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August 9, 2011

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

Hans Hoogervorst, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Subject: *Lessor Accounting: Receivable and Residual Approach*

Dear Chairperson Seidman and Chairman Hoogervorst:

I wish to comment on the Boards' latest deliberations on lessor accounting under the joint Accounting for Leases 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 an auditor, lessee, lessor, consultant, and author.

Although I am of the opinion that the single lessor model proposed by the Boards does not reflect the economic realities of all equipment leasing transactions, I only will speak to certain ramifications of the single lessor model in this letter. In particular, I would like to address the Staff's recent Receivable and Residual approach, as presented in *Agenda paper 5G: Leases: Lessor Accounting*, discussed on July 20 and 21. Quite frankly, before reaching the following conclusions, I struggled to successfully apply this model to real world transactions.

What I have determined through my analysis is that the Receivable and Residual approach proposed by the Staff works well for leases in which there is no difference between the fair value of the equipment and its current carrying cost (i.e., finance lessors). This methodology breaks down, however, when applied to manufacturer lessors and creates unintended accounting and operational consequences.

The example contained in Agenda paper 5G is used to explain my position and analysis of this potential issue. I have calculated the example at a greater numeric precision, however, as rounding obscures the true results. I also have taken the transaction through its life, so as better to compare the overall economic and accounting results.

As a refresher, this example includes the following assumptions:

- Fair value: 120
- Cost: 100
- Payment: 28
- Term: 3
- Yield: 6.3827%
- Residual: 55
- PV of residual: 45.68
- PV of rents: 74.32
- Residual asset: 38.07

I will take a comparative approach in my analysis, the starting point of which is the case of a manufacturer that makes a loan of 120 to a customer and, simultaneously, sells equipment with a fair value of 74.32 to that same customer[1]. The loan contains a balloon payment of 55, due at the end of the third year, and the customer purchases additional equipment with a fair value of 45.68 at the end of the third year.

The true economics of these transactions over their economic lives, whether in combination with each other, or on a standalone basis, are as follows.

Sales revenue		120		
Cost of goods sold		(100)		
Margin			20	
Loan payment	28			
Term	X 3			
		84		
Balloon payment		55		
Loan amount		(120)		
Financing income			19	
Total income				39

The income statements and balance sheets for this scenario, which accurately reflect the economics of the transaction, are shown in **Table One**. **Table Two** shows the income statements and balance sheets presented under the current lease accounting rules. While the total income is reflected properly under the current rules, it can be seen that the timing and characterization of that income is not.

[1] This assumption tracks the sale of the residual asset at lease end

Table One
Loan and Sale Scenario

Income Statements

	0	1	2	3	Total
Finance income		4.74	3.26	1.68	9.68
Balloon accretion		2.92	3.10	3.30	9.32
Sales revenue	74.32	-	-	45.68	120.00
Cost of goods sold	(61.93)	-	-	(38.07)	(100.00)
Total income	12.39	7.66	6.36	12.59	39.00

Balance sheets

	0	1	2	3
Receivable	84.00	56.00	28.00	0.00
Unearned income	(9.68)	(4.94)	(1.68)	0.00
Balloon payment	55.00	55.00	55.00	0.00
Unearned balloon	(9.32)	(6.40)	(3.30)	0.00
Total assets	120.00	99.66	78.02	0.00

Table Two
IASB 17/FAS 13 Treatment

Income Statements

	0	1	2	3	Total
Finance income		4.74	3.26	1.68	9.68
Residual accretion		2.92	3.10	3.30	9.32
Sales revenue	74.32	-	-	-	74.32
Cost of goods sold	(54.32)	-	-	-	(54.32)
Total income	20.00	7.66	6.36	4.98	39.00

Balance sheets

	0	1	2	3
Receivable	84.00	56.00	28.00	0.00
Unearned income	(9.68)	(4.94)	(1.68)	0.00
Unguaranteed residual	55.00	55.00	55.00	0.00
Unearned residual	(9.32)	(6.40)	(3.30)	0.00
Total assets	120.00	99.66	78.02	0.00

The next step of my analysis illustrates the Staff's position on how to account for the example. The income statements and balance sheets for the transaction, reflecting the Staff's approach, are shown in **Table Three**.

Table Three
Staff Position

Income Statements

	0	**1**	**2**	**3**	**Total**
Finance income		4.74	3.26	1.68	9.68
Residual accretion		2.43	2.58	2.75	7.76
Sale revenue	74.32	-	-	55.00	129.32
Cost of goods sold	(61.93)	-	-	(45.83)	(107.76)
Total income	12.39	7.17	5.84	13.60	39.00

Balance sheets

	0	**1**	**2**	**3**
Receivable	84.00	56.00	28.00	0.00
Unearned income	(9.68)	(4.94)	(1.68)	0.00
Residual asset	45.83[2]	45.83	45.83	0.00
Unearned residual	(7.76)	(5.33)	(2.75)	0.00
Total assets	112.39	91.56	69.40	0.00

It can be seen that the total income is, again, correct, as in the prior example, but the characterization of that income is distorted.

Sales revenue	129.32		
Cost of goods sold	(107.76)		
Margin		21.56	
Financing income	9.68		
Residual accretion	7.76		
Interest income		17.44	
Total income			39.00

The reason for this distortion is that the Receivable and Residual model, as described in the Staff Agenda paper, creates a deferral of the profit margin on the economic accretion of the residual. This margin on the accretion, roughly 1.55 ([55 - 45.68] x [20÷120]), is shifted to sales, thereby overstating sales profit and understating finance income.

Alta's position is that this accretion margin must be identified and recognized over the life of the asset. The income statements and balance sheets for the transaction, reflecting Alta's approach, are shown in **Table Four**.

[2] The future value of 38.07, in three years, calculated at 6.3827%.

Table Four
Alta Position

	0	1	2	3	Total
Income Statements					
Finance income		4.74	3.26	1.68	9.68
Residual accretion		2.43	2.58	2.75	7.76
Accretion margin		0.64	0.52	0.39	1.55
Sale revenue	74.32	-	-	45.68	120.00
Cost of goods sold	(61.93)	-	-	(38.07)	(100.00)
Total income	12.39	7.81	6.36	12.44	39.00
Balance sheets					
Receivable	84.00	56.00	28.00	-	
Unearned income	(9.68)	(4.94)	(1.68)	0.00	
Net receivable	74.32	51.06	26.32	0.00	
Residual asset	55.00	55.00	55.00	0.00	
Unearned residual	(7.76)	(5.33)	(2.75)	0.00	
Deferred sale	(45.68)	(45.68)	(45.68)	0.00	
Deferred COGS	38.07	38.07	38.07	0.00	
Deferred accretion margin	(1.55)	(0.91)	(0.39)	0.00	
Net residual asset	38.07	41.14	44.24	0.00	
Total assets	112.39	92.20	70.56	0.00	

This approach results in recognizing the correct total income, represents the economics, and properly characterizes the income. It also is representative of how the lessor would operationally reflect the transaction in its lease management system.

Sales revenue	120.00		
Cost of goods sold	(100.00)		
Margin		20.00	
Financing income	9.68		
Residual accretion	7.76		
Accretion margin	1.55		
Interest income		19.00	
Total income			39.00

I recognize that I have used a multiple charts and tables to illustrate my points, but it has been necessary in order to properly lay out the various scenarios. Furthermore, this detailed analysis does show that the proposed methodology breaks down when applied to manufacturer lessors and illustrates its unintended consequences.

Accordingly, I request that the Boards reconsider the Receivable and Residual model, as the Boards' insistence on segregating the residual asset and treating it purely on a pro rata basis has unintended effects on manufacturer lessors. I apologize in advance if I have misconstrued the direction and/or intent of the Staff in this regard, but these issues are far from intuitively, or even reasonably, obvious from the examples, descriptions, and information in Agenda paper 5G.

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

Sincerely,

Shawn Halladay
Principal
The Alta Group