

Mr. Robert Herz
Chairman FASB

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Dear Sirs

Thank you for the opportunity to comment on the Lease Exposure Draft (ED). I support the theory that operating lease obligations arising from material operating leases should be capitalized, but I disagree with several major elements in the ED.

I do not believe the proposed approach resolves the stated reasons why the lease accounting model is being re-written. The stated reasons are: *“However, those models have been criticized for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions. In particular they omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the boards’ conceptual framework. The models also lead to a lack of comparability and undue complexity because of the sharp ‘bright-line’ distinction between finance leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.”*

Specifically, except for lessees capitalizing lease obligations that are true liabilities, the proposed rules distort the economic effect for both lessors and lessees, rather than faithfully presenting the effects of leases in financial statements. The estimated payments from renewals and contingent rents do not meet the definition of liabilities, resulting in far too much being capitalized. The requirement for both lessees and lessors to estimate payments will lead to a lack of symmetry between lessors and lessees in the same lease and a lack of comparability among lessors, as well as among lessees due to the lack of objective, reliable measures. The cited complexity in the existing rules is merely the one-time classification of a lease whereas the proposed rules make complexity a monthly event as estimates are made, and then adjusted, month after month for large companies that report earnings monthly.

The following is a summary of my main issues with the ED, and my detailed comments about lesser issues follow below

Major Issue	Suggested Change to ED	Reason(s) for Change
Estimated renewals and contingent rents are not liabilities of the lessee at lease inception (1)	Keep the current GAAP definition of the lease term and minimum lease payments and supplement with new principles that deal with contingent rents that are disguised minimum lease payments	Estimated renewals and contingent rents do not meet definitions of liabilities; Estimates are not reliable due to uncertainty and the long time between inception and the triggering contingent event date; P&L volatility is created due to frequent adjustments; Adds complexity, inflates balance sheets, exacerbates the front-end cost pattern, and creates comparability and symmetry issues; Current GAAP is more objective.
Performance obligation (PO) method inconsistent with lessee ROU model (2)	Discard the method except where the lessor performance risk is so great that it is likely the lessee will withhold rent payment	Derecognition is the only method that is symmetrical with the lessee ROU model in reflecting that the value of the ROU is transferred to the lessee.
Derecognition method does not allow residual asset to be accreted to its fair value (3)	Use implicit rate in the lease to present value (PV) expected residual value and accrete residual over the term	Residual is an expected cash flow from the investment in the lease; It is not property, plant and equipment (PP&E); Fair value gives users best information
Reclassification of In-substance Purchases is unnecessary and provides no benefit (4)	Continue to allow transactions that pass all material rights and benefits of ownership under lease accounting rules	The reclassification of in-substance purchases creates additional operational burdens on lessors with no benefit to users of financial statements
Elimination of Leveraged Lease Accounting	Consider keeping leveraged lease accounting	The net rent is an asset of the lessor, not the gross rent. Control of the rent has been transferred to the lender.

(1) The inclusion of renewal payments in the definition of lease term is problematic for both lessees and lessors. It will create significant mismatching of assets and liabilities between lessors and lessees as they try to determine the vague guidance of

- “more likely than not.” The requirement to continually review and restate assets and liabilities will create an onerous burden on lessors and lessees and is simply not feasible for lessors of large portfolios of lease contracts and creates the potential for an environment of non-compliance with the new standard.
- (2) The Performance Obligation model is inconsistent with equipment leasing transactions. Lease agreements are structured such that the Lessee has “quiet enjoyment” once the equipment has been placed into service. Equipment lessors have no continuing obligation to perform under the lease. The PO model also creates a loss of symmetry with lessee accounting and does not reflect the reality of the cashflows inherent in the lease. This hybrid approach which combines components of capital lease and operating lease models is overly complex and will obfuscate the actual assets and liabilities of lessors.
 - (3) The disallowance of the accretion of the residual assumption to earnings is inconsistent with the definition of the “rate charged to the lessee” in the Exposure Draft. Section B12 of the ED allows the accrual rate to incorporate the residual assumption of the lessor to reflect the fact that the lessors earnings are dependent on the residual value. To then disallow any accrual of the lessors residual assumption seems at odds with the use of the Implicit Rate as the rate the Boards have defined to represent the cashflows of the lease. (see Derecognition Example below)
 - (4) In-substance Purchases represents a significant percentage of lease transactions for lessors. Excluding these transactions from the scope of the leasing rules creates unintended consequences of increased operational costs as well as increased transition costs. Lessors may be required to purchase new accounting systems to comply; all without any material benefit to the readers of lessors financial statements.

Renewal Payments – Minimum Lease Payments

The requirement for the lessor to incorporate renewal payments in the calculation of Minimum Lease Payments shows a lack of understanding of the current capitalization of lease financing contracts. Under current lease accounting standards for a capital lease the lessor recognizes an assumed future value of the asset (residual) and recognizes earnings such that the estimated future value of the asset is the remaining amount on the balance sheet at contractual lease expiration. This estimated future value represents the expected cashflows that the equipment will generate over its remaining useful life including both periodic renewal payments AND the final value of the asset in a third party sale. In essence the lessor is under current capital lease rules, already estimating the future cashflows the asset will generate after the end of the contractual lease term. It may be called residual value but it represents all expected cashflows after expiration of the initial lease term.

Derecognition – Implicit Rate

The Exposure Draft defines the discount rate to be used in the PV of lease payments as the rate charged to the lessee. In paragraph B12 it further defines that rate to allow the lessor to include the residual assumption inherent in the lease transaction. To incorporate the residual assumption into the rate allowed to recognize finance income and then disallow the

rate (with residual) to represent the full economic assumptions by removing the accrual of the residual value seems inconsistent and creates a mis-match of rate and earnings.

Summary of Position - Lessor Accounting

- Eliminate lease classification
All but short-term leases are derecognized with a PV receivable and a PV residual recorded. Recognize interest income as the rents are collected. Accrete the residual to its expected fair value at lease expiry. Record any gross profit and cost of sales on the portion of the ROU value transferred. Defer any gross profit on the residual portion of the leased asset retained by the lessor until the asset is sold or re-leased at expiry. Amortize initial direct costs.
- Leases where, at inception, the lease term is one year or less use the operating lease method. If there is a lessor performance obligation that remains unfulfilled, and its risk of performance is so high that it precludes the lessor from derecognizing the value of the asset transferred, then no receivable should be recorded by the lessor. Leases with significant continuing performance obligations are short-term leases.
- Consider keeping leveraged lease accounting since the net rent is an asset of the lessor, not the gross rent. Control of the rent has been transferred to the lender.
- Maintain current definitions of minimum lease payments and lease term but add a principle as follows: "If the lease contains base term contingent rents that are disguised minimum lease payments, an estimate should be capitalized." Use the same definitions of minimum lease payments for lessors and lessees.
- Use the implicit rate in the lease to PV rents and residuals in finance lease accounting. Where the implicit rate is not applicable (as in most real estate leases) use the lessee's incremental borrowing rate.
- For transactions in transition, grandfather existing finance and leveraged leases.

Sub Lease Accounting

- Use the derecognition method for the sublease, which will derecognize the ROU asset and book a receivable and residual. Where the sublessee assumes the sublessor's obligation to pay rent, remove the assets and liabilities from the sublessor's balance sheet.

Sale leaseback accounting

- Use the decisions made to date. That is, if there is no sale, account for the transaction as a financing; if there is a sale, derecognize the asset and use capital lease accounting recognizing a gain or loss. If the terms of the transaction are not market, adjust the gain or loss.

CONCLUSION:

In conclusion I would like to present my views regarding the impacts of the proposed rules change. I know the Boards' view historically has been that if the accounting is correct, the market impacts should not change the decisions. However, when the proposed rules have the potential to drastically change the markets and products of a financial industry the Boards should take pause and reconsider if the perceived benefits indeed outweigh the negative impact to an industry. Unfortunately, I believe this is the case with the proposed changes to lease accounting.

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