2013-270
Comment Letter No. 439

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September 13, 2013

To the FASB and IASB:

Financial Computer Systems has been providing lease accounting services and software to corporations throughout the United States and Canada since the promulgation of FAS 13 in 1976. We have focused on assisting lessees with their reporting requirements (with limited work for lessors, primarily those that are also lessees). We have been concerned for many years about the structuring many lessees do to avoid reporting substantial transactions on the balance sheet, and we applaud the boards for finally taking the steps needed to correct this situation. We believe moving from "the risks and rewards of ownership" to "right of use" more accurately reflects the economics of leasing.

Our clients range from small organizations with fewer than 10 leases to multinational corporations with thousands, both capital and operating, covering all types of assets including equipment, vehicles, communications tower space, and real estate. Based on our experience with our clients, and with developing software to meet the requirements of FAS 13, we offer the following comments on the Revised Exposure Draft for the proposed new lease accounting standard. We are not, however, speaking on behalf of any of our clients, but as observers of the leasing scene and implementers of both the current and future standards.

We are glad that the boards are taking this opportunity to harmonize the lease accounting standard. We believe companies and investors will be better served by having a consistent standard worldwide. We note with regret that there are a few areas where outside differences between US GAAP and IFRS mean that some aspects of lease accounting will be inconsistent between reporting regimes (such as the existence of IAS 40 for investment property and the right to revalue a right-of-use asset at fair value), but we understand that not everything can be harmonized immediately.

Our response will be structured starting with the Boards' questions, then additional concerns at the end.

**Question 1:** We find the proposed definition acceptable.

**Question 2:** We think the Boards' solution is a reasonable way to handle the difficult issues raised by the fact that companies enter into leases for various reasons and think of them in various ways. The unusual method of depreciation for Type B leases, however, makes it difficult to see how one could properly determine impairment valuations.

**Question 3:** We agree that different accounting approaches make sense for different types of leases. The proposal is one reasonable way to handle this, which obviously seeks to maintain as much symmetry as possible between lessees and lessors. However, we think it would be reasonable also to permit a lessor to choose the approach that it considers most appropriate to its own business model, by class of leases. Since leasing is normally a core business for a lessor, we think appropriate selection will be obvious and largely self-policing.

**Question 4:** We consider the Boards' dividing line a reasonable one. We note, though, that "property" may need to be more clearly defined; it's not clear whether a communications antenna would be considered property, which we think it should. We also note that for most

equipment leases of modest duration (less than 10 years), the difference in expense profiles between Type A and Type B is fairly limited; for a 4-year vehicle lease, it's not likely to reach 15%. For a 30-year real estate lease, the difference could easily top 75%, and real estate leases are typically more material as well, making the provision of the Type B methodology more important.

**Question 5:** We agree with the determination of the lease term. However, we believe judgment calls on "change in relevant factors" should be required at most once a year; while an exercise of a renewal option, for instance, should be recognized immediately, reviewing the effect of a new leasehold improvement could be done annually.

**Question 6:** While this would seem like the purest accounting for the need at hand, we are concerned about the practical impact. We have a number of customers with thousands of leases. One of the helpful features of FAS 13 and IAS 17 has been that they don't require substantial alteration of the lease calculations during the lease life (unless the terms are changed). This would not be the case under the new standard. While the most difficult proposed calculations (estimating future inflation, renewals, and variable payments based on sales or usage) have been removed since the prior exposure draft, there is still plenty to keep accountants busy. In particular, the variety of inflation adjustments (which are often different for each property lease, with varying minimum and maximum adjustments and dates of adjustment) and the need to alter the balance sheets each year is likely to prove time-consuming. Therefore, we believe a preferable approach would be that currently used in FAS 13, which is to project future rents based on the index or rate in existence at lease inception, with differences (positive or negative) in actual payments expensed as incurred and no change made to the future rent estimates. If this alternative is chosen, we believe that future rents based on a standard measure of inflation should be booked initially with the inflation estimate (that is, future rents should be calculated to increase based on the current rate of inflation), but then subsequent changes in the inflation measure would not cause a recalculation, but all be booked (positive or negative) to current rent expense.

**Question 7:** In general, we agree with the transition proposals. However, we believe that any leases that expire before the effective date of the new standard need not be restated.

**Question 8:** For most preparers, we think the requirement for narrative disclosure as laid out in Topic 842-20-50-3 about the nature of their leases is going to be either so voluminous or so general as to have limited value.

**Question 9:** We are doubtful that the specified reliefs will make a substantial difference in the costs associated with compliance, but see no significant harm in providing them.

**Question 10:** Given the potential difficulty of interpreting the "economic substance" of a related party lease, and the fact that all asset and liabilities remain within the overall entity, we agree with the proposal.

**Question 11:** This is acceptable to us.

**Question 12:** No response because it is an IASB question.

*General comments outside the scope of the questions:*

We are in agreement with the boards on the importance of putting leases on the balance sheet. We believe this more accurately reflects the resources and responsibilities of lessees and lessors;

we agree with the idea that an airline that shows no airplanes on its books is not reflecting economic reality. The same is true of a retail chain that shows no stores. Clearly leases represent assets and liabilities, and need to be accounted for as such. We believe that the benefits do outweigh the costs. Off-balance-sheet financing (through leasing and other methods) has proven itself to be a source of substantial hidden damage to many companies in recent years; capitalizing all leases is an important step in cleaning up this serious problem. The plea of some to keep operating lease accounting because some companies will look worse financially is nothing more than a plea to avoid truthful accounting.

We consider some of the other voiced objections to the proposal to be unpersuasive:

- Some have been concerned about the liability section of the Statement of Financial Position including amounts that are readily shed in bankruptcy. However, reporting is normally done assuming a company is a going concern. Bankruptcy analysis always requires extensive adjustments, using both disclosed and unreported information: it is highly material whether liabilities are secured or unsecured, for instance, but this is shown only in disclosures, and current market values of assets are not necessarily shown at all. Since lease liabilities would be reported separately, either on the primary statement or in footnotes, there is no difficulty in separating them out as desired.
- Some users of statements suggest they can already do the present valuing needed to treat operating leases as capital, and therefore no change is needed. But in fact, doing such calculations with information currently provided requires estimates of uncertain accuracy (since there is no way to tell exactly when rents more than 5 years in the future are due), and is a nontrivial exercise. The information would be far more accurate and accessible to all if provided by the preparer, and more usable for multicompany comparative analysis.

Yet we remain very concerned about the burden introduced in complying with the proposed standard. While some of the most onerous proposals of the original Exposure Draft have been withdrawn, the reassessment requirements, if conscientiously followed, will mean substantial additional work each quarter or year, for minimal benefit. A methodology that seems straightforward for a single lease can become much more challenging when applied to thousands. As stated in our response to Question 6, we think recognizing variable rent payments as is done currently for contingent rent (changes expensed as incurred, with no balance sheet effect) provides sufficient information.

We also recognize the valid concern that changing the classification of expenses associated with leases from operating to financing or investing may have various unintended consequences. Expenses may disappear from EBITDA, which is commonly used even though not part of GAAP reporting. Cost-plus contracts, which reimburse allowable expenses (typically including rent, but not purchases), may have to be rewritten. These, as well as the impact on financial ratios from adding leases to the balance sheet, are nontrivial issues that are likely to cause real pain to some preparers, and it is understandable that they would object. Unfortunately, it is hard to see a way to eliminate these problems that still accomplishes the purposes of the revision.

The case of month to month leases has not been clearly addressed in the standard. MTM leases are usually cancellable by either the lessee or the lessor at any time (perhaps with 30 days notice). In exchange for the flexibility, prices are normally not guaranteed beyond 30 days, though at times a commitment to a particular price for a length of time may be made, particularly for a new account. It is not clear whether such a lease falls under the short-term lease exception.

In our opinion, if both sides have a right to cancel with no (or an insignificant) penalty, the lease should be considered to have a one-month term (or perhaps the length of any guaranteed renewability at a specified price), and treated as a short-term lease. These do not fit the definition of a liability (or an asset), and it is inappropriate to require capitalization of an utterly arbitrary length of rents for such an agreement. We do not believe there is a meaningful risk of structuring to take advantage of such a provision; lessors will generally not accept the risk of termination, without a commensurate increase in price that will make such a choice uneconomic for lessees that truly want an extended lease (if available; items such as postage meters are typically only available with MTM leases).

We generally believe that disclosure is helpful, but we are concerned that information that in principle is helpful will become overwhelming when applied to hundreds or thousands of leases. Further, narrative disclosure about such things as deciding which options to include in and exclude from the lease term is likely to either be so general as to be meaningless, or force disclosure of strategic planning in a way that could harm a company's competitive position. Disclosure of discrete elements such as residual value guarantees (both maximum and expected actual cost) and initial direct costs is less problematic.

We are concerned about the amount of new terminology introduced in the proposed standard. In many cases, the terms are not clearly defined, which is going to mean the potential for confusion as the standard is implemented. We realize that the Boards wish to avoid "bright line" tests that allow structuring leases to gain advantageous treatment, but it's not clear that the goal of comparability will be achieved if such concepts as "insignificant" and "major part" are left undefined.

The use of "Type A" and "Type B" for the two types of leases is completely arbitrary, non-descriptive, and prone to confusion. While the terminology used in the summer of 2012, "interest & amortization" and "single lease expense," may be too cumbersome, it was instantly clear. Since a significant characteristic of the differentiation is whether a lease is considered to consume an significant portion of the underlying asset's value, we suggest the terms "consuming lease" and "non-consuming lease" in place of the current Type A and Type B.

It is 37 years since the release of FAS 13, and 17 years since the publication of "Accounting for Leases: A New Approach." The problems with operating lease accounting have been visible for a long time, and we applaud the boards for finally taking the steps needed to eliminate this black hole of corporate obligations.

Thank you for allowing us to present our thoughts on this important topic. We look forward to assisting companies in meeting the new standard, whatever final form it takes.

Sincerely,

Kelvin Smith
Vice President