December 6, 2010

Technical Director File Reference No. 1850-100 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update – Leases

Dear Technical Director:

Thank you for the opportunity to offer comments on the Financial Accounting Standard Board's (the "Board") August 17th, 2010 Exposure Draft of a Proposed Accounting Standards Update on Leases (the "Exposure Draft," or "ED"). We provide our comments on behalf of Phoenix Children's Hospital, one of the nation's largest pediatric hospitals ("PCH"), with annual operating revenues of over \$400 million and approximately \$450 million in tax-exempt debt. PCH is organized as a non-profit hospital and utilizes a wide range of leases and tax exempt bonds in its capital structure. PCH publicly files interim and annual financial statements, compliance and management discussion and analysis.

We appreciate and are supportive of the Board's continued efforts to promote projects and issue standards to ensure an organization's financial statements accurately and comprehensively reflect its financial position, including its specific assets and liabilities, as well as those which result in more relevant and useful financial statement disclosures for readers of the financial statements, including the investment community. Regarding the current Exposure Draft, for which we offer our comments herein, we acknowledge the Board's continued efforts to bring off-balance sheet transactions onto the balance sheet, including leases currently classified as operating leases, and that the guidance proposed within the ED will eliminate current off-balance sheet accounting for all leases. However, we have certain fundamental issues with the theory underlying the proposed accounting for leases included in the current ED, as well as significant concerns with how to appropriately apply certain of the proposed guidance to lease transactions.

### **General Comments**

In the exposure draft, the FASB noted that since leasing is an important source of finance, it is important that lease accounting should provide users of financial statements with a complete and understandable picture of an entity's leasing activities. The existing accounting models for leases require lessees to classify their leases as either capital leases or operating leases. The FASB says that those models have been criticized for failing to meet the needs of users of financial statements because they do not provide adequate representation of leasing transactions. And, in particular, that it omits relevant information about rights and obligations that meet the definitions of assets and liabilities in the board's conceptual framework. The FASB also discusses that the models

have lead to a lack of comparability and undue complexity because of the sharp 'bright-line' distinction between capital leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.

PCH's most significant concerns with the guidance proposed in the ED are noted below, including support for our position on these items.

We do not believe <u>all</u> leases represent liabilities that should be recognized in the balance sheet. Specifically, we do not believe cancellable leases should be recognized liabilities and associated assets in the balance sheet. While PCH acknowledges the overlapping nature of leases and borrowed money capital financing, the proposed guidance trades one set of financial reporting issues for another.

We strongly believe that certain elements of the proposed guidance require far too much judgment and estimation in calculating the recorded assets and liabilities. As a result, we firmly believe that any resulting calculation of the lease liability and right-of-use asset, at inception, cannot be deemed to be "probable," as the underlying definition of a liability requires. Furthermore, from a pure operational perspective, estimating lease terms on longer term leases, such as real estate, would often be 'a best guess,' and therefore also not "probable."

The proposed lease accounting also calls for the lease liability and related asset to be calculated using a more likely than not lease term, including contingent rentals, penalties and other elements that in our experience would result in material under- or overstatement of the liability. Estimating a "more likely than not" lease term at inception, particularly for leases that are longer term in nature, such as real estate leases, is highly judgmental and would be operationally difficult to determine with relative certainty. Considering application of the proposed rule making on the PCH use of leases for existing long term real estate leases would have resulted in significant restatements of the financial statements during normal renewal periods that in our opinion would have created more confusion than insight. We feel the costs related to the proposed guidance outweigh the benefit provided.

The proposed guidance would materially change the classification of PCH leases. The resulting impact will be the breach of a number of financial covenants under the organizations bond indenture. The costs of modifying debt agreements and the potential acceleration of debt could have significant and potentially permanent adverse impacts on the organization.

We believe that a better alternative is the development of more extensive disclosure of lease obligations. Credit rating agencies already take existing "operating leases" into their evaluations and have indicated the proposed guidance would not impact their credit ratings. Enhanced disclosure would assist both sophisticated and other users to better understand the nature of the lease obligations and allow them to better understand the financial statements. The proposed guidance would result in more confusion due to the extensive use of estimates in many leases on both balance sheet

and operating statements. While overall income during the lease term would likely not be materially different, the classification of expenses would result in material changes to current management reporting of key measurement tools such as EBIDA (earnings before interest, depreciation and amortization).

Based on the above discussion and the likelihood of material adverse impact of the proposed guidance on the debt covenants which were based on existing lease guidance, PCH is opposed to the proposed guidance. We feel the current concerns regarding rights and obligations related to operating leases could be better addressed through disclosure requirements.

In response to the questions posed in the proposed guidance, we provide the following comments.

### **Question 1: Lessees**

- (a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?
- (b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We are not of a general opinion that the recognition of such lease assets and liabilities should result in a characterization of the expense associated with leases that is different than the expense classification utilized today. The underlying nature of the expense is not changing; only the manner in which the transaction is reflected in the financial statements is changing. As indicated above, our opinion is based on the extensive required use of estimates on long term leases such as real estate leases; we believe that the standard is unnecessarily complicated and subject to estimates of uncertain future events. While shorter term current operating leases (generally equipment) could be more readily estimated, we feel the current guidance if combined with enhanced footnote disclosure would more appropriately reflect the intent of the transactions.

## **Question 3: Short-term leases**

This exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65). (See also paragraphs BC41-BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

We agree that simplified requirements for short-term leases as discussed in Appendix A to the proposed guidance are appropriate. However, we feel that the need for this exception further supports the costs associated with implementation of this guidance that outweighs benefits to readers of the financial statements. The short term nature of many leases would require significant resources to set up, monitor and report activity for leases that are often for as short as one month.

#### Definition of a lease

This exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). This exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

#### Question 4

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

We agree that the definition of a lease is appropriate. The proposal is generally consistent with current guidance under ASC 840-10-15.

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

We agree that the criteria referred to above is adequate and is generally consistent with current guidance. However, the guidance is excluded for these agreements under the proposed guidance. Greater clarification is needed for these transactions when they are no longer considered leases, particularly for transition.

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

### Refer to Question 6

# Question 6: Contracts that contain service components and lease components

This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, Revenue Recognition (Topic 605): Revenue from Contracts with Customers, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

- (a) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.
- (b) The IASB proposes that:
  - (i) A lessee should apply the lease accounting requirements to the combined contract.
  - (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
  - (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We do not agree with the proposed guidance to consider the service and lease components as a combined lease. We feel it would be a more appropriate approach to determine the fair value of the service component treated outside of the lease related obligation.

# **Question 7: Purchase options**

This exposure draft proposes that a lease contract should be considered terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

We agree that purchase options should only be accounted for when exercised. We feel that obligations created within the lease terms should be the primary assumptions used for estimates. Future rights should only be accounted for and become an obligation only once the obligation is no longer subject to management election.

We believe this position is consistent with the intent of the definition of a liability as defined in Statement of Financial Concepts No. 6.

### Measurement

This exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

- (a) assumes the longest possible term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).
- (b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121-BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value quarantees that can be reliably measured.
- (c) is updated when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments, including expected payments under term option penalties and residual value guarantees, since the previous reporting period (paragraphs 17, 39, 56 and BC132–BC135).

### **Question 8: Lease term**

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

We do not agree with the FASB's proposal that the lease term be determined as the longest possible term that is more likely than not to occur, inclusive of any options to extend or terminate. We believe that the more likely than not criteria is highly subjective and difficult to accurately determine at the initiation of the lease term; it would likely result in inconsistent application among various organizations. In addition, we do not believe that an option to extend should be taken into account until it has been exercised as an option to extend. We believe that an option to extend that has not yet been exercised does not meet the definition of a liability, as defined in Statement of Financial Accounting Concepts No. 6. We believe the resulting estimates will be highly subjective. When coupled with the variability that will be evident as lease terms either expire or are renewed in a manner inconsistent with previous estimates, the estimates will be detrimental to the level of confidence that financial statement users place on the statements' financial reliability and integrity.

We believe that the noncancellable term of the lease as stated in the lease agreement should be defined by FASB as the lease term, similar to the terms associated with disclosure requirements of future minimum lease payments for operating leases. We believe that this provides users of the financial statements with an accurate depiction

of the liability outstanding for organizations at a given point in time. We also believe that this approach would eliminate some of the judgment and potentially inconsistent application among various organizations that would impact users of the financial statements, ultimately providing preparers with a consistent basis by which to apply the proposed guidance.

## **Question 9: Lease payments**

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured? Why or why not?

PCH does not support FASB's proposal that contingent rentals, expected payments under term option penalties, and residual value guarantees that are specified in the lease be factored into lease assets and liabilities. At the inception of a lease, this cannot be reliably calculated as an estimate nor is it appropriate to record a liability for an estimate, as no events have occurred to create an outstanding obligation. Consequently, PCH supports treatment of contingent rentals, payments under term option penalties, and residual value guarantees as an expense as the contingencies are resolved and penalties incurred, consistent with payment obligations.

#### **Question 10: Reassessment**

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

Assuming that penalties, contingencies are not recognized until the underlying obligation is incurred (see response to Question 8), PCH supports FASB's proposal that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change. The assets and liabilities from leases should be reassessed when noncancellable lease terms or payments (i.e., lease renewals, lease extensions) are factors.

### **Presentation**

This exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

# Question 12: Statement of financial position

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease (paragraphs 25 and BC143-BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

We do not support a methodology of requiring the lessee to distinguish the liability to make lease payments separately from other financial liabilities. While we recognize that such a distinction could have merit in certain cases, we do not believe that such a distinction merits a unilateral change. PCH does support a footnote disclosure when lease payments are not presented separately on the statement of financial position.

We believe that right-to-use assets should be disclosed within the footnotes to the financial statements where an organization has elected to show a single total for all property, plant and equipment on the face of the financial statements and categorize the assets in the footnotes.

## **Question 13: Income statement**

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

We do not support a methodology that requires the lessee to distinguish lease income and lease expense from other income and expense in the income statement. While we recognize that such a distinction could be useful in some cases, we do not believe that such a distinction merits a unilateral change. When material, PCH supports footnote disclosure when lease income and expense are not presented separately from other income and expense in the income statement.

## Question 14: Statement of cash flows

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

We do not support a methodology of requiring the lessee to distinguish cash flows from leases and other cash flows. While we recognize that such a distinction could be useful in some cases, we do not believe that such a distinction merits a unilateral change. When material, PCH supports footnote disclosure when cash flows from leases are not presented separately from other income and expense in the income statement.

## **Disclosure**

## **Question 15**

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognized in the financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows? (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

We support a methodology of disclosing amounts recognized in the financial statements specific to leases and the impact on future cash flows will ultimately enhance the understanding between the organization and end-users of this information.

### **Transition**

#### **Question 16**

- (a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
- (b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?
- (c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

The impact of the proposed guidance on financial statements could negatively impact both metrics and compliance requirements within existing legal agreements. Therefore, we believe that a complete retrospective approach, along with financial statement disclosures identifying the approach taken by the entity, should be allowed but not required. An entity should have an opportunity to mitigate the potentially negative effects on its legal agreements and financial statements through an appropriate selection of approach to use at transition.

We also believe the Board should consider its transition approach, whereby the guidance would be assumed to be applied to the earliest period presented. If the method for recognizing interest expense is retained, then interest expense would effectively be altered for a historical period. We do not understand how this type of transaction would work, as it could lead to the failure to meet covenants for a historical period previously disclosed without such issue. If the notion that lease liabilities result in interest expense is retained, we suggest that only a prospective transition would work.

## Benefits and costs

## **Question 17**

Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

We do not agree with the boards' assessment that the benefits of the proposals would outweigh the costs. Our basis for this position is included in a number of related comments herein. We feel that many leases, most particularly long term real estate leases, contain terms that are subject to wide variations in estimates. These agreements intentionally structure in materially different terms that purchase agreements and are most appropriately disclosed under current guidance. Additional clarification, as needed, would be more meaningful in a footnote disclosure. Other comments

# **Question 18**

Do you have any other comments on the proposals?

Impact on Reimbursement for Patient Care

PCH is concerned that there may be an unfavorable impact on patient care reimbursement. Some healthcare providers are compensated based on cost-based reimbursement models (i.e., Medicare program) and some states provide a percentage of Medicaid reimbursement based on costs. In some cases operating expenses are reimbursed in a manner different than capital expenditures. A change to the respective accounting practice would directly impact the reimbursement in scenarios such as these. These changes may result in further revisions and complications to the way health care providers are reimbursed, creating further strain on an industry already forced to live with unprecedented levels of change.

## <u>Impact on Debt Covenants of Not-for-Profit Organizations</u>

An area of particular concern to PCH is one in which many not-for-profit healthcare organizations could be negatively impacted by the FASB's proposal with regard to

certain covenants on outstanding debt. The FASB's proposed changes would result in the recording of additional debt on the balance sheets of not-for-profit healthcare organizations, which would have a direct negative effect on certain debt covenants that are based on debt or debt service.

Increases in debt and debt service could cause organizations to be in default of certain covenants purely as a direct result of a change in Generally Accepted Accounting Principles. This poses a significant problem to not-for-profit healthcare organizations as it is generally very difficult to amend a master trust indenture, which defines the debt covenants and related calculations applicable to the entity.

The basic issue in amending master trust indentures is that the obligations issued under master trust indentures frequently secure publicly-sold bond issues. There are not banklenders or a limited number of institutional investors, who might be approached to obtain consent to master trust indenture amendments as may be the case for other organizations. Rather, one would generally need the consent of a majority of the holders of all bonds to accomplish a substantive amendment. Given that bonds issued by not-for-profit healthcare organizations are largely held under the Depository Trust Company book-entry system, the process of identifying bondholders is typically very difficult. As a result of these considerable difficulties PCH believes the adverse affect to not-for-profit healthcare organizations of the proposed guidance is substantial.

# Non-public entities

## **Question 19**

Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

We do not believe that there should be different guidance for nonpublic entities. The underlying nature of the lease transactions do not vary based on ownership type.

We appreciate the opportunity to provide our comments on the proposed Accounting Standards Update for Leases, and would welcome the opportunity to participate in upcoming roundtable meetings relating to the exposure draft.

Sincerely,

Craig McKnight
Senior Vice President and Chief Financial Officer

Dennis Bruns Vice President - Finance