September 5, 2013

Mr. Russell Golden, Chairman
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856

Submitted via electronic mail to director@fasb.org


Dear Mr. Golden:

Bridgeway Capital Advisors, Inc., appreciates the opportunity to respond to the request for comments on the exposure draft (ED), Leases (Topic 842): a revision of the 2010 proposed FASB Accounting Standards Board Update, Leases (Topic 840).

Our firm consists of a team of equipment leasing professions with an average experience of 30 years in senior leadership positions with major financial institutions encompassing credit, marketing, financial and tax reporting, and risk management. We assist lessors and lessees in raising capital and financial modeling. We also assist lessors in strategic planning and business development. We have in-depth knowledge of the decision-making process by a broad cross-section of investors and creditors, ranging from publicly traded companies to private equity firms. We understand the relevance of accounting information in making credit and investment decisions and in monitoring performance.

Given our team’s experience, we have generally limited our overall comments and responses to the solicited questions from the standpoint of equipment leasing. However, in so doing, we do not intend to imply support for the proposed property-based approach to the accounting for leases or otherwise imply different accounting for equipment and real estate. Instead, we support a principles-based approach similar to IAS 17 and its more generalized application. Additionally, we believe most of our specific comments—notably on lease classification and its implications—would equally apply to real estate leases. Although not the subject of this ED, we support the FASB’s project on investment property which we believe offers a more faithful accounting for certain real estate and equipment leases.
We find creditors and investors are better served when the accounting faithfully captures the economics, or, alternatively, the accounting information can be readily recast to facilitate specialized analysis. Our overriding concern with the ED is that it achieves neither of these objectives and does not deliver improvements to the existing accounting for leases consistent with user needs with due regard for cost-benefit.

We believe the FASB Board (Board) has ended up with a proposal unmoored from legal and economic realities and thus a distorted accounting of leasing transactions. As explained below, we believe the Board needs to revert to classification based on risks and rewards to establish the appropriate linkage between legal and economic realities and accounting. In assessing relevance and cost-benefit, the Board should recognize classification based on risks and rewards is the common, established basis for classifying leases in the U.S., i.e., for commercial law, income tax law, regulatory authorities, sales and property tax laws. We believe making accounting an “outlier” creates an unwarranted incremental cost absent a showing that an overlapping approach with these disciplines results in form over substance accounting.

We believe the U.S. commercial law for equipment leases—the Uniform Commercial Code (UCC)—should provide a presumptive basis for classifying leases, or serve as a key reference document to affirm the appropriateness of the classification tests set forth in IAS 17 (FAS 13 tests without bright lines plus additional economic realities tests) or for use in developing a variation. The Board should recognize leasing exists as a major, alternative form of financing in the U.S. because the UCC sets forth distinctively different legal rights and obligations from secured financings and thereby results in meaningful differences in economic outcome.

The UCC uses economic realities tests in differentiating between lease contracts which transfer ownership interests and true leases which transfer a temporary leasehold interest. The former group of contracts comes within the scope of secured transactions (Article 9). These contracts are afforded the same rights and obligations as those in a traditional creditor-debtor relationship. True leases come within the scope of Article 2A and distinguished from secured transactions because such contracts are executory in nature, involve the conveyance of a temporary right of possession and use of (control over) “goods” (typically, equipment), and revert a “meaningful residual interest” to the lessor by the end of the term. These characteristics mean the lessor has to look to the secondary market to recover its investment.
In the event of default or bankruptcy, the UCC generally limits a true lessor’s remedies to return of the asset and the right to make an unsecured claim for actual damages arising from the default or bankruptcy subject to the lessor duty to mitigate. Unlike a loan, the lessor retains any upside potential in redeploying or remarketing the leased asset. These distinguishable characteristics matter to financial statement users in making credit and investing decisions. As is plainly evident from the publications and expressed views of rating agencies, these users analyze leases which qualify as executory contracts differently than secured transactions. Accordingly, we reject the notion that no substantive differences exist between leases classified as secured transactions and true leases. This glossing over notion has inappropriately lead to the conclusion such that both lease types should be lumped together as Type A leases and commonly accounted for as the acquisition and financing of an asset.

If the Board proceeds with its proposed classification and accounting for true leases as Type A leases for lessees, we believe users will need US GAAP to identify this subset of leases and to clearly present their specific financial statement effects to enable users to recast the GAAP-based statements for their analysis and decision making purposes. In a full-fledged capitalist system such identifying information is critical since this economic system inherently involves “creative destruction.” True leases have played a major role in the “democratization” of commercial airline travel and also have proven to be an important “safety value” in the survival of the major carriers in economic downturns as they were able to reject thousands of such leases in bankruptcy. More systemically, true leases represent a major source of capital for small and medium sized businesses, which represent the majority of the lessees and which also involve significant default and bankruptcy risk.

U.S. federal and state income tax laws works in harmony with U.S. commercial law. If a lease contracts qualifies as a true lease under U.S. commercial law, the lessor generally qualify as a true lease for U.S. tax purposes, meaning the tax benefits incident to ownership flow to the lessor and the lessee enjoys a subsidized rent payment. For the most part, existing U.S. GAAP has neutrally affected this harmony since true leases naturally qualify as operating leases for the standpoint of the lessee and lessor’s accounting generally aligns its business model. We see nothing but downside in terms of capital formation and job creation from accounting nonconformity.

Before the Board decides to create major accounting nonconformity, they should study true lease economics and in their deliberations explain the basis of conclusion to treat all equipment leases as essential the same or to distinguish between them similar to U.S. commercial law.
Briefly, for true leases, the U.S. taxing authorities allow for the tax benefits arising from the use of the asset to transfer from the lessee to the lessor. Due to competitive conditions, lessors pass through a portion of the economic value of the tax benefits to the lessee in form of lower rentals. To stimulate the acquisition of durable capital goods (equipment) and associated job creation, the U.S. taxing authorities provide accelerated depreciation deductions (generally 200DB/SL over a significantly shorter period than the economic useful life of the asset) and situationally provide investment tax credits or their equivalent (cash grants). Since the tax benefits of accelerated depreciation depend on the mismatch between tax depreciable life and economic life, longer term true leases create a greater economic pie to share between the parties. Then, to prevent an undue mismatching between revenue and deductions, U.S. tax law for equipment leases generally limits variations in the rent pattern to 90/110 of average rent. In practice, most rental schedules involving small to medium sized ticket items and leases to small and medium sized enterprises contain straight-line rentals. Taken as a whole, user-lessees gain access to asset-based capital by exchanging a meaningful residual value and significant tax benefits to obtain 100% financing with a periodic fixed payment generally significantly lower than that of 100% loan (if available). Owner-lessees generally accept less pre-tax cash in the bargain in exchange for a premium yield relative to a comparable loan.

However, if the Board should decide to issue a new standard with the current Type A classification for essentially all equipment leases (lumping executory and non-executory leases together), we believe its provisions should mirror those applicable for loans. In other words, it should require the same accounting and reporting for these leases as the accounting for a note for cash or a note for property, goods or services. It should account for modifications and indexed payments on the same basis as the existing guidance for receivables and debt. It should also extend the fair value option to such contracts. If the Board maintains its specialized, more costly accounting for most equipment leases, it would effectively be placing its thumb on the scale of lease vs. buy decisions in favor of lending.

We do not support the elimination of leveraged lease accounting, generally and at least retroactively. The Board’s proposal appears to be grounded on international convergence even though this lease type is generally unique to the U.S. based on our unique legal, tax, and economic environment. We do not view convergence for its own sake as a valid basis for eliminating leveraged lease accounting. The predecessor Board based its decision to allow this unique method of accounting because it faithfully portrayed these leases in financial statements.
Just as the proposal to eliminate leveraged lease accounting has slowed new business origination, we believe the proposal to replace it with Type A accounting would so pervasively dilute common performance metrics (notably, return on assets, return on equity, leverage ratios, and net interest margin), it would effectively shut down the origination of such leases by GAAP-sensitive reporting entities (e.g., banks) who offer the lowest cost of capital. A side-by-side comparison of the proposed accounting and economics (pricing) shows the proposed accounting inverts the economics and portrays such investments as persistent net loss generators. Since such leases have been a critical source of capital for big ticket assets, such as aircraft, fleets of railcars and trucks, vessels, and facilities, we believe the dislocation of market participants arising from severely distortive accounting is an unwarranted cost to impose on the U.S.

More broadly, we believe the Board has not appropriately considered the accounting for tax benefits associated with U.S. lease investments. U.S. tax law provides accelerated cost recovery deductions for the benefit of the lessor as the tax owner, which it explicitly and observably schedules into its pricing runs in determining lessee rentals. In effect, the lessor trades pre-tax cash for favorable tax timing. In certain solar transaction, the magnitude of government incentives are so significant the pre-tax yield is negative while the after-tax yield offers a premium over conventional transactions. Hence, as a follow up to the leases project and its project on affordable housing credits, we believe the Board needs to add a new project to improve the financial reporting for investments with significant tax benefits. The Board could defer on whether to eliminate or modify leveraged leasing in the context of this new project.

We also disagree with the Board’s proposed change in the accounting for leases with residual value guarantees and insurance. First, we believe the characterization of full lessee residual guarantees as substantively a fixed payment should be extended to partial lessee residual guarantees where the sum of the guarantee and the sales prices is expected in all likelihood to cover the stated residual value. Second, we believe that third party guarantees should be treated the same as lessee guarantees when taken out lease commencement. These guarantees are an integral part of the leasing transaction and place the lessor in the same position as if the lessee had made the guarantees and generally only differ based on the credit worthiness of the guarantor.

Apart from the above discussed conceptual differences we have with the ED, we also believe it contains costly provisions which on their own right exceed any corresponding benefit. A discussion of these follow with a recommendation to achieve a better cost-benefit outcome:
• **True leases with SMEs.** Most true lease transactions involve size transactions with terms ranging from 3 to 7 years to small and mid-sized businesses. For equipment leases, U.S. tax law generally requires the scheduling of straight-line rentals (or rentals varying 90/110 from average rental) to preclude including a financing element in the rental economics. Since these businesses generally have limited personnel and computer resources, we do not see the benefit of requiring “front-loaded” expensing for US GAAP purposes and the computation of originating and reversing deferred taxes. If capitalization is deemed appropriate and necessary, we believe a better cost-benefit solution would be to report a right-of-use asset and lease obligation with the carrying values set equal to the present value of the remaining future rentals and to allocate straight-line rent expense between interest and depreciation expense, say, by imputing interest and then reporting the difference between straight-line rent expense and imputed interest expense as depreciation expense.

• **Sale-leasebacks with purchase options.** True equipment leases commonly extend a non-bargain purchase option to lessees. Lessees have established the commonality of granting such options in a competitive marketplace because it prevented its lessors from realizing “windfall profits” and because the granting of such options had no effect on both the tax and accounting treatment of the transactions. Further, due to administrative ease, lessees often fund a group of assets during a quarter and then enter into a sale-leaseback transaction or make down payments and receive reimbursement at lease commencement (as required by U.S. tax law as the lessee cannot have an investment in the property for true lease purposes). In recognition of this flow of business, the taxing authorities have provided a 90-day window under which the transaction is treated as if a new transaction if the sale-leaseback is consummated before the end of the window period. However, the proposed change in the guidance of sale-leaseback transactions would, if issued as proposed, would treat all such transactions as “financings,” again lumping together executory contracts with debt financings. We believe the Board should allow sale-leaseback accounting for equipment transactions containing a non-bargain purchase option in the leaseback.

• **Unwinding of the residual asset discount.** The proposal requires lessors to separately calculate and disclose lease income associated with rentals and the residual asset (the unwinding of the residual asset discount). For leases currently classified as direct financing or sales-type leases, given the minor nature of the residual asset, we question
the cost-benefit of requiring costly system changes to provide such discrete reporting. We believe such disclosure is only appropriate for leases formerly classified as operating leases with significant residual income relative to the lease income from rentals.

We appreciate the Board willingness to redeliberate throughout the history of this project. We trust the information will prove useful to the Board to ensure changes to the accounting for leases or disclosures provide users with more relevant information for their decision making purposes, while also ensuring direct preparer and indirect societal costs associated with providing such information are commensurate with the envisioned benefits.

We encourage the Board to conduct further field studies and maintain an open dialogue with those engaged in equipment leasing. Please do not hesitate to contact our firm for additional dialogue.

Sincerely,

Rodney W. Hurd
Chief Financial Officer

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Question 1: Identifying a Lease

The proposed definition of a lease represents an appropriate revision to the existing definition of a lease given that the proposed scope includes assets other than “property, plant and equipment (land and/or depreciable property)” and replaces “stated” with “period of time” to better reflect the requirement to look beyond the stated terms in assessing the lease term. The addition of “in exchange for consideration” appears to make explicit what has been implicit in practice.

On the other hand, unlike U.S. commercial law, the definition does not exclude contracts which convey ownership rights (e.g., sale/purchase transactions) or create a security interest (e.g., secured financings). Further, unlike the existing GAAP for leases, the downstream provisions do not provide for a difference in the accounting based on the nature of the conveyance—the transfer of ownership with related financing vs. the transfer of a leasehold interest where the lessor retains a meaningful residual interest in the property.

For the benefit of users, accounting should distinguish between contracts based on their substance, either by means of scope exceptions or by self-contained provisions. A high quality standard should result in similar accounting for contracts with similar rights and obligations. The revised Exposure Draft does not accomplish these fundamental objectives as it lumps together two distinctively different types of contracts—in terms of their legal standing and economics—into the same classification category (generally, Type A). In the U.S., leases of “goods” (generally, equipment) which transfer ownership interest by the end of the lease term to the lessee (e.g., those containing $1 purchase option) have the same rights and obligations as a note for cash or a note for an asset. These contracts generally have the standing of a lease intended as security under U.S. commercial law and come within the scope of Article 9 of the Uniform Commercial Code (Secured Transactions). By contrast, lease contracts which convey a leasehold interest involving a meaningful allocation of the risks and rewards incident to ownership generally have the standing of executory contracts under U.S. commercial law. These contracts are defined as “leases” in the Uniform Commercial Code with distinctively different rights and obligations as set forth in Article 2A.

The lumping decision also creates downstream anomalies in the accounting for reporting of asset-backed transactions based on the form of the contract. The accounting for identical provisions or events (e.g., indexed payments, reassessments, and fair value option) differs based on whether the title or form of the contract is a “note” or a “lease,” even when the lease document is entitled “lease intended as security.” The financial statement reporting
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also varies depending on whether the contract is titled “conditional sale agreement” or “lease.” Strikingly, in the statement of cash flows, the “note” issuer reports the interest portion of the payments under operating activities and the principal portion under investing activities, while the revised Exposure draft proposes the “lessor” in name only lump these components together as “lease payments” under operating activities.

To eliminate the above described lumping problems, the revised Exposure Draft should either revise the definition, provide a scope exception for leases which are the same as secured financings or conditional sales, or include within the proposed standard the same provisions for these leases as if they were subject the existing guidance for loans. The Board could draw on the definition of a “lease” from Article 2A of the Uniform Commercial Code or the proposed variation below in revising the definition and in developing a scope exception:

UCC, Article 2A

“Lease” means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return or creation of a security interest is not a lease.

Proposed Variation to UCC’s Definition for GAAP Purposes

A lease is a contract that conveys the temporary right to use an asset (the underlying asset) for a period of time in exchange for consideration.

Proposed Scope Exception

This definition excludes contracts which have similar rights and obligations to those of a note for cash or a note for property, goods or services.

Question 2: Lessee Accounting

Financial statement users recently have expressed mixed views about the efficacy of requiring capitalization of all leases using the proposed methodologies relative to expanding footnote disclosures. Given the significant incremental preparer cost to capitalize all leases as proposed by the revised Exposure Draft, ultimately to be passed through and borne by society as whole, the Board should conduct a thorough cost-benefit study before choosing between capitalization of all leases and expanded footnote disclosures.
Today the U.S. rating agencies use different capitalization and analytical methodologies for operating leases, drawing on the current disclosures often supplemented by additional information provided by the companies they rate. If the Board proceeds with capitalization of all leases, the Board should recognize its methodologies based on asset type do not provide a common ground solution. Accordingly, the Board should revise the presentation and/or disclosure requirements to allow the rating agencies to readily recast lessee financial statements for their analysis purposes. Further, since the proposed capitalization results in a lumping together executory (generally operating leases under Topic 840) and non-executory contracts (generally capital leases under Topic 840), the rating agencies and others who use similar capitalization methodologies will likely need separate presentation or separate disclosure of the leases formerly classified as operating leases and qualifying as executory contracts.

To address likely user needs for separate presentation and/or disclosure of capitalized operating leases, our firm proposes grouping leases based on the nature of the contract—one group for leases which legally or economically transfer ownership of the property to the lessee by the end of the term and another group for those which convey a temporary leasehold interest subject to an executory contract.

- If the lease transfers **ownership** of the property to the lessee by the end of the term (e.g., $1 purchase option), the accounting should mirror the accounting of a note exchanged for cash or a note exchanged for property, goods or services. The capitalized asset should be described as, say, “Asset under a financing lease” and the capitalized liability as, say, “Obligation under a financing lease.”

- If the lease conveys a **leasehold interest** (that is, a temporary right to control the asset with a meaningful residual interest reverting to the lessor at the end of the term, or a “true lease” in the U.S.), the accounting for the asset and liability generally should remain linked throughout the term, with the periodic carrying value of the asset and liability set equal to the present value of the remaining lease payments. The capitalized asset should be described as, say, a “Right-of-use asset” and the capitalized liability as, say, “Lease obligation under an executory contract.”

The above described distinction depicts the economics more faithfully than the proposed asset type split because an ownership/leasehold interest split reports the nature of the bargain struck between the parties. Under U.S. commercial and tax law, the lessee as counterparty to a contract which transfers ownership obtains secured financing or seller-financing in connection with the acquisition of an asset, has the power to direct the use of the asset, and can derive all or substantially all of the risks and rewards incident to asset ownership, including generous tax
benefits afforded to equipment assets compared to real estate assets. By contrast, the lessee as counterparty to a U.S. true lease has quiet enjoyment over the possession and use of the asset during the term of the lease conditioned upon making its lease payments. In a U.S. true lease, the lessee exchanges the residual interest in the property and the tax benefits of ownership which arise from its use of the asset (e.g., accelerated tax depreciation, tax credits, or at times government cash grants) for a meaningful reduction in its lease payments (measured on a nominal or present value basis) relative to 100% secured loan or seller financed payments. In this exchange, the lessee transfers the variability associated with changes in residual and tax economics.

Our firm supports continuing the current “front-loaded” expensing for leases which transfer ownership to the lessee by the end of the term and continuing the current expensing on a straight-line basis (unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the property) for leases classified as executory contracts.

Our firm notes the U.S. income tax system, consistent with U.S. commercial law, mirrors the current difference in U.S. GAAP expensing of lease cost—front-loaded expensing for secured financings and generally straight-line expensing for true leases. We believe continued book-tax symmetry offers a superior cost-benefit solution. Today, U.S. tax and U.S. GAAP accounting are both based on the nature of the contract. Although these disciplines use different criteria (all facts and circumstances with economic realities testing for U.S. tax laws), the outcome exhibits a high degree of overlap (with an even higher degree of overlap between U.S. income tax law and IAS 17). If the contract transfers ownership to the lessee by the end of the term, today both disciplines generally report a depreciable asset and related financing with “front-loaded” expensing thereafter. If the contract only conveys a temporary leasehold interest, today both disciplines generally report straight-line expensing. The Board’s approach creates a conceptual divergence with U.S. commercial and income tax law and advances the unproven theory that the difference created by these laws and economic effects is not sufficiently substantive to matter to decision makers. The Board apparently holds this view even though commercial practice and rating agency calculations represent strong proof to the contrary.

If the Board decides to diverge the accounting treatment for true leases (executory contracts), it will create the need for significant changes in systems of record and require reconciliation between them, including deferred income tax calculations. Unlike depreciation differences, where deferred taxes reflect a temporary cash inflow (effectively, a borrowing from the government), deferred taxes arising from the difference in lease cost for true leases does not reflect cash.
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economics. Further, the preparer cost of diverged accounting has questionable benefit given that important users have stated they would have to remove and replace the Board’s proposed accounting for operating leases for their analysis purposes.

Question 3: Lessor Accounting

The Board added the Leases project principally in response to fundamental concerns about lessee accounting. By and large users have not raised fundamental concerns about lessor accounting. Accordingly, our firm believes only targeted changes are necessary and appropriate. Further, since the benefit to users is limited, the cost should be minimized and commensurate on a change-by-change basis.

As explained above, our firm believes the Board should retain the current approach to lessor accounting, a risks and rewards approach grounded in U.S. commercial law upon which leases are created and distinguished by type. For leases which transfer ownership to the lessee by the end of the term, the accounting should remain unchanged. For leases which only convey a temporary leasehold interest (executory contracts), we believe the existing accounting for direct financing and leveraged leases should be retained. These leases revert a significant, but not substantial, residual interest with such leases generally originated by lessors whose business model principally involves the disposition of such interest at lease end--effectively, a terminal cash flow whose realization is predictable based on access to active secondary markets.

For leases which involve the reversion of a substantial residual interest, we believe the accounting for such leases should remain operating lease accounting or, as appropriate, investment property accounting. Lessors who originate leases with high residual values are generally those in asset management business, where their business model involves expertise in redeploying the asset multiple times over its useful life and often involves the rendering of value-added operational services. We view leases involving substantial services as essentially the same service contracts. We note service contracts involving the use of significant assets either explicitly or implicitly recover capital cost in their pricing.

Our firm does not support the elimination of leveraged lease accounting as the proposed change so dramatically distorts the economics of such transactions that it misleads instead of informs financial statement users. By divorcing clearly and closely related tax benefits and disassociating the assignment of unremitted rentals to nonrecourse lender(s), the accounting flows portray leveraged leases as persistent loss generating investments eroding an investor’s equity until at or near lease end when any economic analysis shows the opposite as occurring.
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The Board apparently has proposed the elimination of leveraged leasing to move to a framework without exceptions as a general goal and for convergence purposes. However, we believe that, unless the Board can rebut the basis of the previous Board’s conclusion—the unique economic effect warrants unique accounting—the accounting should remain settled. Otherwise the Board is communicating the goal of achieving “one size fits all” accounting can involve sacrificing faithful portrayal of the economics of transactions, “throwing overboard” faithful representation of transactions arising from a jurisdiction’s unique economic environment for the sake of global convergence. Further, since leveraged leases represent long-term investments, the Board is communicating investors will need to factor the risk of an arbitrary change of accounting into their propensity to enter into long dated transactions.

Question 4: Classification of Leases

Our firm supports the classification of leases into two types; however, the author believes the existing classification criteria set forth in International Accounting Standards No. 17, Leases, is superior to classifying leases under the proposed consumption principle or its proposed presumptive application which effectively asserts equipment loans and leases are generally indistinguishable.

IAS 17 provides a single classification model reflective of the underlying economics of leasing transactions—whether the contract conveys eventual ownership or a meaningful allocation of the risks and rewards incident to ownership. The classification criteria mirrors those commonly used in the U.S. by all other major disciplines, notably commercial law and tax law (including sales, property and income tax laws). The author believes the Boards should seek commonality for cost-benefit reasons unless the other major disciplines regulate transactions based on their form instead of their underlying substance. In the U.S., lease classification is based on substance with indicative (not bright-line) markers designed to ensure a significant transfer of risks and rewards with the attendant variability occurs between the parties.

Our firm believes users and preparers (collectively, society) would be better served with symmetry in lease classification at least in the U.S. By creating a “worlds apart” classification system, the proposed asymmetry would not only create significant incremental preparer costs but it would also create a conflict among the disciplines with the effect of working at cross purposes. U.S. commercial law applicable to equipment leases (Article 2A of the Uniform Commercial Code or “UCC”) clearly and substantively distinguishes the rights and obligations of the parties to a lease compared to the parties to a secured financing. The UCC represents the longest and most elaborate undertaking of uniform acts in U.S. history, taking some 50 years to harmonize
state law with only Louisiana not generally adopting Article 2A. U.S. income tax law allocates the tax benefits in a manner consistent with U.S. commercial law, affording the tax benefits of ownership to either the lessee or the lessor based the substance of the allocation. Apart from the unique “bright line” issue, existing U.S. GAAP for leases generally results in an accounting consistent with the results under U.S. commercial law or income tax law, i.e., the transaction is either a capital lease (a secured financing) or an operating lease (the conveyance of a temporary right of possession with a meaningful residual interest reverting to the lessor).

Question 5: Lease Term

*Initial determination.* We support the Board’s initial determination of lease term as it appears to carry over the well vetted basis of determining lease term from existing U.S. GAAP. To avoid any confusion about the meaning of “significant economic incentive,” our firm recommends the Board affirmatively state in the basis for conclusions that the change in the defining words does not intend to signal a change in the current practice under the existing definition of lease term and the associated definition of penalty. However, if the change in the definition intends to change practice, the Board should state how the initial determination of lease term might differ under the new guidance.

*Reassessment.* Our firm supports extending the existing guidance for debt modifications and extinguishments instead of creating asymmetry between leases and loans through the proposed reassessment regime. If the Board proceeds with lumping together leases which transfer ownership to the lease by the end of the term (leases which are in substance secured financings or conditional sale transactions) and true leases, we believe the same “reassessment” criteria and related accounting applicable to debt should apply to changes in such leases (Topic 310 for lessors and Topic 470 for lessees). If the Board revises its proposal for leases which convey a temporary leasehold interest (e.g. U.S. true leases), we believe any rebooking should be limited to a material change in the provision of the lease agreed by the parties and that it should be accounted for as the extinguishment of an existing lease and the origination of a new lease.

Our firm believes the above recommendation regarding lease term—no change to existing practice in determining existing lease term, generally conformity in the accounting for changes between loans and leases which transfer ownership to the lessee by the end of the term, and extinguishment accounting for material contractual modification of true leases—has a sounder conceptual basis with superior cost-benefit outcome. Further, it ensures the substance and not the form of the contract determines the accounting.
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Question 6: Variable Lease Payments

Since most equipment lease contracts with variable lease payments tied to an index or rate are leases which transfer ownership to the lessee by the end of the term, the accounting for such contracts should mirror the accounting for secured financings or conditional sale transactions. Otherwise, the proposed (re)measurement of variable lease payments would create asymmetry based on the form instead of the substance of the contract. Further, since the Board has proposed essential all equipment leases should be accounted for as Type A leases, it appears internally inconsistent to require asymmetrical accounting between receivables/debt and Type A leases. Finally, since lessors like lenders commonly match fund, the proposed accounting would yield distortive results if the lessor uniquely had to reassess the lease receivable periodically but not the corresponding liability and could not even “fix” the mismatch by electing the fair value option.

Question 7: Transition

Existing capital leases. For cost-benefit reasons, our firm does not support the proposed transition at least with respect to existing capital leases. Since both lessees and lessors would have brought 90-100% of the original fair value on balance sheet and accounted for the recorded amounts as if secured financings or conditional sales agreements, a requirement to recalculate the capitalized amounts for an immaterial difference is unwarranted.

Existing operating leases. Our firm believes users are better served if the Board required operating leases which do not qualify as executory contracts (leases where the parties have the same rights and obligations as lender and borrower) to be accounted for set forth in the transition guidance. For operating leases which qualify as executory contracts, our firm believes the lessee should bring them on balance sheet as if a new lease as of the earliest comparative period presented or as the initial amounts disclosed in the footnotes if constituent feedback and research studies supports expanded disclosure over capitalization (assuming a methodology with common usefulness can be found). We believe a linked presentation either on balance sheet or in the footnotes is appropriate for such leases (executory contracts). For lessors, the transition should yield similar results to those finally adopted by the Board for new transactions. As stated above, we believe the lessor’s business model should determine lessor accounting.
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Question 8: Disclosure

We believe the nature of the contract and internal consistency in reporting should determine the disclosure requirements. As mentioned above, we do not support disclosure by the proposed Type A and Type B as this proposed classification does not properly distinguish between secured financings and true leases (executory contracts) and thus does not meet user needs. For leases which transfer ownership to the lessee by the end of the term and hence constitute either secured financings or conditional sales agreements, we support requiring the same disclosure for these lease contracts as applicable to receivables and debt. We do not see any basis for requiring separate reporting of contracts with identical rights and obligations with similar economic effects differently based on the form of the contract. We believe the preparer should decide whether to aggregate the disclosures for leases which transfer ownership with loans.

Lessee Disclosures for True Leases (Executory Contracts)

For true leases (executory contracts), we support the proposed disclosures for lessees, except for the proposed reconciliation of opening and closing balances for public companies (842-20-50-4). We believe a detailed reconciliation would not be necessary if, for these contracts, the Board appropriately adopts straight-line expensing and a linked presentation (where the reported right-of-use asset and corresponding liability equal the present value of the remaining rentals). We believe users seek information about scheduled future cash flows as proposed at 842-20-50-8 and would derive little benefit from detailed information about past movements through the recordkeeping accounts. We see the proposed reconciliation as evidence of the undue complexity of the Board’s proposed accounting for lease more than a response to user needs.

Lessor Disclosures based on the Business Model

We support the Board’s proposed disclosure for lessors except for the requirement for all lessors to disclose lease income recognized in the reporting period in a tabular format and a detailed reconciliation. We believe the business model should drive disclosures. We believe the Board should not require such disclosures for lessors who generally originate capital leases today, notably bank and finance company lessors. We do not believe users have sought such information in the past nor do we believe they would sufficiently benefit from such disclosures to warrant the cost. For lessors whose are engaged in ongoing asset management, entering into shorter term leases and deriving significant revenues from asset redeployment and asset management services, we believe the existing disclosures for service contract business should apply.
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Question 9: Nonpublic Entities (FASB Only)

In the context of the broad-based consensuses for differential accounting and reporting for nonpublic entities, we support the Board’s efforts to find a reasonable balance between the costs and benefits of information with respect to such entities. Again, we believe the Board can provide a better balance by harmonizing the accounting with existing US GAAP and existing U.S. laws with respect to the reporting of true leases. For leases which convey ownership, the Board should require the same accounting and disclosures as applicable for receivables and debt. For leases which convey a temporary leasehold interest (true leases/executory contracts), the Board should provide for straight-line expensing for lessees with either a linked presentation on the balance sheet or in the footnotes and business model driven accounting for lessors. Since the vast majority of the true leases to nonpublic entities involve small ticket items (e.g., PCs, telecommunications equipment, office furniture and equipment, farm equipment, light manufacturing or processing equipment, trucks and trailers) on leases ranging from 3 to 7 years, we do not see the benefit of the proposed complex lease accounting compounded by the deferred income tax implications. Further, we believe the depressing effect of proposed “front-loaded accounting” for true leases on net income and equity would hamper capital raising for these entities, particularly those in their high growth phase. Users and preparers would be better served with a close alignment of cash, tax and accounting flows.

Question 10-11: Related Party Leases

We agree with the Board’s conclusion that it is not necessary to provide different recognition and measurement requirement for related parties or additional disclosures beyond those required by Topic 850 for related party leases. We do not believe the all-in cost of differential accounting or reporting would provide a commensurate benefit.

Several of our clients are emerging small and mid-sized businesses with related party leases between commonly owned entities. These leases are primary entered into for tax and estate planning purposes or to separate operating and investing activities. Today, if these transactions are material, we generally obtain or prepare combined financial statements as supplemental financial information for use in capital raising. Such statements allow for a clearer assessment of sources and uses of cash and as a reference point in developing the terms and conditions of any related external financing. We find this supplemental information to be more useful than attempting to confirm whether the accounting reflects the economic substance of such leases.