

June 4, 2010

Robert Herz, Chairman  
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  
February 9, 2010

**Subject: Lessor Accounting for Leases**

Dear Chairman Herz and Chairman Tweedie:

I wish to comment on the Boards' recent meetings and decisions regarding lessor accounting issues as they relate to the Lease Accounting Project. 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 auditor, lessee, lessor, consultant, and author. Please visit [www.thealtagroup.com](http://www.thealtagroup.com) for more information about The Alta Group.

I also submitted a comment letter (CL 196) to the 2009 Discussion Paper on lease accounting. The lack of specificity and direction of the lessor accounting requirements at that time, however, precluded an in-depth analysis. Decisions reached by the Boards since the Discussion Paper have raised significant issues that I feel compelled to address. I would ask that you consider these matters in your deliberations leading up to the issuance of the planned Exposure Draft on Leases.

## Choice of Lessor Approach

I continue to support derecognition of the leased item by the lessor for finance leases, also known as the derecognition approach (DA). As expressed in my comment letter, I believe that the DA more properly reflects the substance of the transaction than the performance obligation approach (POA). Additionally, the impact of the POA on lessors' business activities, financial statement presentation, key financial metrics, internal controls, and lease accounting systems will be profound.

My main purpose in sharing my thoughts with you, therefore, is to examine the disruptive and asymmetrical effects on lessors, regulators, auditors, investors, and capital markets of implementing the POA. Although I prefer to stay away from the individual business models of lessors, it may be necessary, at times, to bring them into the discussion of the practical implications of the POA on operations, policies, and feedback and control mechanisms.

I have segregated my comments into the following categories:

- Economic and accounting asymmetry
- Distorted metrics
- Operations
- Systems
- Affected constituents

### Economic and accounting asymmetry

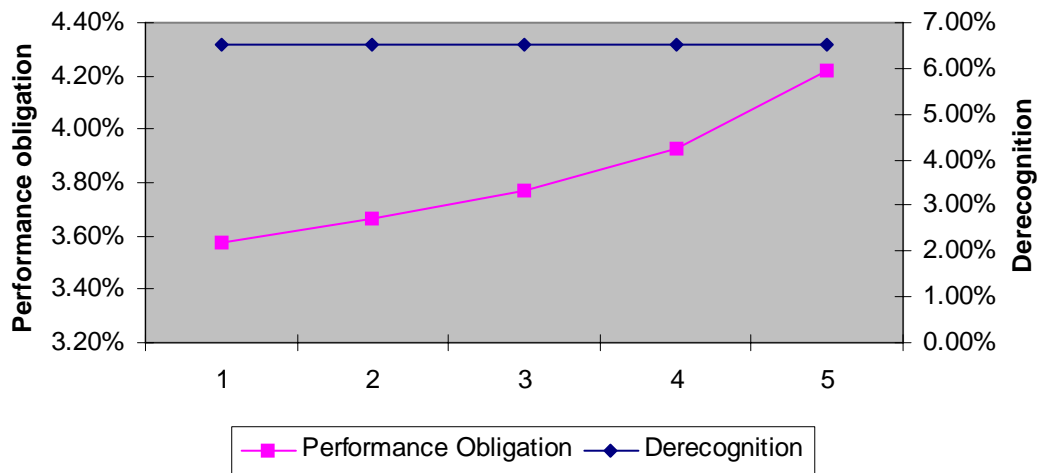
If one accepts the premise that the purpose of accounting is to provide information for sound decision-making by management, investors, creditors, regulators, etc., the POA falls short. Instead of faithfully representing the economics of the lease, the POA, instead, grossly misstates those economics.

Consider the following equipment leasing example:

|                      |           |
|----------------------|-----------|
| <b>Cost:</b>         | \$100,000 |
| <b>Term:</b>         | 5 years   |
| <b>Residual:</b>     | 20%       |
| <b>Pretax yield:</b> | 6.5%      |

The economic, or pretax, cash-on-cash yield in this example is 6.5%. The DA for this lease reflects this constant yield, as can be seen in **Figure One**, which compares the yields under each model as derived from the financial statements. Figure One also illustrates the asymmetry between the actual economic yield and that reported in the financial statements under the POA. 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 6.5% on its investment.

**Figure One**  
**Pretax Yield Comparison**



The practical piece that is missing from the POA is the recognition that a leased asset is not a pure long-term asset in the traditional accounting sense. The accounting for leases should reflect this. The revenue producing capacity of a machine tool, for instance, is constant over time, assuming proper maintenance. The revenue producing capacity of a leased asset, however, is a function of the remaining fair value of the asset, or residual value, at any given point in time.

The POA does not capture this nuance. For example, when an asset comes off lease under the DA, it is put into available-for-lease inventory, where it can be monitored from both a market and risk perspective. The leased asset is a current asset at this point, not a long-term asset. A separate shadow accounting process will have to be set up to accomplish this important function under the POA.

**Distorted metrics**

Measuring results based on the POA 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.

The distorted metrics of the POA are evident in a variety of areas. Dissolution of the residual component of the net investment in the lease under the POA diminishes management’s ability to track future income by credit and asset risk categories. Furthermore, the straight-line residual income pattern of the POA is not representative of the economic accretion of the residual.

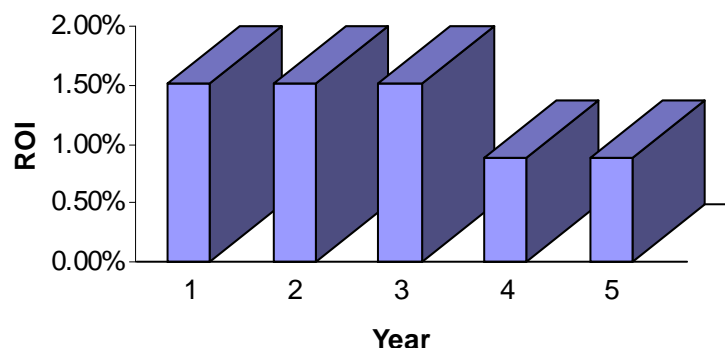
One of the most visible and, hence, easily illustrated, effect of the POA is on bank lessors. A typical, nonbank lessor generally deducts the depreciation of its leased assets from revenue, thereby reporting a financing margin. This, however, is not the case for bank lessors, due to regulatory requirements.

Banks are required to show depreciation as an operating expense rather than as a deduction from revenue. Doing so, as required by the POA, negatively impacts banks' operating leverage metrics even though the banks do not use these assets in their day-to-day business operations. The addition of the performance obligation to the balance sheet also skews the debt-to-equity ratio, conceivably requiring a bank to boost its regulatory capital against what is, basically, an accounting entry. A requirement to do so will increase the cost of capital in an economy that already is capital-constrained.

A change to the POA will almost double the lessor's assets overnight.<sup>1</sup> This bloating of the balance sheet undoes all the underlying metrics of the leasing company, from managerial reporting to pricing practices. Banks again will be faced with the potential requirement to add regulatory capital.

**Figure Two** compares the return on investment (ROI) of a hypothetical lease portfolio based on the previous forklift example. This example assumes a change, in Year Four, from the current direct financing lease model (or DA) to the proposed POA. The ROI drops from 1.52% to .88% even though the economics of the portfolio have not changed. A lessor would face a similar problem when trying to benchmark against historical industry norms as the POA will require a complete revision of industry metrics.

**Figure Two**  
**ROI Comparison**



<sup>1</sup> This effect will occur unless some sort of netting mechanism, such as the one currently being considered, is put in place. Even then, the net investment in the lease receivable and the performance obligation will not net to zero during the lease term.

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.

## **Operations**

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 POA. For example, there will be increased customer analysis and tracking necessary to determine the lease term, not only at inception, but also at each reporting period. These incremental processes and procedures will alter the internal control environment and potentially increase audit costs.

The risk management process also will be affected by the POA as each lease will require impairment testing of both the asset and the lease receivable. Furthermore, given the unique nature of a leased asset, current impairment processes may not be appropriate. Other increases in the operational burden for lessors include:

- ◆ Changes in how sales taxes are remitted
- ◆ Increases in deferred tax tracking associated with the performance obligation and inception date assets and liabilities
- ◆ Renegotiation and modification of debt covenants
- ◆ Modification to treasury management processes and models
- ◆ Changes to regulatory requirements and reporting
- ◆ Adaptation of processes to track inception date assets and liabilities, including fair value adjustments
- ◆ Adjustments to regulatory capital
- ◆ Alterations to reporting and budgeting processes

## **Information systems**

The POA 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 POA, however, will require each of these modules to be linked and then integrated. New performance obligation capabilities will have to be created and then linked to the lease asset and receivables.

The POA 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 POA. Additionally, lease origination systems will need to be modified to track and accommodate the performance obligation and inception date assets and liabilities booked at inception.

### **Affected constituents**

The effect of adopting the POA goes well beyond lessors, as other constituents of the equipment leasing industry also will be impacted. There will be disruption of the regulatory oversight function, for example, as regulatory capital, as measured in the financial statements, will be inadequate under the POA. This change will necessitate altering metrics, regulatory guidance collateral, and, potentially, audit approaches, documentation, and focus.

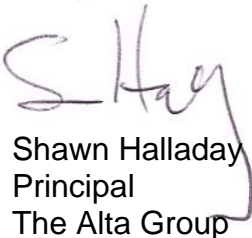
The rating agencies will be forced to adjust their metrics and analysis, not only in their scrutiny and investigation of leasing companies, but also in how they measure and assess lease securitizations. Investors and lenders in the equipment leasing industry also will have to adjust to viewing the industry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

### **Conclusion**

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 (the DA). It must be one or the other. The current blend of both, as embodied in the POA, does not reflect the economic attributes of the transaction and creates additional costs and reporting requirements. More importantly, I do not believe the POA creates any added value in terms of the information reported to users of the financial information.

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

Sincerely,



Shawn Halladay  
Principal  
The Alta Group