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December 13, 2010

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

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

Subject: *Proposed Accounting Standards Update on Leases*

Dear Chairperson Seidman and Chairman Tweedie:

I wish to comment on the Boards' Exposure Draft, *Proposed Accounting Standards Update on Leases,* (the ED). I am a Principal with The Alta Group, a worldwide consultancy serving financial services companies and manufacturers engaged in, among other things, equipment leasing. I personally have been involved in accounting for leases for over 30 years in such diverse roles as an auditor, lessee, lessor, consultant, and author.

While I understand the motivations behind revising the lease accounting standards as they relate to how lessees measure and report leases, I believe that the current lessor accounting models provide investors and other stakeholders with adequate information on which to base their financial decisions. I am concerned that the changes to lessor accounting being proposed in the ED will not accurately reflect true economic activity, thereby adversely impacting users and preparers of financial information.

Accordingly, I request that the lease accounting proposals be reconsidered in light of the issues and principles I have set forth in this letter. I will limit my comments to the primary lessor issues that most concern me. These are the:

- Performance obligation approach, and
- Elimination of residual accretion under the derecognition approach

Performance obligation approach

If one accepts the premise that the purpose of accounting is to provide information for sound decision-making by management, investors, creditors, regulators, etc., then the performance obligation approach falls short. Consequently, I do not support adoption of the performance obligation approach, as I believe that it does not properly reflect the substance of the transaction. Additionally, the impact of the performance obligation approach on lessors' business activities, financial statement presentation, key financial metrics, internal controls, and lease accounting systems will be profound.

The determining factor given in the ED for using the performance obligation approach is whether the lessor retains exposure to significant risks or benefits related to the underlying asset. Use of the term "significant risks or benefits" is a theoretical way of saying that the lessor is allowing the lessee to use the lessor's asset over a period of time, in return for which the lessee pays rents. This is the classic definition of a lease.

The Boards have taken great pains to make the distinction that the asset is the continuing economic resource of the lessor in a performance obligation lease and not a financing, as under the derecognition or current finance lease approach. In spite of this distinction, the Boards have introduced a financing concept into the accounting for what is, essentially, a rental agreement.

Consider the example of a company that owns and operates a ship. The ship, however, is temporarily surplus to its requirements, so the company leases it to a third party for a period of one year. The transaction in this example is a rental agreement and would most appropriately be reported by retaining the ship in the company's balance sheet and recording rent revenue. This is not a financing and to bring such an element into the reporting of the transaction, as under the performance obligation approach, is superfluous.

The performance obligation approach does not improve the balance sheet presentation of the transaction. At inception, the net presentation of the performance obligation approach is the same as the current presentation for operating leases. During the term of the lease, however, the presentation diverges from operating lease accounting due to the differences in the amortization of the performance obligation and the right-to-receive payments. At

this point the performance obligation approach not only is superfluous but also unnecessarily disruptive to the presentation.

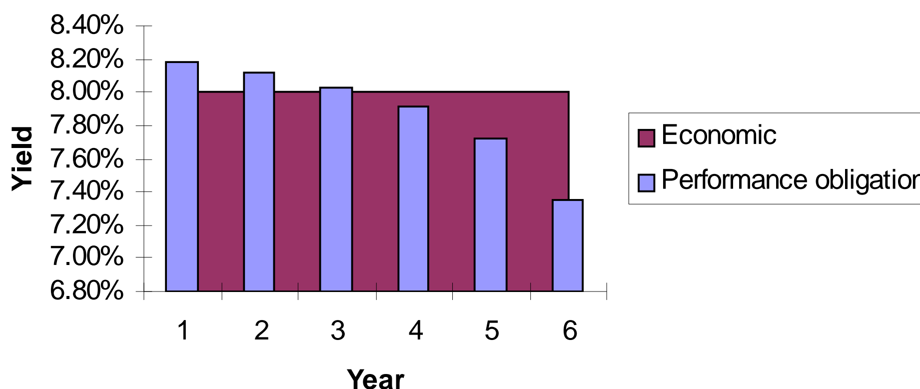
The performance obligation approach also does not improve the income statement presentation of the transaction and, in fact, does not faithfully represent the economics of the transaction. For instance, the economic, or pretax, cash-on-cash yield in the following equipment leasing example is 8.0%:

Cost:	7,000,000
Term:	6 years
Residual:	1,125,000
Payment	1,361,000

Figure One illustrates the asymmetry between the actual economic yield and that reported in the financial statements under the performance obligation approach. As can be seen, the financial statement reporting of the transaction does not reflect the lessor's economics, i.e., a constant pretax return of 8.0% on its investment.

Figure One

Yield Comparison



These distortions occur irrespective of the lease term, the length of which should not be determinative as to the accounting model applied. Assume that a lessor acquires a ship similar to the one in the previous scenario and leases it to a lessee for ten years (a minority of the asset's life). In this case, the lessor retains exposure to significant risks or benefits related to the underlying asset. Current operating lease treatment would be more appropriate than the performance obligation approach in this scenario.

Other factors the Boards should consider when deliberating adoption of the performance obligation approach include:

1. Measuring results based on the performance obligation approach represents an extremely disruptive paradigm shift in the lessor's management reporting environment, not only at a great cost, but without increasing the value of the information. Furthermore, comparability and benchmarking to past results will no longer be an option, essentially rendering obsolete over 40 years of industry data and research.

   This disruption will not be limited to metrics. Pricing algorithms will need to be adjusted for those who are trying to price to financial statement results and funding methodologies will require modification when adjusting debt levels and capitalization. Another possible outcome of such a drastic change in methodologies and measurements is that companies will utilize the 'noise' of the change to obscure undesirable reporting results.

2. The operational burden faced by lessors will increase substantially under the proposed lease accounting rules as lessors establish new processes and data analytics to accommodate the requirements of the performance obligation approach. The risk management process also will be affected, as each lease will require impairment testing of both the asset and the lease receivable. Other increases in the operational burden for lessors include increases in deferred tax tracking associated with the performance obligation and potential changes in how sales taxes are remitted.

3. The performance obligation approach will require modifications to both origination and lease management systems, resulting in significant compliance costs, yet little, if any, additional reporting value. Current lease management systems have the capability to track operating leases and finance leases. The performance obligation approach, however, will require each of these modules, along with the newly created performance obligation, to be linked and then integrated.

   The performance obligation approach also will require more asset tracking capabilities than some legacy lease management systems currently possess. Tracking subvention income, blended income, and other subsets of income and deferred charges now will become even more complicated and difficult to implement as the number of components associated with the lease transaction increase under the performance obligation approach. Additionally, lease origination systems will need to be modified to track and accommodate the performance obligation.

4. The effect of adopting the performance obligation approach goes well beyond lessors, as other constituents of the equipment leasing industry also will be impacted. There could be disruption of the regulatory

oversight function, for example, as regulatory capital, as measured in the financial statements, may be inadequate under the performance obligation approach, depending on the regulators' treatment of the components of the performance obligation approach. This change will necessitate altering metrics, regulatory guidance collateral, and, potentially, audit approaches, documentation, and focus.

The rating agencies will be forced to adjust their metrics and analysis, not only in their scrutiny and investigation of leasing companies, but also in how they measure and assess lease securitizations. Investors and lenders in the equipment leasing industry also will have to adjust to viewing the industry in a whole new light.

The Boards should assess whether an equipment lease is simply usage of the asset (operating lease model) or the provision of that usage through a financing transaction that embodies time value of money concepts, such as under current finance lease accounting. It must be one or the other. The current blend of both, as embodied in the performance obligation approach, does not reflect the economic attributes of the transaction and creates additional costs and reporting requirements. More importantly, I do not believe the performance obligation approach creates any added value in terms of the information reported to users of the financial information.

If the Boards decide to eliminate operating lease accounting, it should not be replaced by the performance obligation approach. Instead, in my opinion, the current finance lease model should be used for all leases.

Residual accretion

In my opinion, if the Boards eliminate the operating lease accounting for lessors, the current finance lease model should be used for all leases, including those that fall under the proposed derecognition approach. The primary reason for my stance on this issue relates to the elimination of residual accretion for leases that represent transfers of the economic risks and rewards of the asset, i.e., transactions identified in the ED as derecognition leases.

Dissolution of the residual component of the net investment in the lease under the derecognition approach creates several issues, the most important of which is the asymmetry between the economic performance of the lease and its reported performance. A derecognition lease, by definition in the ED, is representative of a financing, having transferred the economic benefits of the underlying asset to the lessee.

The financing extended by the lessor consists of two components – the payment portion and the unguaranteed residual portion. This financing is repaid through two sources, as can be illustrated with the assumptions of the previous example.

The first source of repayment is the contractual lease payments. The lessor finances the present value of these payments, which, in the example, are equal to 6,291,000. The second source of repayment in the lease is the unguaranteed residual. The lessor finances the present value of the unguaranteed residual, which, in the example, is equal to 709,000.

This arrangement is no different, other than the sources of repayment, than a loan with a balloon payment in the same amount as the unguaranteed residual. In a loan, the repayment of the payment portion and balloon portion of the financing comes from the borrower. In a loan, interest is earned on both the payment portion and the balloon portion, as principal has been advanced for each portion.

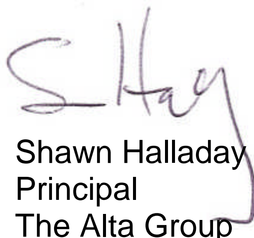
This same logic should be applied to the lease, as the lender and lessor both have the same amount of principal outstanding, over the same period of time, and with the same repayment pattern. Yes, the balloon payment in the loan is coming from the borrower and the residual in the lease is being recouped from the market, but the unguaranteed residual is subject to impairment/fair value testing just as is the balloon payment in a loan. These impairment tests require that any diminution in the principal is recognized, whether a loan or a lease.

Disallowance of the residual accretion goes beyond economic distortion. It also diminishes management's ability to track future income by credit and asset risk categories. Furthermore, the straight-line residual income pattern of the performance obligation approach is not representative of the economic accretion of the residual.

In my opinion, the residual accretion model should be retained in any new lessor accounting model.

Thank you for your time and consideration in reviewing this letter. I greatly appreciate the Boards' openness and willingness to consider all views.

Sincerely,



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