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To the Director:

Thank you for the opportunity to comment on the exposure draft for lease accounting, referred to above. Please note that the comments contained herein are my personal opinion, and are not those of my employer or any organization I am a member of.

**Question 1-Lessees**

- a) For leases that are for the rental of equipment, or items immaterial to the financial statements as a whole, particularly those that would have been considered operating leases, no lease “asset” or “liability” should be recorded. Classifying part of rental payments as “interest” expense instead of rent expense is also misleading. Arguably some transactions, particularly those entered into with leasing companies instead of product manufacturers, may have been entered into for financing purposes. However, there are many times that leasing is entered into for the purpose of “renting” a machine, instead of purchasing it, whether due to economics or because of other reasons.

The recording of these “phantom” liabilities and assets will serve mainly to balloon balance sheets, cause record keeping issues due to the need to record depreciation differently and differences in how expenses are recognized and deemed deductible for income tax purposes. Further, this new model may cause significant issues with debt covenants. Mathematically a company may now be in violation of debt agreements due to a change in accounting principles, but with no change in a true economic financial condition. Renegotiating covenants to exclude the effect of leases may be difficult, as some lessors may be unwilling to change a provision as a result of the changes in lease accounting without the lessee agreeing to changes in other lease provisions. Now there will be real, economic and operational effects as a result in the proposed standard.

For example purposes, consider an extreme, the rental of a Gulf of Mexico drilling platform renting for \$500,000 daily. Renting the equipment for one year and one day would require capitalizing the present value of \$180,500,000 while renting it for 364 days would not. These liabilities/assets very easily could dwarf other balance sheet items.

- b) As referred to above, recognizing interest expense is inappropriate. Renting equipment is an operational decision, not financial, and the expenses related thereto should be so treated.
- c) Consider establishing different treatment based on whether a company is publicly held or privately owned. Small business owners as well as lenders and other creditors think of lease payments as “rent”. Credit evaluation models will now have to be reconsidered as well. Consider also the effect that the new treatment will have on
- a. Deferred taxes
  - b. Depreciations methods and book/tax differences
  - c. Income tax reporting of interest on K-1's separately as “interest” vs. rental income

**Question 4-Definition of Lease**

- a) The term should be defined as “a contract in which the right to use a specified tangible asset is conveyed...”
- b) Whether or not a contract is a purchase or sale should also consider
  - a. The amount of economic life of an asset remaining at the end of the lease as compared to the term of the lease,
  - b. Consider that the initial term of the actual lease may be X years but for accounting purposes X+Y is used, to take renewal options into account. However, as the renewal options are not obligations, and there is a possibility that the renewal option will not be exercised, the longer term itself may cause a contract to be considered a purchase or sale. This needs to be considered.
  - c. While admittedly current standards are somewhat flawed, implementing a rules based criteria might be more useful, and fair to determine if a contract is a purchase/sale.

#### **Question 7-Purchase Options**

- a) Purchase options should be accounted for only when they are exercised. Until that point, there is every possibility that a piece of equipment or real estate will be returned to a lessor. Unless there are contract provisions strongly suggesting that it is only being entered into for facilitating the financing of a piece of property, it is renting the property not a purchase of property.

#### **Question 8-Lease Term**

For other than rentals of real estate, taking renewal options into account for lease term is ill conceived. Equipment may be replaced after the initial lease term if newer versions of the equipment have undergone major revisions, even if at inception company practice, if not plan, was to renew. Equipment changes (not counting large, production equipment) are much more common than premises changes. Options are just that options, not obligations. Shouldn't the balance sheet reflect the “unconditional” obligation to pay rather than what “might” be payable? As long as the footnotes disclose the effects that exercising a renewal option would be, ballooning the balance sheet is inappropriate.

### **Questions Not Directly Asked by Board**

#### **Initial Measurement**

Paragraph 33(a)-Initial Direct Costs of a lease include (but were not included in the ED discussion) the cost of space improvements made by a landlord renting real estate. These costs should continue to be considered fixed assets, not a reduction of rental income. Additionally, certain upfront costs will be mismatched with revenues. Commissions are payable to a leasing agent after the expiration of a period of time less than the lease term, and would be a period expense regardless of the lease term. Add to this that the lease term might be expensed over a long period of time exceeding the initial lease term...

#### **Reassessment of the Right to Receive Lease Payments**

Paragraph 39 indicates the need to reassess the carrying amount due to a change in circumstances. Consider the effect on a lessor being required to record a significant increase in a liability because of a change in circumstance. Restatement could cause significant covenant issues to be addressed many times, with the result being that management time needs to be spent on issues resulting from accounting principles instead of on managing the business.

#### **Paragraph B 27**

This paragraph indicates that rental income should not be effected by credit risk. Yet for a company whose business is renting property, this is their "revenue". Why should one entity be required to reduce revenue (under new revenue recognition ED) while a lessor does not, solely because of the type of business they are operating?

Thank you again for the opportunity to comment on the proposed change to the accounting treatment of leases.

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