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July 17, 2009

Mr. Russell Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 1680-100

Dear Mr. Golden:

The Equipment Leasing and Finance Association ("ELFA")[1] welcomes the opportunity to respond to the request for comments from the Financial Accounting Standards Board ("FASB" or "the Board") on the proposal contained in the FASB Discussion Paper, *Leases: Preliminary Views* ("the Discussion Paper or DP").

Summary Comments

We support the Boards' efforts as they seek to establish a sound, workable accounting standard that applies to the assets and liabilities arising from lease transactions. We find, however, that the lease accounting model as proposed in the DP is unduly complex and will impose a compliance burden on lessees that will not result in a significant improvement in the quality or reliability of financial information. The model in the DP seems to be overly concerned with preventing potential abuse, rather than accurately reporting the economic aspects of leasing transactions. Further, we are of the view that the proposed model is now so close to current GAAP that it would be more efficient to merely amend IAS 17/FAS 13 to capitalize operating leases and leave capital lease accounting and the P&L accounting for operating leases unchanged.

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[1] ELFA is the principal trade association representing financial services companies and manufacturers engaged in financing the utilization and investment of and in capital goods. 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. Its over 600 members include independent and captive leasing and finance companies, banks, financial services corporations, broker/packagers and investment banks, as well as service providers. The equipment finance business is estimated to be a $650 billion industry in 2008. For more information, please visit http://www.elfaonline.org.

We also believe the proposed modifications of the accounting for capital leases and the proposed income statement treatment for operating leases distort the financial statement presentation of these transactions and do not faithfully represent the economic effects of lease transactions presented in the financial statements of lessees. And, we believe that excluding or "de-linking" lessor accounting from the scope of the project will result in additional unnecessary complexity.

<u>Specific Concerns</u>

- ***The proposed rules do not reflect the economic differences between right to use leases (rental contracts) and right of ownership leases (a purchase financed by a loan) so that representational faithfulness in financial reporting will not be achieved.***

  The Board's stated intention is to account for the rights and obligations in a lease contract as a whole; however, the DP provides no guidance on how to analyze such rights and obligations in their totality in determining the nature of a transaction. Unlike the DP, we believe the substance, not the form of the lease transaction, should either determine the scope of the DP or form the basis of the accounting treatment. Right of use leases generally involve a temporary conveyance of the right to use leased property and a meaningful allocation of risks and rewards incident to the underlying asset between the parties. In the U.S., such leases are commonly referred to as "true" leases, to which a distinct body of commercial law (i.e., Article 2A) applies, with rights and obligations fundamentally different from contracts that convey a security interest in the underlying asset.

  Under U.S. law, these leases convey contract rights (intangible assets), not property rights. By contrast, other contracts nominally identified as leases convey all of the risks and rewards incident to the underlying asset. Such leases constitute loans (commonly referred to as leases intended as security) or conditional sales agreements and, as such, come within the same body of U.S. commercial law applicable to secured loans (Article 9). Unlike true leases, these debt-like lease contracts convey property rights to the underlying asset. Accordingly, to achieve representational faithfulness, we believe the proposed model must portray the legal and economic realities. Similar contracts should be accounted for similarly, meaning debt-like leases should continue to be accounted for in the same way as a note for property, plant or equipment transactions. The accounting for lease contracts that is distinctly different than loans, e.g., U.S. true leases, should reflect the distinctly different economic bargain.

  We believe the Board has proposed an appropriate methodology for the initial recognition and measurement of right of use leases by the lessee, i.e., present valuing the lease payments at the incremental borrowing rate to determine the lease obligation and a corresponding linked asset. We note that this is an established methodology and has been used by some of the major credit rating agencies and other financial analysts for some time. We also believe that this methodology is understandable and can be implemented within acceptable cost-benefit parameters.

However, we disagree with the proposed approach for subsequent measurement of right of use leases because it distorts the legal and economic realities. Since these leases convey contract rights and not property rights and the leased asset generally cannot be transferred separately from the lease obligation, we believe the accounting for the asset and liability should remain linked. In other words, we believe, absent impairment, the carrying value of the asset should continue to equal the carrying value of the liability. We further believe the linked approach would provide a faithful representation of the periodic expense in the income statement, generally an equal allocation of the total consideration over the lease term. We note the capitalization techniques historically used by rating agencies and other financial statement users have not involved changing the expensed amount.

We also note the proposed delinked approach generally will result in reporting the lease obligation in excess of the leased asset throughout the lease term, implying most leases are "underwater" and involve a disproportional consumption of the total consideration in the early years of the lease. Since most leases are not underwater and the consumption of the benefit is generally at the same rate throughout the contract, we believe the proposed delinked approach is patently distortive. Finally, we note the proposed delinked approach is internally inconsistent in that, under business combination accounting, the amounts would be re-linked.

Further, we note that the proposed model, which does not properly distinguish between right of use and debt-like leases and involves de-linked accounting, will create new book-tax differences. In application, it means ***<u>every</u>*** lease will have a book-tax difference (in many cases the amounts will be annoyingly small, yet there will be a requirement to account for them). We believe these newly created differences will not provide clarity about the after-tax effects of lease transactions. Instead, these differences will arise from diverging book and tax accounting for non-substantive reasons.

Finally, we believe symmetrical issues will arise in lessor accounting. For example, we believe the lessor should account for leases that convey all of the risks and rewards incident to ownership as sales or loans. It would also create book-tax differences arising from the proposed standardized method of accounting and not from the underlying economics. In short, failure to account for such contracts on the basis of their substance will result in dissimilar accounting for similar contracts.

- ***The proposed rules are overly complex.***

  All companies lease, and small- and medium-sized companies use leasing as their primary source of acquiring the use of equipment and real estate. Small- and medium-sized companies may not have the skilled human resources or systems to undertake the complex initial accounting and the subsequent accounting and re-measurement resulting from the proposed standard contained in the DP. Since more than 90% of leases involve assets of less than $5 million and terms of two to five years, this complexity will result in immaterial but required adjustments. We recommend linked capitalization of leases at inception, linked subsequent accounting and only adjusting in the event of a change that is material to the operations of the lessee.

- ***We believe that contingent rents should not be estimated and capitalized unless they are "disguised" minimum lease payments***

  This is the approach that is currently followed in the U.S. by the major public accounting firms regarding their implementation guidance under the current rules. This can be accomplished by stating a material contingent rent principle (e.g. estimated contingent rents must be included in minimum lease payments in cases where the intent is to make up for below market minimum rents) and will mean that all leases where contingent rents are immaterial will be spared the undue complexity of the proposed rule. We also believe that use-based contingent rents do not meet the definition of a liability at lease inception. Lessee estimates will mean lack of consistency between companies' financial reports. Continuous adjustment is an unnecessary burden except in the rare cases that the contingent rents are disguised minimum lease payments. In our opinion, this is a case where the Board has not tested the market to determine the possible extent of material contingent rents and is creating an anti-abuse rule rather than a principle.

- ***A de minimus exception is needed.***

  We estimate that 75% of the monetary value of off-balance sheet operating lease payments is from real estate leases (approximately 70%) and long-term equipment leases such as commercial aircraft (approximately 5%). The balance represents equipment leases of less than $5 million in cost and terms that average two to five years. These equipment leases are fleeting and churn in the financials, growing only at the rate of GDP while real estate leases generally accumulate. For example, Walgreen's is the largest operating lessee in the U.S., and over the last 5 years, its reported operating lease payments grew from $22 billion to $33 billion due to growth in long-term store leases and not from equipment leases. We recommend the Board provide a de minimus or practicality exception for right of use leases (former operating leases) that have an equipment cost of less than $250,000 and a lease term of five years or less.

  If a de minimus exception is not provided, we urge the Board to further consider the income statement treatment of leases that represent the temporary right of use. If the income statement treatment for leases is consistent with the current operating lease model, lessees will be able to measure materiality by reference to the balance sheet alone, which would greatly ease the administrative burden on lessees of determining which leases are material to a company's financial statements.

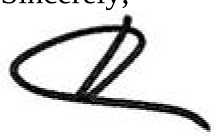
- ***Lessor accounting must be addressed.***

  A one-size-fits-all model for lessor accounting is not workable. We suggest a direct finance lease model in cases where the lessor leases the entire asset to one lessee for a term of one year or more. We suggest an operating lease model (no de-recognition of the leased asset) for leases of less than one year or where the asset or portions of the asset are leased to multiple lessees We suggest that sales-type lease accounting is appropriate for manufacturers/dealers in cases where the lease transfers ownership rights as those are in substance sales financed by a loan. We also suggest that the current rules for leveraged lease accounting be maintained as previous boards recognized the unique economic benefits justified special treatment.

As a separate attachment to this cover letter, we include our Answers to Questions for Respondents to the DP.

We certainly appreciate the opportunity to comment on this most important matter. We also thank the FASB for their policy of open communication. We remain available to the Board and staff to assist you in your deliberations. We are committed to helping create sound and workable rules that reflect the economic substance of lease transactions to improve the clarity in financial reporting.

Sincerely,



Kenneth E. Bentsen, Jr.
President

Attachment

Answers to Questions for Respondents

Introduction

Chapter 2: Scope of lease accounting standard

Question 1
The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach?

If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

Answer
For consistency purposes, the current scope should be based on the <u>nature of the transaction</u> and should not preserve the historical anomalies arising from past standard-setting. Under current GAAP, the accounting nature of the underlying asset determines whether the contract constitutes a lease for accounting purposes ("FAS 13 leases"). As stated in Statement 13, paragraph 64, nuclear fuel leases qualify as FAS 13 leases because the underlying asset (a nuclear fuel installation) constitutes a "depreciable asset" under "present generally accounting principles," whereas economically similar contracts to supply coal or oil do not under this same criterion. Further, the existing scope involves a "one-way" approach to scope by (x) including all contracts nominally identified as leases as well as those which substantively meet the accounting definition of a lease (EITF 01-8) and (y) not excluding those which constitute a loan or a conditional sales agreement. Additionally, the one-way approach has proven ineffective in dealing with transactions that are structured in the form of a lease for tax purposes but, in substance, constituted the sale or purchase of tax benefits ("safe harbor leases" or loans ("synthetic leases").

In the context of other provisions of the proposed accounting, notably the proposed measurement provisions, the continued use of the existing scope could result in accounting for similar contracts dissimilarly. If a contract is nominally identified as a lease (e.g., "lease intended as security") but conveys rights and obligations similar to those conveyed by a note for cash or note for property, plant or equipment, we do not believe the accounting and reporting should be dissimilar. We believe the same standard for initial measurement and subsequent measurement should apply to such contracts as in current practice, where FAS 13 accounting mirrors that of APB 21 accounting.

We believe accounting should faithfully represent legal and economic realities. In the U.S., the Uniform Commercial Code ("U.C.C.") provides for distinctively different legal rights and obligations for transactions qualifying as leases under Article 2A where such rights and obligations arise from distinctively different economic realities compared to loans. We note that the DP is devoid of any legal and economic background information about leases. We view the absence of such information as a fundamental flaw in defining the scope the proposed standard, particularly since the proposed accounting for all leases within its scope may not vary based on distinctively different legal or economic realities. Accordingly, if the board remains committed to a single accounting model for all leases (regardless of substance differences), it should re-deliberate on scope so that the final standard does not result in "form-over-substance" accounting or a distorted portrayal of legal and economic realities.

Not all leases are right of use contracts. Some leases are contracts that convey property rights and, in that case, it is appropriate to account for the underlying as PP&E because the contract conveys the underlying asset. In these cases the asset is not an intangible. Also, in this case the obligation is a loan and the implicit rate is the appropriate rate to use to recognize interest expense.

Right of use leases are contracts that convey contract rights (which are intangibles) and not property rights. Accordingly, we do not believe it is appropriate to characterize and account for the capitalized asset as though it were essentially the same as the underlying asset. Accordingly, while we agree the present value of the lease payments constitutes a financial liability, we do not believe the capitalized asset constitutes a depreciable asset. .

In the U.S., the rights and obligations of the parties to a lease contract involving "goods" (e.g., movable equipment and fixtures) vary based on the *economic substance* of the arrangement. The Uniform Commercial Code ("U.C.C.") provides the basic framework for distinguishing between a sale (Article 2), a lease (Article 2A), and a secured financing (Article 9). Under U.C.C. § 1-203 "Lease Distinguished From Security Interest" and applicable case law, three fundamental and robust criteria have been developed, criteria which focus strictly on transaction economics:

- Contractual provisions whose presence would automatically disqualify an agreement from being a lease and characterize it as a means of creating a security interest (e.g., $1 buyout option);

- Contractual provisions whose presence, in and of themselves would not automatically convert an agreement into a security interest (e.g., the presence of a purchase option); and

- The economic realities test, under which all relevant facts and circumstances are considered to determine whether the contract conveys both control over leased property and substantially all of the risks and rewards incident to ownership.

The above criteria do not place any reliance on the intent of the parties or who holds legal title. Accordingly, the U.C.C. criteria appear to be highly compatible in meeting financial accounting and reporting objectives.

This framework is used everyday in conducting commercial business in the U.S., with business and legal professionals applying the U.C.C. guidance in making judgments. We believe accountants can and should be able to develop a similar economic substance model in differentiating lease contacts, applying professional judgment to ensure accounting faithfully portrays the legal and economic realities of lease contracts in financial statements. If a contract nominally identified as a lease constitutes a conditional sale, in terms of the legal and economic rights and obligations of the parties, then the accounting for such contract should be identical to the accounting for a contract explicitly labeled a "conditional sales agreement." If a contract nominally identified as a lease constitutes a loan, in terms of the legal and economic rights and obligations of the parties, then the accounting for such contract should be identical to the accounting for a contract explicitly labeled a "loan agreement." Accordingly, we believe that the scope of the new standard should involve contracts that convey the "right to possession and use" (that is, a temporary possessory interest) and do not by their terms or surrounding circumstances constitute a sale or loan.

Question 2
Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

Answer
This or a similar exclusion provision should be included in the proposed new standard for cost-benefit reasons. The proposed standard contains considerable recognition and measurement complexity, including deferred tax accounting, principally in response to off-balance-sheet reporting of long-term leases of big ticket items (e.g., airplanes, retail properties, etc.). We do not believe the current accounting for small ticket or short term leases were at issue. Accordingly, we believe differential accounting is appropriate, particularly since most of these leases involve small and mid-sized enterprises as lessees. More broadly, we note that regulators generally recognize the appropriateness of differential treatment to avoid unintended consequences and disproportionate impact. For example, the tax rules exempt rental contracts with aggregate rental payments totaling $250,000 or less from complex uneven rent accrual regulations. These tax regulations intend to prevent abuse in the mismatching of taxable revenues and deductions and include this threshold to appropriately target its impact. Since leasing is a principal source of financing for small and mid-sized businesses (SMEs), we believe the boards should recognize the need to provide an exclusion to improve the targeting and to avoid imposing a disproportionate "friction cost" on capital raising for SMEs.

We recommend the boards consider either lease term or transaction size as the basis for differential accounting for right of use leases (that is, leases that do not transfer ownership to the lessee by the end of the lease term). As originally proposed by Warren McGregor, we support excluding right of use leases with a term of one year or less and allow for the rentals to be reported as an operating expense. For small ticket leases, which we define as leases with an expected term of 60 months or less and an underlying acquisition cost of $250,000 or less, we also recommend operating expense treatment.

As a possible variation, we suggest the lessee provide a "linked" on balance sheet reporting for such leases by present valuing the remaining non-cancelable lease payments and reporting the resulting amount as the carrying value of the lease obligation and leased asset.

Recognizing the broader goal of fewer exceptions, we believe the boards could also address the issue by modifying the following two provisions to lessen the compliance burden:

1. Subsequent measurement. We believe "linked" reporting on the balance sheet and the straight line method of expense recognition is appropriate for all right of use leases. Under the straight line method, the average expected rent should be accrued as rent expense and the asset and liability should be amortized using mortgage amortization with the offset as rent expense. This is simpler and will reduce the need for deferred tax adjustments.

2. Continuous adjustments. We believe the boards should consider increasing the threshold or providing triggers instead of requiring continuous periodic adjustments due to changes in contingent rents or renewal expectations. Small ticket transactions should be spared continuous review and adjustment.

Chapter 3: Approach to lessee accounting

Question 3
Do you agree with the board's analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

Answer
The simple lease contract does not contain sufficient information to determine whether it constitutes a sale or loan in legal or economic terms. Assuming that the simple lease contract is not a sale or loan, the description should note whether the lease constitutes an "executory contract" under applicable commercial or bankruptcy law, as this may become relevant in the ongoing analysis of the lease as otherwise proposed by the Discussion Paper. If the lease qualifies as an executory contract, it can be rejected in bankruptcy. Accordingly, the board should provide guidance in any new standard on when and how to take the executory nature of the lease contract into account. In developing and assessing such guidance, the board should reference the wave of lease rejections by the U.S. commercial airline companies following the terrorist attacks on 9/11.

We suggest that you supplement the simple lease example, and also present one with a bargain purchase option or automatic transfer of title and another (as in the current example) where the lease does not contain a purchase option or transfer of title. The answers as to the nature of the assets and liabilities would be different. Both leases are common in the market and simple in terms. We agree that some leases have rights that are rights of use, but many leases transfer ownership rights. Since the economic bargain is substantively different, the accounting treatment should portray the difference. Right of use leases transfer contract rights (an intangible asset) while leases that transfer ownership rights transfer property rights (PP&E).

To date, the board has not undertaken deliberations about the fundamental analysis of lease contracts counterparties perform every day in commercial practice in determining the nature of the transaction. This is a basic issue that was recognized by prior boards as well as U.S. tax and legal authorities and legal and tax authorities in many other countries. Claiming that doing away with assessing the nature of the transaction (also known as lease classification) simplifies the accounting leads to a model based on the form of the transaction instead of the substance where similar transactions are accounted for dissimilarly and significant economic distinctions are muted out. It seems that some members of the board or staff agree with the view that the accounting for leases that are financed purchases should be different from right-to-use leases as evidenced by section 5.40 which says "For leases of items in which it is expected that the lessee will obtain title at the end of the lease term, the amortization period would be the economic life of the leased item." What is missing from that section is how the staff or board intends to identify those leases.

Question 4

The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognize:

(a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)

(b) a liability for its obligation to pay rentals.

Appendix C describes some possible accounting approaches that were rejected by the boards. Do you support the proposed approach?

If you support an alternative approach, please describe the approach and explain why you support it.

Answer

We disagree with the boards' generalized characterization of the leased item (the corresponding debit to the recorded liability) as a "right-of-use" asset. As explained below, depending on the substantive nature of the transaction, we believe the leased item should be reported as the lessee's asset or the corresponding debit should be characterized as "prepaid rent-right-of-use leases". Symmetrically, we believe the liability should be characterized as indebtedness or as an obligation to pay rentals.

Assuming that the board decides to include all lease contracts within the scope of the new standard (a proposed approach on which we disagree as noted at Question 1), we believe that contracts nominally identified as leases but which constitute a sale should be treated as the acquisition of the leased item (the underlying asset) and the incurrence of a secured debt bearing a rate equal to the implicit rate in the lease. This characterization would faithfully represent the transaction as the functional equivalent of a note exchanged for property, plant and equipment since the rights and obligations conveyed by either contract form are identical. Similarly, we believe that contracts nominally identified as leases but which constitute a loan (e.g., a synthetic lease) should be treated as the issuance of a secured note for cash where the proceeds are used to acquire the leased item. Again, this characterization would faithfully represent the transaction as the functional equivalent of a note exchanged for cash since the rights and obligations conveyed by either contract form are identical.

However, we believe that contracts which convey a temporary right-of-use (e.g., true leases or the former operating leases) should be treated as the rental contracts, meaning the initial amount recorded should be characterized as "prepaid rent under right-of-use leases" and not the acquisition of the underlying asset in whole or in part. We believe that the board agrees that, if the lessee made one upfront payment instead of making periodic payments over time, the lessee would report the payment as "prepaid rent." We also note that, in Interpretation 45, the offset to the recording of a residual guarantee provided by a lessee-guarantor under an operating lease is currently characterized as "prepaid rent." We do not believe that the payment methods (upfront or over time) or payment type (fixed or contingent) should determine the characterization of the recognized asset (the debit).

If one had known that the project would evolve from a components approach to a contract rights approach, one could have saved a lot of effort by merely modifying FAS 13/IAS 17 to capitalize operating leases and leave the current capital lease rules in place (including use of the implicit rate in the lease) and leave the P&L and cash flow treatment of the former operating leases in place.

Question 5
The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognizes:
(a) a single right-of-use asset that includes rights acquired under options
(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.
Do you support this proposed approach? If not, why?

Answer
The contract approach is a more practical approach and it is the only workable approach. It is very much like current GAAP as there is judgment involved in determining the lease term and whether options are minimum lease payments. As stated above, there are two types of leases from a lessee perspective that result in two types of assets – either the underlying or an intangible. We do not agree that all contingent rents are liabilities and we do not agree that all contingent rents should be capitalized. Using the "most likely" approach, the board has really lowered the recognition bar and we object to the precedent that is being set. If the most likely concept were applied to other executory contracts it would result in their capitalization as well.

Chapter 4: Initial measurement

Question 6
Do you agree with the board's tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?

If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

Answer
Assuming that the board decides to include all lease contracts within the scope of the new standard (a proposed approach on which we disagree as noted in Question 1), we believe the obligation to pay rentals under a contract nominally identified as a lease but which constitutes a sale should measured on the same basis as a note exchanged for property, plant or services—that is, at the fair value of the property or at an amount that reasonably approximates the fair value of the note, whichever is more clearly determinable. Similarly, if the obligation to pay rentals under a contract nominally identified as a lease but which constitutes a loan should be accounted for on the same basis as a note for cash, that is, measured by the cash proceeds exchanged. Since the rights and obligations under the different contract forms are the same, we do not believe there is any decision-useful basis for differential measurement for financial reporting purposes.

Where a lease transfers the right of ownership the lessee knows the cost of the asset and knows the minimum lease payments; therefore, the implicit rate in the contract can be calculated. The implicit rate is the rate that the U.S. tax and legal authorities recognize in that type of lease as the financing rate. Failure to use that rate means that the lessee will have to account for deferred taxes since it, in and of itself, creates a book/tax difference.

Additionally on implementation all the former capital leases will have to be adjusted using the then current incremental borrowing rate. We think this is illogical as the implicit rate is the right rate for the contract. It will also mean excessive work for a very minor adjustment. The boards should also understand that the majority of leases that transfer ownership rights are small ticket equipment leases. They are large in number of leases but small in dollar amount. Real estate leases with no automatic transfer of title or bargain purchase option make up more that 75% of the dollar amount of operating lease obligations. It also brings to mind the original objective, which was to only to capitalize the former operating leases. In our opinion there is no need to revise the accounting for the former capital leases.

With respect to leases that convey a temporary right-of-use (e.g., true leases), we believe the proposed present value method represents a practical expedient that has been historically employed by some users of financial statements in performing "as if" capitalized computations. We view this method as an acceptable method, with an appropriate cost-benefit trade-off for small ticket items and small- and mid-sized businesses.

We also note that the board should provide for consistency in the initial measurement between new leases and leases acquired in a business combination.

Question 7
Do you agree with the board's tentative decision to initially measure the lessee's right-of-use asset at cost? If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

Answer
We agree with the board's "linked" approach in initial recognition and measurement. However, in the context of the board's tentative conclusion regarding scope, we do not view the proposed initial "linked" measurement approach—where the present value of the rentals is used to record both the liability and the asset—to be appropriate in all circumstances. For contracts nominally identified as leases but constituting sales or loans, we believe the appropriate initial "linked" amounts should be the same as used to record a note for property, plant or equipment or a note for cash—that is, the fair value of the leased property or at an amount that reasonably approximates the fair value of the note, whichever is more clearly determinable. Since the rights and obligations under the different contract forms are the same, we do not believe there is any decision-useful basis for differential measurement for financial reporting purposes. Using the implicit rate in the contract for leases that transfer ownership would solve this problem as the PV of the rents would be the cost of the leased asset.

With respect to leases which convey a temporary right-of-use (e.g., true leases), we believe the board's proposed "linked" approach represents a practical expedient, as an extension of the approach historically employed by some users in performing "as if" capitalization computations for debt capacity purposes (see our response to Question 6). .

Again, we also note that the board should provide the opportunity for consistency in the initial measurement between new leases and leases acquired in a business combination. In business combination accounting, the measurement involves the concept of a favorable or unfavorable lease. The DP apparently does not provide for this adjustment.

Chapter 5: Subsequent measurement

Question 8
The boards tentatively decided to adopt an amortized cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do you agree with this proposed approach? If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favor and why.

Answer

We do not believe the proposed subsequent measurement approach provides decision-useful information about the lessee's asset. The use of amortizing cost results represents a historical cost accounting convention grounded on the notion that a lease conveys ownership rights similar to the acquisition of a fixed asset. For comparability purposes, we agree the same subsequent measurement approach should be used for outright purchases and conditional sales agreements or contracts that transfer all or substantially all of the risks and rewards of the underlying leased asset. However, we disagree with using the same measurement approach as that for contracts that convey a temporary right to use or inherently constitute an allocation (not a transfer) of the risks and rewards incident to asset ownership. We believe that accounting should portray the substantive differences in legal and economic realities and should not gloss over such differences.

We believe the amortization of the recognized asset and liability generally should remain "linked" throughout the life of the lease as they are at lease inception, subject to adjustment for asset impairment (consistent with the accounting model for assets in general). We note that, unlike a fixed asset subject to secured debt, the lessee generally cannot transfer the leased item independently of transferring the lease obligation. Further, we note that, in a hypothetical transfer, the boards' proposed approach would result in the replacement lessee recording the right-of-use asset and obligation to pay rentals on a "linked" basis. Similarly, in a business combination, we understand the acquirer would record the right-of-use asset and obligation to pay rentals on a "linked" basis, subject to an adjustment for favorable or unfavorable lease terms. Hence, we cannot understand the logic of "de-linked" accounting in only one scenario, after the start of the lease.

We propose continuation of the linked accounting where the recorded asset and liability generally would remain interdependent to best reflect the legal and economic realities with the asset subject to impairment accounting. We also note the proposed measurement approach introduces a bias in valuation as it generally results in portraying the asset (the probable future benefits) as less than the corresponding liability (the probable future sacrifices) after the initial recognition. We believe this observable bias evidences a fatal flaw in the proposed measurement approach as an "underwater" relationship should only exist when a lease is impaired.

Question 9
Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

Answer
We believe the new lease standard should permit a lessee to elect to measure its obligation to pay rentals at fair value. This obligation qualifies as a financial liability, and Statement 157 provides sufficient guidance for determining the fair value. For example, in certain big ticket leases, the lease obligation has been economically defeased with mark-to-market posted collateral and a third party standing ready to assume the payment obligation. Hence, we can find no conceptual basis for continuing the current scope exception for recognized lease obligations.

However, we believe that, if the new lease standard permits a lessee to elect to measure its obligation to pay rentals at fair value, then an electing lessee should also be required to re-measure the recognized leased asset at fair value. In the general situation for equipment leasing transactions, where the lessee is not afforded the ability to control the asset in essentially the same way as an owned, mortgaged asset (e.g., the lease contract specifies maintenance requirements, contains anti-discrimination provisions and does not permit subleasing), the fair value election necessarily should involve first valuing the contract as a whole and then using such amount as the control total in determining the separately reported asset and liability. By contrast, in the situation where the lessee is afforded the ability to control the asset in essentially the same way as an owned, mortgaged asset and where sufficient, credible information exists to value the lessee's leasehold interest (e.g., the lease contract affords liberal sub-leasing rights with observable or determinable sub-rental income), the lessee should be required to separately value the leased obligation and leased asset in making the fair value election.

We also propose that the boards afford a simplified, practical fair value methodology for small ticket right of use leases. Since most such leases do not afford the lessee with the ability to control the asset in the same way as an owned, mortgaged asset, we believe that, absent impairment, the fair value of the obligation should be used to establish the fair value of the leased asset. This outcome can be readily achieved if the board permits the use of mortgage amortization for the lease obligation and the leased asset. We believe this method of amortization is the best proxy for estimating the fair value of the asset and liability over the life of the lease.

Question 10
Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.

If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

Answer
No. This is much ado about nothing for small ticket and short term equipment leases, which constitute 90+ % of leases when measured by numbers rather than dollar amount. For all right-of-use leases, our theory is the value of the asset equals the value of the liability absent impairment so it also would mean that changes in the PV rate would not materially affect the financial position of the lessee as the change in the asset value would equal the change in the liability value.

For practical purposes, the fewer adjustments the better for equipment leases as they are generally short term, small ticket and high volume.

Question 11
In developing their preliminary views, the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for

the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities. Do you agree with the proposed approach taken by the boards? If you disagree, please explain why.

Answer

We agree that the obligation to pay rent should be capitalized at the present value of right-to-use lease payments or the cost of the underlying asset for leases that are financed purchases. Where we don't agree is to impute interest expense for leases that are right-to-use leases. In our opinion, that does not reflect the nature of the lease, complicates and confuses P&L and cash flow statements and forces deferred tax accounting. For leases that transfer ownership rights, the obligation is the same as a note that bears interest at the implicit rate in the lease.

Question 12

Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortization or depreciation in the income statement. Would you support this approach? If so, for which leases? Please explain your reasons.

Answer

Assuming the board does not change the proposed scope, we agree with those board members who support the rental expense approach for contracts that convey the temporary right of use and possession (e.g., true lease), but not otherwise. Contracts nominally identified as leases but which constitute sales or loans should be accounted for in the same way as other asset purchase contracts.

With respect to leases that truly convey the temporary right of use, we believe the board should review lease pricing before concluding on this matter. At least in equipment leasing, the rental amounts generally reflect the pass-through of tax benefits incident to ownership and the sharing of residual value economics. Accordingly, a rental payment is fundamentally different than a loan payment since such economic features are unique to leasing. Loan payments generally only involve the time value of money, where lease payments involve the multiple considerations. To capture this difference in a manner consistent with the board's tentative decision not to adopt a component approach to lease contracts, we believe the "rental expense" approach offers a viable solution.

We note that the use of the incremental borrowing rate overstates the inherent interest expense in a lease involving the allocation of tax and residual value benefits. For example, in lease-buy analysis, lessees customarily compare the pre-tax cost of loan and lease financing by assuming asset exercise of a purchase or buy-out option on the lease side or sale of the asset on the loan side. In so doing, lessees observe the "buy down" in the financing rate afforded by the tax and residual value benefits. In longer-term equipment leases, where robust tax and residual benefits are present, the buy-down in the rate represents hundreds of basis points. While we believe the accounting model should portray this economic phenomenon, we recognize the inherent limitation of today's accounting model in dealing with the transactions involving interrelated pre-tax and after-tax economics. We believe the proposed "rental expense" model represents an effective means to ensure the income statement reflects the appropriate consumption of the economic benefit.

Chapter 6: Leases with options

Question 13
The boards tentatively decided that the lessee should recognize an obligation to pay rentals for a specified lease term, i.e. in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Answer
We support the approach and have been operating under that approach in the U.S.   FAS 13 as amended by FAS 98 includes concepts that extend the lease term such as a bargain renewal, a renewal term that precedes a bargain purchase option and a penalty that compels a lessee to renew . What we do no support is the idea that a probability weighted approach could be used and result in an outcome that is not possible under the contract. The issues we have are that this approach adds unnecessary complexity, automatically results in a need for at least one adjustment and it seems to violate the concept that we are accounting for the contract, yet the answer is not possible under the contract. A simpler approach that is workable is better than a theoretical approach that makes more work with no added clarity in reporting.

Question 14
The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognized as an adjustment to the carrying amount of the right-of-use asset. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why. Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

Answer
The vast majority (99%) of equipment leases in the U.S. is less than $5 million in equipment cost and 54% are less than $25,000 in equipment cost. The requirement to review leases at each reporting period is burdensome and will result in minor adjustments that will not have an impact on the clarity and usefulness of financial statements. We need sound, workable rules that provide meaningful information. The alternative approach is to adjust only when the change will have a material P&L impact on the total operations of the lessee. This should exempt more than 99% of equipment leases from subsequent adjustments.

Question 15
The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease. Do you agree with the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Answer
We agree that a bargain purchase option should be included in minimum lease payments to be capitalized. In such cases, the lease should not be considered a right-to-use lease, but rather a lease where the rights are ownership rights. In addition, the implicit rate should be used as the interest rate in the contract as all of the factors are known in the process of determining the liability and the asset, that is, the cost of the asset, the term and all of the payments that will result in transfer of ownership.

Chapter 7: Contingent rentals and residual value guarantees

Contingent rentals

Question 16
The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements. Do you support the proposed approach? If you disagree with the proposed approach, what alternative approach would you recommend and why?

Answer
Only contingent rents that meet the definition of a liability should be included in minimum lease payments. Where the event that triggers the contingent rent has not occurred, no liability has been incurred. Contingent rents based on usage where the lessee controls the use are not rents until the usage level is reached.

It seems that potential abuse is driving the capitalization of contingent rents and this adds tremendous complexity and is overly burdensome considering the limited benefit. The board seems to believe that lessors will structure leases with all rents being contingent. In equipment leases representing 90-99% of the number of lease contracts, contingent rents are minor factors. Most equipment leases have third parties as lessors and they are unwilling to take the risk of a structure where the minimum lease payments do not amortize their investment to a reasonable residual. The only case of 100% contingent rents that we recall being discussed was the rare commercial retail space lease to a very attractive "name" retail tenant that would attract other retail tenants to the mall and *could* be offered a lease with rents entirely based on sales. We ask the board to research the relative prevalence of such arrangements before enacting a burdensome rule that will result in little impact on the financials of lessees. There may be instances where a contingent rent is a disguised minimum lease payment such as "if the sun rises, contingent rent is due" and in that case, an estimate should be recorded. Why not state a principle that contingent rents must be capitalized only where the minimum rents are materially below the market rent for similar leases? In that case, only material contingent rents will be capitalized and 99+ % of leases will be exempt from capitalizing, re-measuring and adjusting contingent rents.

Question 17
The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

Answer
We do not agree that contingent rents should be estimated and capitalized unless they are obviously disguised minimum lease payments for the reasons stated in the answer to Question 16. Take the example of contingent rents based on CPI in today's economic environment – who can predict which way it may go, let alone how much it will change? Also consider rents based on usage in today's environment with assets being idle. The principle should be to capitalize contingent rents only if they are material and are disguised minimum lease payments and let the preparer make the estimate and defend it to the auditors. This concept exists in practice in the U.S. and is based on judgment and it is not written in the rules. The use of probability weighted methods creates excessive work and needs to be documented for audit review. The idea of having to reassess equipment leases of less than $5 million in cost with contingent rents on a quarterly basis using a probability weighted calculation is too burdensome considering the minor adjustments that will result. We recommend the board research the prevalence and dollar amount of contingent rents before enacting a burdensome rule that we believe will add little value to the financial presentation of leases.

Question 18
The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Do you support the proposed approach? Please explain your reasons.

Answer
We agree with that approach for floating rate leases and we believe that subsequent changes should be accounted for on a cash basis with the offset charged or credited to rent expense. Floating rate leases are a very small portion of the U.S. equipment leasing volumes. Only very large investment companies are interested in rents that are not fixed rate rents because they can get low rate LIBOR based pricing. We estimate that less than 1% of equipment leases in the U.S. are floating rate leases. Again, we urge the board to research market statistics before enacting overly complex rules that impact such a small

percentage of leases in immaterial amounts. We cannot comment on CPI based rents as they are not common in equipment leases.

Question 19
The boards tentatively decided to require re-measurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments. Do you support the proposed approach? If not, please explain why.

Answer
As stated in our answer above, we do not agree that contingent rents should be capitalized. We also think the impact of a quarterly assessment on 99% of equipment leases will result in immaterial adjustments. By the way, the annual volume of leases in the U.S. of less than $5 million in cost is estimated to be between 500,000 to 1 million transactions.

Question 20
The boards discussed two possible approaches to recognizing all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:
(a) recognize any change in the liability in profit or loss
(b) recognize any change in the liability as an adjustment to the carrying amount of the right-of-use asset.
Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

Answer
We do not support capitalizing contingent rents so our preferred method is to account for them as incurred through P&L. The boards should research the market to determine if this complex and burdensome requirement will result in material adjustments. Our assessment is that it will not make any meaningful or material difference.

Residual value guarantees

Question 21
The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

Answer
We agree that residual guarantees are a liability and should be measured at the present value of their likely payout amount.

Chapter 8: Presentation

Question 22
Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons. What additional information would separate presentation provide?

Answer
We agree, as we think the obligation is unique. It may not be payable in bankruptcy. It is not interest bearing. It is linked to the asset.

Question 23
This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position. How should the right-of-use asset be presented in the statement of financial position? Please explain your reasons.

What additional disclosures (if any) do you think are necessary under each of the approaches?

Answer
The asset created by a right of use lease is an intangible asset that should be classified separately but with PP&E and could be called "prepaid rent – right-of-use leases". The asset created by a lease that transfers ownership rights is PP&E and does not need to be broken out. The reason the right of use asset should be separate is that readers need to know which leased assets are merely the temporary right to use an asset. Calling the asset "prepaid rent – right-of-use leases" gives the reader a better understanding of the nature of the asset. The reason it should be placed with PP&E is to give the reader the full picture of the PP&E and leased assets that are needed to generate the revenue in the business

The lessee should describe its right-of-use leasing activities, explain its intentions at expiry, provide a schedule of material expiring leases, provide a schedule of expected future payments under current leases and a schedule of expected payments under replacement leases. A right of use asset and obligation are far different from an owned asset and associated debt as the right of use contract must be replaced at expiry, while under a right to own lease, the asset is still used after the debt is retired. Users of financials need to know what the future cash outflows of the business to maintain the needed level of assets.

Chapter 9: Other lessee issues

Question 24
Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

Answer

If the board continues with its view that right-of-use lease assets and liabilities are not linked, then when should a lessee adjust its assets and liabilities when bankruptcy is probable as the bankruptcy court's view is the values are the same?

Chapter 10: Lessor accounting

Question 25
Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

Answer
Yes. The lessor controls the asset, it arose from a past event and the lessor can collect the rent or sell the rent receivable to get cash.

We believe that direct finance lease accounting (derecognition of the leased item and recognition of the rent receivable and residual) is appropriate where the lessor is leasing the entire asset to one lessee for a material term (e.g., 12 months or more) as the transaction is analyzed as a financial investment with an expected yield over the cost of funding the lease. We believe operating lease accounting (no derecognition of the leased item) is appropriate for all other leases (short term leases, fractional share leases and multiple lessee leases like commercial real estate) as the lessor views rent as revenue and the leased item as inventory that should be written down over its remaining term. Those transactions are not priced like financial investments; rather, they are priced like a retailer trying to calculate how much rent will be earned over costs of the equipment being leased out.

Question 26
This chapter describes two possible approaches to lessor accounting under a right-of-use model:
(a) derecognition of the leased item by the lessor, or
(b) recognition of a performance obligation by the lessor.
Which of these two approaches do you support? Please explain your reasons.

Answer
As sated in our answer to Question 25, we believe that there is a need for two types of lease accounting – direct fiancé lease accounting and operating lease accounting for the reasons noted. We will answer this question assuming it only applies to those leases where direct finance lease accounting applies. View (a) is the logical choice as the two assets in a right-of-use lease where the entire asset is leased to one lessee are the right to receive rent and the economic benefits after the asset is returned. In view (b), the leased asset, other than the residual rights, is no longer an asset of the lessor as the lessee--and only the lessee--has the economic benefits of the right to use the asset during the lease term. Also in view (b), the board had previously decided that the lessor's obligation to provide the asset to the lessee ends on delivery and acceptance, so no such liability exists during the lease term.

Question 27
Should the boards explore when it would be appropriate for a lessor to recognize income at the inception of the lease? Please explain your reasons.

Answer
Yes, in situations involving realization of manufacturer or dealer's profit (loss). If the lease contract transfers control over the leased item and conveys all or substantially all of the risks and rewards of ownership to the lessee, the lessor should recognize the full profit (loss). In this situation, a seller-financing transaction has occurred and the lessor should recognize all manufacturer or dealer's profit (loss) as it would in an economically similar transaction--the sale with a note for property, plant or equipment. Further, if the board concludes that, in all leases, the lessor has essentially fulfilled its obligations upon delivery and acceptance by the lessee and has surrendered control over the asset for a portion of its useful life, it would appear the lessor should recognize an allocable portion of the total profit.

Question 28
Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

Answer
Investment properties are not an equipment leasing product in the U.S. If investment properties are leases, then the new lease accounting standard should apply to them. If investment properties are afforded a favorable accounting treatment that is theoretically sound, then it should apply to all leases, unless there are differences in leases that would justify different treatment. The same applies to leveraged lease accounting in the U.S. It is a special rule in that it only applies to one market, but it has basis in theory as evidenced by the deliberations and decisions of a previous board – why should it not be preserved and be available to all?

Question 29
Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

Answer
The lessor's after tax implicit rate should be used to recognize the tax attributes in a right-of-use lease that qualifies for direct finance lease accounting. When should a lessor re-recognize a leased asset as a lessee approaches bankruptcy? Leveraged lease accounting should be seriously discussed and considered for all leases just as investment properties accounting is being discussed.