

December 21, 2010

Ms. Leslie Seidman, Acting Chairwoman, Financial Accounting and Standards Board 301 Merritt 7 P.O Box 5116 Norwalk, CT 06856-05116

Sir David Tweedie, Chairman, International Accounting Standards Board 30 Cannon Street London ED 4M6XH United Kingdom

Attention: Respective Technical Directors on Lease Accounting

Re: File Reference No. 1850-100, Exposure Draft: Leases and Exposure Draft, Leases, ED/2010/9

Submitted via electronic mail

Dear Board Chairs Seidman and Sir David:

The Association for Financial Professionals (AFP) appreciates the opportunity to express our members' thoughts on the proposed *Accounting Standards Update on Leases* (FASB Topic 840 and IAS 17). AFP represents approximately 16,000 accounting, financial and treasury professionals from over 5,000 corporations, including the Fortune 1,000 and the largest of the middle market companies. Our membership includes a number of corporations who lease property and equipment as part of their normal business operations, such as those whose primary business is in the retail and manufacturing industry. This proposal would have a significant impact on the financial reporting of their existing leases, and could significantly impact their decision when entering into future leases.

AFP applauds the FASB and the IASB for taking on this important issue and supports your goal to improve the transparency, credibility and usefulness of lease accounting. The Equipment Leasing and Finance Association (ELFA) estimate that US public companies have approximately \$1.3 trillion in operating lease payments that are currently not being reported on the balance sheet. AFP recognizes that there have been questionable practices surrounding the off balance sheet reporting of some

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operating leases, particularly leveraged leases and structure transactions. However, we question whether the proposed model is the right answer.

Earlier, AFP sent in comments on the *Discussion Paper*, *Leases: Preliminary Views*. AFP also signed on to the joint comment letter issued to the G-20 spearheaded by the Chamber of Commerce and the joint letter submitted to the FASB and IASB on this exposure draft. While those documents express our consensus views on lease accounting issues, this letter explains our specific views.

## Consider Impact of Debt Covenants and Other Contractual Agreements upon Implementation

Upon implementation of the proposed standard, companies' debt covenants and other contractual agreements tied to their balance sheet ratios may have to be restructured as the liability that would be required to be booked could have a significant impact on liabilities within their current allowable limits. While the new standard will also raise the amount of recorded assets, many companies' leverage ratios will go up nevertheless because (1) the increase in the asset base was funded with liabilities and not equity and (2) the write-down of the liability may not be proportionate to the corresponding asset. Thus, the implementation of this standard could add additional strain on business credit lines.

# <u>Consider the potential impact on the ability of businesses to borrow, the cost of leases, and capital formation</u>

The proposed approach to lease accounting will cause companies to reflect a greater amount of assets and liabilities on the balance sheet, which could potentially cause companies to be more leveraged. The proposal requires that the former rental expenses be replaced with interest and depreciation expenses as part of the asset and liability calculations. These changes will change the calculation of earnings before interest, depreciation and taxes (EBIDTA) and the current leverage ratios, which are key economic performance indicators. Such changes would likely increase EBIDTA thereby affecting financial incurrence covenants. The standard setters should consider that because of the proposed changes, companies might inadvertently be unable to meet an incurrence test, which could hamper their ability to incur debt, divest companies or acquire companies.

In addition, these lease accounting changes could add to the calculation of financial maintenance covenants that could result in a default of bank agreements. These agreements may be large enough to cross default bond and other agreements. Permitted debt baskets are also in jeopardy of being breached, due to the added debt to a company's balance sheet. Such a breech could ultimately reduce the amount of credit available to the company.

There are also energy supplier agreements and other vendor agreements that can often include triggers that will change credit terms or require a credit review. Some are tied to ratios or leverage levels. A change in the liabilities stated on the balance sheet could easily trigger these agreements, providing a company less credit or even prepayments in cash. A company may be required to take on more debt since they will not have as favorable vendor terms.

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AFP members utilize the lease option because it gives them an alternative to having the rights and use of a needed asset without deploying a significant amount of cash for the acquisition. According to the ELFA, the equipment leasing finance industry is estimated to be a \$650 billion industry. Without the perceived benefits of leasing equipment, companies may decide purchasing the assets is the more viable option versus leasing and then having to comply with the proposed lease accounting requirements. If companies begin adopting this business strategy, the leasing industry will be adversely impacted.

## **Consider Cost vs. Benefit**

Standard setters should consider the impact that its rulemaking will have on small to medium sized companies with average personnel and uncomplicated systems. The proposed standard should not be so complex that implementation of this standard would far outweigh its benefit. In our previously submitted individual comment letter, we urged the standard setters to consider a de minimus scope exception for applying the standard to simple lease contracts. We applaud your reaction to this comment in this proposed standard for leases whose contractual term is one year or less. However, only scoping out these "short term" leases will still have a significant impact on many companies with simple ancillary lease contracts for a slightly longer term. Additionally, the proposed guidance may also cause lessors to structure contract for shorter terms as a way of circumventing the spirit of accounting standard.

In the lessor accounting model, you provided two accounting approaches: (1) performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying assets during or after the expected lease term and (2) derecognition approach otherwise. The Boards should also consider a simple lease accounting approach for lease contracts terms three years or less that are considered ancillary to companies' business operations (e.g. copiers in a retail company). AFP is a proponent of financial statements that are transparent but not so detailed as to detract from their usefulness. We hope you also consider materiality, size and complexity of the entity and business use for the lease when providing a scope exception.

## **Conclusion**

We thank you for the opportunity to share out comments on this matter. We would be glad to discuss our opinions with you further should you have any questions or require additional information. Please feel free to contact Salome J. Tinker, AFP's Director of Accounting Policy ad Financial Reporting at (301) 961-8871. She will be present at your roundtable on leases held at Norwalk on January 6<sup>th.</sup>

Sincerely,

June M. Johnson, CPA, CTP

Chair of the AFP's Financial Accounting and

**Investor Relations Task Force** 

Joseph C. Meek,

Chair of the AFP's Government

**Relations Committee** 

# Responses to Questions Proposed in the Proposed ASU on Leases (FASB Topic 840)

## The Accounting Model

#### **Question 1: Leases**

- (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?
  - We understand your rationale for taking this position. However, we believe that the level of complexity needed for determining the initial and ongoing values associated with the asset may not be available for some mid and small sized entities.
- (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?

Applying different methods for subsequently amortizing the right-of-use asset and the lease payment liability may cause unwarranted volatility in earnings. Under the proposed approach, the right-of use asset is amortized on a straight-line basis, while the lease payment liability is amortized using a level-yield method. We believe that the right-of-use asset is directly linked to the lease payment obligation. Tying the amortization of the asset to the periodic reduction of the corresponding liability would also provide for greater operational simplicity and transparency for users of the financial statements and reduce the income volatility. Thus, if this proposed standard becomes a formal standard, we urge the Boards to reconsider the proposed amortization approach.

#### **Question 2: Lessors**

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risk or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

We believe the current accounting for lessors is not conceptually flawed. Thus, we do not understand the need to move away from that model. If, however, this proposal becomes the standard, we believe there should be symmetrical accounting for the lessor and the lessee. Therefore, if the lessor has the ability to recognize the asset on its balance sheet because it has retained significant control during the leased term, the performance obligation approach is reasonable. The corresponding lessee should not be able to recognize that same asset because the rights and obligations have not been passed. Likewise, if the lessor has relinquished control over the asset during the lease term, the derecognition approach is warranted and symmetrical accounting for the lessee should be applied.

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- (b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?
  - See (a) above.
- (c) Do you agree that there should be no separate approach for lessors with leveraged leases, as currently provided for under US GAAP (par BC 15)? If not, why not? What approach should be applied to those leases and why?

Initially, this project was undertaken to develop one model of accounting for lessors and lessee. However, during deliberations, a two tier approach has been proposed for the lessor. We agree that there should not be a separate approach for lessors with leveraged leases. However, since a two tiered lease accounting model was created for the lessor, we urge the consideration of a two tiered on-balance-sheet approach be also proposed for the lessee.

#### **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 payment 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 (par. 64).
- (b) At the 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 I a 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 (par 65) (also pars. BC41 and BC 46)

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?

While we agree with the alternative approach for short-term leases, we do not see how this will be practically applied. Most simple lease contracts span a period of greater than one year. In the case where a simple lease contract can be made shorter to meet this definition, it would be scoped in if the contract has any options for renewal that the company will more likely than not exercise.

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We urge the FASB/IASB to take this into consideration how such an accounting decision could significantly cripple the whole leasing industry. Take a basic copier or computer lease contract as an example. Many companies utilize these forms of leases after weighing the costs of acquiring such capital expenditures used to support their core business objectives. These lease contract terms generally span three year with possible renewable options; not a one year term. The proposed scope exception would not be applicable and will require that these ancillary leases follow the same stringent lease accounting requirements. Again, AFP recognizes that there have been questionable practices surrounding the off balance sheet reporting of some operating leases, particularly leveraged leases and structure transactions.

However, proposing such stringent accounting requirements on all simple leases may consequently cause companies to reconsider whether leasing is still a viable business option versus purchasing the same asset. Thus, we urge you to consider expanding the proposed approach to consider either the business use of the leased asset or a instituting a materiality criteria for application.

Alternatively, a less stringent lease accounting model could be developed for companies falling under this criteria. FASB/IASB might consider allowing non-core leases to continue to be accounted for as operating lease and/or move forward with the AICPA/FAF/NASBA Private Company "Blue-Ribbon Panel's" recommendation to consider creating separate accounting guidance for private and smaller entities; similar to the IASB's SME guidance.

## Question 4: Definition of a lease

This exposure draft proposes to define a lease as a contract in which the right to use a specific asset or assets is conveyed, for a period of time, in exchange for consideration. This exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale and n distinguishing a lease from a service contract.

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

We can support your proposed definition of a lease.

## Scope

#### **Question 5: Scope Exception**

This exposure draft proposes that a lessee or a lessor should apply the proposed guidance to all leases, including leases of right-to-use assets in a sublease, except leases of intangible assets, leases of biological

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assets and leases to explore for or use minerals, oil, natural gas or similar non-regenerative resources. Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

We believe if the leased equipment is used to support a company's core business activity it should be scoped in this proposed guidance. There is no apparent difference between an oil company that leases the rigging equipment to mine for oil and an airline company leasing its planes. The entities should follow the proposed guidance as the leased asset is critical to their core business activity.

## **Question 6: Contracts that Contain Service Components and Lease Components**

This exposure draft proposes that leases 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. If the service component in a contact that contains service components and lease components is not distinct:

- (a) The FASB proposed the lessee and lessor should apply the lease accounting requirements to the combined contract.
- (b) The IASB proposes that:
  - a. A lessee should apply the lease accounting requirements to the combined contract.
  - b. A lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
  - c. A lessor that applies the derecognition approach should account for the lease component in accordance with the guidance in the exposure draft on revenue 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?

AFP understands your rationale but notes that it could be very difficult to implement for mid to smaller sized entities following US GAAP, and an onerous reporting requirement for entities that enter into ancillary leases that are not necessarily needed to fulfill their core business activity. The IASB should consider making a distinction in their SME guidance.

## **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.

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 lessees or a lessor should account for purchase options and why?

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We agree that a purchase option should be accounted for only when they are exercised.

#### **Question 8: Lease Term**

Do you agree that 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 any effects 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?

The lease term should not take into consideration any options to extend or terminate the lease, or any other contingencies. The lessor or lessee should only consider the contractual lease terms that exist at the recording date. At inception the lessor/lessee is not committed nor obligated to exercise its option even if it believes it may. Subsequently, management may revisit its strategy and take a different approach. Taking these options into consideration upon entering a lease may mislead the users of the financial statements as the calculation would introduce a great deal of subjectivity. We would be more in favor if the effects of such options and contingencies be disclosed in the notes of the financial statements.

#### **Question 9: Lease Payments**

- (a) 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?
- (b) 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 reliability measured? Why or why not?

Consideration of such contingencies, such as renewable options, expected payments, option penalties or residual value guarantees, should not be included in the initial measurement of the right-of-use assets or liabilities. These factors should not be considered until the option is exercised, an obligation is created or a penalty has been imposed. We agree with Mr. Stephen Cooper's dissention that:

- Lease payments which an entity has not contractual or constructive obligation to pay do not meet the conceptual definition of a liability;
- Including such amounts would therefore overstate financial leverage on the part of the lessee (and would also overstate the lessor's receivable, implying an exposure to credit risk when the reality is an exposure to underlying asset risk); and

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> Estimating contingent rentals and lease renewal periods out many years in the future would lead to a greater amount of subjectivity, and a consequent loss in reliability and comparability in the financial statements.

## **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?

All assets or liabilities should be reassessed and revalued if conditions changes that would make the current value of such assets or liabilities misleading to users of the financial statements.

#### **Question 11: Sale and Leaseback**

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchase or sales and leases. If the contract represents a sale of the underlying asset, the leaseback also would meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee.

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

We express no opinion regarding this question.

#### Presentation

#### **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? 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?
- (b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totaling to a net lease asset or lease liability? Why or why not? If not, do you

- think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?
- (c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from the financial assets and should present residual assets separately within property, plant and equipment? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?
- (d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

We express no opinion on how it is reported so long as it's presentation is transparent to the users and the disclosures are not so detailed and overly complex that the intended usefulness is diminished.

#### **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? Why or why not? If not, do you think that a lessee should disclose hat information in the notes instead? Why or why not?

See response to question 12.

#### **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? 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?

See response to question 12.

#### **Question 15: Disclosure**

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;
- (b) Describes how leases may affect the amount, timing and uncertainty of entity's further cash flows?

Why or why not? If not, how would you amend the objectives and why?

See response to question 12.

#### **Question 16: Transition**

(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. Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

We could support a simplified retrospective approach for existing leases. This would include retrospective application of leases existing at the initial adoption date and not those that have expired during comparative years presented. Making a determination of what was "more-likely-than-not" in earlier periods and estimating full lease terms taking into consideration contingencies and options would be extremely subjective.

(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

We would not be in favor of a full retrospective approach as we do not believe that the benefit of deriving such figures for all leases retrospectively would outweigh the costs that would have to be expended.

(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

We have no additional comments in this area.

#### **Question 17: Benefits and Costs**

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 think that for larger companies the Boards' rationale may hold true. However, AFP questions whether this is the case for all companies, irrespective of size, who follow US GAAP. We question how many smaller companies have the level of sophistication needed upon adoption to record the leased asset under the proposed approach. What costs would have to be expended for compliance? Would this require system changes, periodic valuation of leases from external sources? AFP does not see the benefit that will be derived from the costs that will have to be expended to implement this new approach.

#### **Question 18: Other Comments**

Do you have any other comments on the proposal?

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We do not have any additional comments at this time but reserve the right to make additional comments if we are made aware of any new issues with this proposal.

# **Question 19: Non-public entities**

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?

As stated above, we urge the FASB to consider a scope exception based on the use of the leased asset as well as materiality. We also urge the FASB to consider the AICPA/FAF/NASBA Private Company "Blue-Ribbon Panel" recommendation for an alternative accounting standards for such entities.