumed not to occur; likewise, if the lessee incurs a significant penalty for not extending a lease, the extension period should be included.

Question 9: Lease Payments

This question asks about including contingent and other rents and residual value guarantees in measurement of assets and performance obligations.

Firstly, we do not think that the receivable / POA is appropriate for operating leases, as outlined above. Secondly, if that approach is used, we think that contingent amounts generally should not be included in the calculation of the receivable or obligation (although the nature and, possibly, estimates of future contingency amounts should be disclosed). To the extent it is felt that the “pattern of use” of the underlying asset should be reflected in the income of the lessor, that pattern is much more directly included through recognition of contingencies in income when and as recognized, rather than through estimated receivables, interest rates, and non-level amortization of the performance obligation.

Residual guarantees and other, similar contingencies based on factors other than the pattern of lessee use should be included to the extent they are more likely than not to occur and are reasonably estimable.

Question 12: Statement of Financial Position

Part (b) deals with lessor accounting for not-derecognized assets, and is the only matter we address here. It asks if we agree with presenting the underlying asset, the receivable and the “lease liabilities” (i.e. the performance obligation) “gross” but netted together.

We do not think the present value lease receivables or the “performance obligation / liability” should be presented at all. We believe that disclosures about future contingent and non-contingent rents will more adequately meet financial statement users’ needs and avoid complexity and opacity that including such estimates in the lessor’s accounts will create.

Summary

As is no doubt clear from our discussions above, we consider the proposed performance obligation approach to deal with not-derecognized lease assets to be needlessly complex and opaque. It is fraught with unnecessary assumptions and estimates and re-evaluations of assumptions and estimates, and will not truly add to financial statement users' understanding of the financial position or earnings pattern of lessors' businesses, and is in fact contrary to the way users view the financial aspects of the lessor's business as working. It will, however, adopt a model of accounting that does not accurately reflect income earned by lessors for the reasons set forth above and add substantial cost and complexity to lessor accounting and internal controls.

We urge the Boards to revisit this topic and reconsider this unnecessarily complex and burdensome accounting proposal.

Respectfully submitted,

AeroCentury Corp.