FASB Technical Director August 20, 2013

Reference No. 2013 - 270

My comments focus on the proposed accounting for lessees. I do not believe a final standard based on this ED will improve financial reporting. That is hard to say because of the low bar set by current accounting. Current accounting by lesses overstates a reporting entity's return on assets and understates leverage and finance costs because of its off-book presentation.

A major reason the ED fails to improve financial reporting is it's failure to follow though with the Right to Use and the Lease Obligation that results from a lease contract. Instead the ED reverts to looking at the underlying item for a complicated classification scheme and a unique expense recognition approach.

In so doing this ED:

- 1. Creates unneeded complexity with type A and type B leases.
- 2. Adds complexity by having 3 steps to determine lease classification.
- 3. Creates a cottage industry of auditors and regulators to define the ambiguous terms used in the 3 step classification. For example:
- a. What is a MAJOR part of the underlying item's life?
- b. What is an INSIGNIFICANT portion to the item's life?
- c. What is an INSIGNIFICANT amount of the item's fair value?
- d. What is SUBSTANTIALLY ALL of the item's fair value?
- e. Are INSIGNIFICANT and MAJOR / SUBSTANTIALLY ALL converse conditions? is there a condition between these two conditions? if so, what is it?
- 4. Provides incentives to structure leases based on the classification scheme to achieve desired amortization of Right to Use and avoid reporting interest expense.

I do not believe there is a conceptual or practical reason for switching from the Right to Use and Lease Obligation perspective to an evaluation of the underlying item's life and fair value in relation to lease terms. This is a step back to current lease guidance which is based on whether the lease is essentially an asset purchase of the underlying item.

Forcing the pattern of amortization of Right to Use to obtain a level rent expense and the mislabeling of interest expense as rent expense has NO financial reporting justification. Right to Use is a time-based contractual asset. It does not change based on the underlying item or the amount of "consumption" of the item. What

would be the amortization pattern for Right to Use if the entire lease payment was made upfront? I doubt it would be the pattern required for a type B lease. Why would a decision to prepay a lease affect the amortization of the acquired asset?

It is the lessor that accounts for the underlying item. The lessor is concerned about the expected amount of consumption of the item while it is subject to the lease and whether the item is impaired. The lessee avoids these issues. The lessee is concerned about changes in lease rates but current accounting does not allow the recognition of a charge for overpriced leases outside a business combination.

Also, the presentation of a deferred payment lease as not having interest expense is a clear misrepresentation. A Lease Obligation with payments over time is a finance instrument with interest cost. Isn't that why an operating lease is called off-balance sheet financing?

The issue discussed above is not the only reason the ED does not improve financial reporting. If it were, I might accept that the ED would improve the very poor current accounting for leases by reporting a Right to Use and Lease Obligation on the balance sheet. However, the ED requires the Right to Use and the Lease Obligation to be understated by having their measurement exclude significant elements of lease contracts.

It excludes:

- 1. Almost all variable payments.
- 2. "Executory" payments for items integral to the underlying item.
- 3. The consideration of almost all renewal rights.

For many retail location leases, variable payments are a large part of the total lease payments because of its risk sharing attribute. Excluding these payments in measuring the lessee's Right to Use and Lease Obligation is not representationally faithful of the contractual asset and liability nor of the amortization of the asset and interest expense. I expect the accounting incentive to understate these amounts will create new variable payment arrangements for other types of leases that do not have this economic risk sharing. I expect these leases will have higher than necessary lease rates.

In my view, a lease that includes "executory" items that are integral to the underlying item should be part of Right to Use and Lease Obligation. In the ED's example 6, I believe the Right to Use and Lease Obligation is for "maintained" equipment and the \$10,000 should be included in their measurement. The \$10,000 payment is clearly part of the lease contract.

Excluding almost all renewal rights distorts a key element of many lease contracts. It will provide an accounting incentive to write leases in a manner that will reduce the recorded amounts. I expect these leases will have higher than necessary lease rates.

These exclusions to simplify the measurement of Right to Use and Leases Obligation rob the informational content of the recorded amounts.

The ED's Basis for Conclusions reports that most FASB constitutes agree that a lease creates a Right to Use and a Lease Obligation. Why does this ED back off this breakthrough and create the complicated classification scheme and unique amortization and interest expense approach? Why does this ED understate Right to Use and Leases Obligation and provide incentives to structure leases that may be uneconomical? The Basis for Conclusions does not support these changes with an evaluation of whether the results produce decision-useful information (see Concept Statement No. 8).

Contact me at ewtrott@gmail with you would like to discuss.

Edward W.Trott