

August 28, 2013

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Via email: director@fasb.org

File Reference: FASB No. 2013-270 *Leases (Topic 842): a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840)*

Dear Chairman Golden:

The American Bankers Association¹ (ABA) appreciates the opportunity to comment on the exposure drafts (ED), *Leases* (the IASB proposal) and *Leases (Topic 842): a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840)* (the FASB proposal). Banking institutions are not only preparers of financial statements as lessees and lessors, but are also users of financial statements that analyze and depend on such statements of customers. In fact, credit officers at banking institutions probably make up the largest group of users of financial statements that will be affected by the ED.

The most significant part of the ED affects lessees, and is the requirement to record right-of-use assets and lease liabilities for virtually all leases with terms longer than twelve months. These requirements will change key metrics used to analyze both a lessee's financial position and its financial performance if those metrics are derived strictly off of amounts recorded on the balance sheet, income statement, and statement of cash flows. The requirements will naturally present operational challenges to any organization in the U.S. that leases property or equipment due to the need to set up and continuously account for the new assets and liabilities, as well as to auditors and users of financial statements who must understand the new and ongoing complexities.

The ED also proposes to eliminate leveraged lease accounting for lessors. Current U.S. GAAP recognizes the difference, in both form and economic substance, between standard two-party lease transactions and three-party leveraged lease transactions. By eliminating leveraged lease accounting and implementing the proposed requirements, lessors will be required to present receivables that have no practical risk of loss and report income in portions of the income statement that do not reflect the substance of the investment.

¹ The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$14 trillion banking industry and its two million employees.

As a result, the changes proposed in the ED will have an enormous impact for both preparers and users of financial statements and may change how business is conducted for almost all entities in the U.S.

A Thorough Cost/benefit Study Must be Done.

The ED operationally simplifies several key portions of the 2010 exposure draft – especially as they related to renewal options, contingent rents and property lease revenue and expense recognition. These concerns were expressed by ABA and many other respondents to the 2010 exposure draft, and ABA salutes FASB and the IASB for conducting a thoughtful and deliberate due diligence process thus far and responding to constituent concerns. However, significant concerns related to the ED still remain – we believe that lessee accounting is still too complicated and we are not convinced that the vast majority of financial statement users – especially lenders to small businesses – will obtain a sufficient increase in decision-useful value to justify the change. Given the enormous impact of the changes proposed, one of the most important steps of legitimate due process – a cost/benefit study supported by field testing – has yet to be shared with constituents.

The requirements in the ED will essentially end the vast majority of off-balance sheet financing opportunities that are currently taken advantage of by companies in various industries. This does not necessarily spell the end of the leasing industry, as there are other very significant advantages of leasing, namely flexible financing terms, transfer of ownership risks (such as obsolescence and market values), and certain tax advantages. However, the breadth of change proposed is extensive and the complexity staggering to all but the most sophisticated of financial statement preparers. Considering that all lessees – from the largest corporations that lease their heavy equipment to the local nonprofit organization that rents its store space – must comply with these requirements, the cost/benefit study must address the issues that apply to entities of all sizes.

Important Points to Evaluate When Analyzing the Benefits of the ED

The central tenet of the ED – all long-term lease obligations are recorded on the balance sheet – appears to be the main benefit of the ED.² Evidence of this is that many credit analysts are already making adjustments (noted below) that are being proposed in the ED for operating leases. The goal appears to be to enhance transparency, improve comparability, and remove the bright-line tests, thereby reducing most instances of structuring leases to achieve specific accounting results. While perhaps awkward that such obligations for operating leases are not currently recorded, the *incremental* benefit of changing this standard is, in the end, questionable. Although the fact that analysts are making these adjustments help support the rationale for the ED, the ease of adjustment by investors also makes it more difficult to justify the implementation costs of making the changes required by the ED. As the boards conduct their study of the benefits of recording these liabilities on the balance sheet, we urge the boards to address the following questions:

² In both the FASB proposal and the IASB proposal, improvement to current lease accounting focuses almost solely on the recording of the assets and liabilities on the balance sheet.

- Considering that many analysts (and virtually all analysts of large companies) already estimate a leverage and cost impact of operating leases and accordingly adjust the financial statements within their own analyses, how much more accurate will the buy/sell (or lend/reject) decision be as a result of the new accounting standard? Would past decisions have changed if users had utilized the proposed standard? Will capital be allocated more appropriately in the future?
- Considering that those analysts that already estimate and adjust financial statements for the impact of operating leases, but do not do so in accordance with the methods required in the ED, what incremental value will be received by these analysts, especially if they will substitute their existing formulas to determine leverage and future expenses for those recorded on the face of the financial statements?³
- Considering that leasing expenses will often be presented in at least three different places on the income statement, as well as two different sections in the statement of cash flows, will users really find improved transparency? Or will additional adjustments be required?⁴ Will the benefit of an improved comparability of leverage⁵ be overshadowed by more confusing statements of performance?
- Should the removal of bright-line tests and the reduction of structuring opportunities be considered a “benefit” in the cost/benefit analysis? Upon implementation, bright-line tests may quickly form around terms such as “significant economic incentive” (as it relates to renewal options), “major part of the underlying asset’s remaining economic life” and “substantially all of the fair value of the underlying asset” (as they relate to Type A leases), and “insignificant” (in relation to the total economic life and the fair value of the underlying asset of Type B leases). In fact, ABA believes that bright-line tests are necessary, in many cases, to limit the costs of compliance and auditing.⁶

³ We understand that enhanced disclosures will benefit the financial statement user. However, it is virtually certain that analysts will continue to make adjustments to recorded amounts for many companies, as amounts for contingent rent assumptions (for example, based on projected sales) and renewals will be factored in. We also believe differences in assumed discount rates are another source of adjustments to be made. Some also believe that many credit officers will replace recorded expense amounts with cash amounts paid, as credit officers generally focus strictly on cash flows.

⁴ Amortization expenses and interest expenses (related to Type A leases), lease expenses (related to Type B leases) and other expenses (relating to short-term leases, variable payments and non-lease components) will be reported in different sections of the income statement. Those who are interested in total leasing costs will be required to find these costs in three different places.

⁵ Improved comparability of leverage is not always achieved; as it appears that nonprofit institutions that report donated rent as in-kind contributions must record corresponding right-of-use assets and lease liabilities. Further, according to Accounting Standards Codification Topic 958-605, such donation revenue would be recorded at fair value, though, as we understand the ED, the corresponding lease expense may not necessarily reflect fair value.

⁶ While the ED requirements will greatly reduce the structuring opportunities related to whether right-of-use assets and liabilities will be recorded on the assets of the lessee, there will continue to be structuring opportunities related to the size of the assets and liabilities recorded by the lessee, as well as to whether the lessor will record the assets and liabilities.

- It is understood that lease agreements are different from service and other executory contracts. However, significant value is normally placed on the value of those other contracts when making an investment or lending decision – just as much as the value of a lease. Considering that the purpose of general purpose financial reporting is to provide information related to the amount, timing, and uncertainty (prospects for) future net cash inflows to the entity,⁷ are the similarities between service contracts and leases sufficient enough that the boards may be viewed as undermining their overall conceptual framework by including lease agreements on the balance sheet and excluding other contracts?⁸ We also believe that the boards should provide a basis as to why leases are not considered forward contracts, accounted for as financial assets or liabilities on a net basis⁹. As the requirements in the ED represent an enormous change in accounting theory (in essence, a new class of asset is being introduced), sufficient explanations should be provided for all treatment alternatives.

Analyzing the Costs Borne by the Lessee

Of course, significant one-time costs will be borne to identify and evaluate all possible contracts that may now fall into the scope of the new standard.¹⁰ It is also clear to us that the requirements in the ED will require not only new, robust software to perform the calculations, but also a savvy gatekeeper who can make the required judgments needed on an ongoing basis to comply with the requirements. The cost of these complications will be largely shouldered by lessees, most of which will be small, privately-held and nonprofit entities¹¹ that likely lack the expertise needed to continuously maintain the required lease accounting systems. We are concerned that the boards may be under estimating compliance costs for most lessees, which could be significant, especially for those that are subject to audit. With this in mind, the following questions related to requirements of the lessee are important to evaluate:

- Is it worth it for lessees to continually remeasure Type B lease liabilities that are solely due to changes in the variable rate index, when such changes will have no impact on the total lease expense?

⁷ Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting*.

⁸ The Basis for Conclusions in the ED explains how a service contract is different from a lease. However, it should be noted that the proposed accounting for Type B contracts, with straight-line expense recognition by lessees that is also presented as “lease expense”, appears to be the same as the accounting for a service contract. The ED’s proposal for lessors also mirrors this service contract accounting, as no lease receivable/obligation is recognized in the ED or under service contract accounting. So, it appears that the boards are mixing accounting models within the ED.

⁹ We are not advocating this treatment at this time. However, the ED and the original discussion paper do not explain why the right-of-use asset is not a financial asset.

¹⁰ Transition will include not only analyzing all current operating leases, but it will require analyzing all leases to determine whether observable standalone prices exist on maintenance and other service contracts. Without observable standalone prices, both the lease and the service contract are included within the lease’s unit of account.

¹¹ Many of these organizations will be customers of ABA-member institutions, of course.

- Given that many current operating leases are anticipated to be Type A leases (with treatment similar to current capital leases) rather than Type B leases (with straight-line expensing), are small organizations equipped to perform regular impairment testing?
- Given that expense recognition for Type B leases makes it more likely that impairment of the right-of-use asset can occur during the early years of a lease term,¹² are small organizations equipped to perform impairment testing on these leases?

ABA is confident that software vendors will develop and sell solutions that can greatly assist in the calculation of right-of-use assets. However, the underlying assumptions that will drive the software will need to be determined by someone in the organization that understands both the requirements and the business in order to drive the various factors needed for re-measurement of the lease liabilities. We are not confident that many small businesses have such an individual.

Analyzing the Costs Borne by the User

In addition to the time required to adjust the financial statement amounts as noted above, financial statement users will incur additional costs within the transition period in order to change the contractual infrastructure around leasing activity. Based upon our reading of the basis for conclusions, it appears that such costs have not yet been considered. However, banks, bondholders, and governmental entities (both regulators and entities which contract with companies that enter into leases) will need to reconsider loan covenants and regulations that refer to amounts or ratios based on current GAAP.¹³

Within the banking system, in addition to a change in the key metric “net interest margin”¹⁴, changes resulting from the standard will have an impact on regulatory leverage ratios and common equity tier 1 capital. Further, these changes will then affect FDIC assessment rates on individual banks and also subject banks to related deferred tax asset and fixed asset limitations. While FASB does not regard the industry regulator to be its prime constituent and may believe that regulators may adjust their formulas from GAAP-based metrics, FASB must take into account the time it will take to review this change

¹² This occurs because, in order to attain a straight-line total lease expense, the pattern of the amortization of the right-of-use asset is the opposite of the pattern of interest expense recorded. Since interest expense is front-end loaded, the amortization is, thus, back-end loaded. While impairment of the right-of-use asset is less likely for Type B (most real estate) leases than Type A (most equipment) leases, the pattern of the amortization will make it likely that the analysis will be a critical requirement during an audit. Therefore, while the boards sought to simplify the Type B lessee accounting by providing a straight-line expense solution, the impairment review process, as required by eliminating the off-balance sheet treatment of the lease, has eliminated that operational benefit.

¹³ Among other metrics, leverage ratios, long-term debt-to-equity ratios, fixed asset ratios, intangible asset limitations, earnings before income taxes, depreciation, and amortization (EBITDA), net income, and operating cash flows will be affected.

¹⁴ Users of bank financial statements will make an adjustment to exclude interest expense amounts from lease liabilities, due to the common understanding that net interest margin measures the spread between the income earned on financial assets and the expenses on debts that fund those assets. Lease liabilities are generally not assumed to fund financial assets.

within the cost estimates. This change will not only be addressed by banking regulators, but regulators and government agencies across virtually all regulated industries at the federal, state, and local levels.

As users of financial statements prepared by bank borrowers, we believe that most existing covenants will need to be changed as a result of the new standard. It should be noted that this is a time-consuming process: banks will need to contact customers; explain the reason for the change; in some cases, renegotiations can result in other costs either to banks or their customers who may want to renegotiate other portions that they would not otherwise consider; banks will need to involve legal counsel (for many smaller banks, this will likely involve hiring outside counsel); and banks will need to obtain signatures from customers. In addition to the legal and other administrative costs involved to change the contracts, significant time will be needed to determine the appropriate metrics to be included going forward.

Analyzing the Long-Term Costs to the Overall Accounting Environment

Although users of financial statements generally prefer one set of high quality accounting standards, the FASB has appropriately recognized that users of private company financial statements often do not require or desire compliance with certain standards that are complex, may obfuscate practical risks, or are not cost-beneficial. As a result, the Private Company Council (PCC) was formed by FASB's parent organization, the Financial Accounting Foundation. The PCC was formed to improve the process of setting accounting standards for private companies and is currently in the process of reviewing certain existing standards for possible modification. We supported the formation of the PCC and understand that the PCC will weigh-in with its recommendations to FASB related to lease accounting. However, due to the recent formation of the PCC, we are concerned that it has not had the time to appropriately examine and deliberate on the exposure draft. This, combined with our concerns about the impact of the ED on smaller companies, leads us to believe that FASB's and the PCC's credibility toward the concerns of private companies will be compromised unless the PCC is given adequate time to address leasing.

The American Institute of CPA's Financial Reporting Framework for SMEs (FRF) is an Other Comprehensive Basis of Accounting for small and medium-sized entities that is meant to be sensitive toward these entities. For example, lease accounting within the FRF complies with current GAAP, and certain representatives from the AICPA have indicated that there is no intention to change lease accounting. The recently-issued FRF may, thus, be viewed as a competing set of accounting standards to GAAP. Normally, a competing set of standards does not present a problem for users or for preparers of financial statements, as differences in the standards are normally vast (for example, cash basis accounting is significantly different from accrual accounting), and their purposes distinct. However, assuming the ultimate approval by FASB of the outstanding exposure drafts that have been issued so far as a result of recommendations of the PCC, it appears that if the ED is approved, the sole significant difference between private company-GAAP and the FRF will be related to lease accounting.

ABA believes that an accounting environment of similar and competing accounting standards will create confusion among many of the constituents of the FASB, especially for those who use, prepare, and audit small business financial statements. Although we prefer that accounting standards be the same for

all sizes of companies, we understand the need for there to be differences in accounting between large and small companies under certain circumstances.¹⁵ Our preference is to ensure that any new leasing standard pass the costs vs. benefits test for all users and preparers, both large and small, without a need for a private company version of leasing.

With this in mind, ABA strongly urges FASB to allow the PCC sufficient time to review the ED, perform their own constituent outreach, and evaluate the impact on their constituents. We believe it is important for the PCC to weigh in on leasing, and we hope that this process will result in an improvement to lease accounting that can be adopted by companies of all sizes.

The Requirements Will Distort Lessor Risks in Leveraged Lease Agreements

Within the Basis for Conclusions, the ED notes that the boards expect the proposed requirements will result in "...a more accurate reflection of the rights and obligations from leases..." While there are those who find this to be a reasonable assumption for many leasing arrangements (subject to the cost/benefit analysis described above), this is certainly not the case for lessors in a leveraged lease arrangement. While leveraged leasing involves contracts as defined in the ED, the risks involved and the returns are significantly different from standard leases.

Unlike other leases, leveraged leases have three parties (a lessee, a lessor, and a third-party creditor). While the lessor acquires and leases equipment with funds borrowed from the creditor, the creditor looks to the credit of the lessee and the underlying equipment value in the event of default of the nonrecourse loan. Tax advantages are key aspects of these transactions, and the current accounting standards appropriately address the economic risks and returns inherent to the lessor by presenting rent receivable net of the portion that is applicable to principal and interest on the nonrecourse debt, by recognizing income on an after-tax basis, and by presenting that net revenue within operating income.

The requirements of the ED ignore the three-party arrangement and the critical aspect of how leveraged leasing decisions are made, including the after-tax advantages. As a result, lessor leverage is overstated, as the rent receivable will no longer be reported net of the portion to be paid for principal and interest of the underlying nonrecourse debt. Further, operating revenue will be misstated, with a portion of the economic benefit now reflected within income tax expense.¹⁶

ABA understands that current International Financial Reporting Standards do not address leveraged leases and that the removal of leveraged lease accounting under GAAP represents an effort to converge

¹⁵ ABA supports providing longer transition periods for smaller companies, as this practice merely provides temporary differences in the standards. Smaller companies can learn from mistakes made during implementation by other companies. ABA further believes that differences in the level of disclosure and in the limited use of practical alternatives related to recognition and measurement can be appropriate for smaller companies. The exposure drafts recommended by the PCC generally conform to these principles.

¹⁶ Some may say that operating income will now be accurately presented. However, a predominant factor in the investment decision (the income tax advantages) will be removed from where the related income is reported.

with IFRS. Further, ABA understands that the boards believe it is desirable to streamline the different lessor accounting models.¹⁷ However, we highly recommend that FASB maintain the existing leveraged lease accounting.¹⁸ As noted above, leveraged lease transactions have both a very different transaction structure from other leases and also a different investment motivation. Two key differences are:

- Leveraged lease transactions involve three parties, in which nonrecourse debt is issued by the lessor. Unlike a standard leasing transaction, the lessor has not effectively provided financing to the lessee. Funding obtained by the lessor comes from a nonrecourse loan, underwritten based on the credit quality of the lessee and the value of the equipment.
- Leveraged lease transactions are investments made by the lessor whereby substantially all the expected benefits of the leasing arrangement are from tax credits or other tax benefits.¹⁹ After-tax return is an important factor in entering into such arrangements. These transactions are so unique that specific tax rulings in the U.S. address leveraged leasing issues.

If it is the intent of the boards to more accurately reflect leverage and income based on how an entity views its investments, then the boards must retain the unique features of current leveraged lease accounting.²⁰ If the boards insist on ending leveraged lease accounting, various operational challenges exist, related mainly to previous business combination accounting, and we strongly recommend that existing leveraged lease arrangements be grandfathered to continue the current accounting until the expiration of these leases. Grandfathering will maintain the accuracy of leverage of lessors and greatly alleviate the challenges presented by transition.²¹

¹⁷ Within the ED's Basis for Conclusions, only the streamlining issue ("all leases should be accounted for in a consistent manner") is mentioned as a reason to discontinue leveraged lease accounting.

¹⁸ We emphasize that leveraged lease accounting is unique only for lessors. Lessees currently account for leveraged leases as capital leases, and we anticipate that such leases would generally be considered Type A leases under the ED.

¹⁹ It should be noted that Current leveraged lease accounting, whereby income recognition is based on expected after-tax benefits and presentation of the after-tax benefits are reported within operating income, is consistent with the recent decisions of the Emerging Issues Task Force, which resulted in Exposure Draft EITF 13-B *Accounting for Qualified Affordable Housing Projects*. Exposure Draft EITF 13-B recognizes the critical aspect of tax credits and other tax benefits within a business decision and proposes that net income from these investments be presented in one section of the income statement.

²⁰ Some may equate the current leveraged lease accounting treatment to the "off balance sheet" treatment of mortgage loans related to securities formed through Qualifying Special Purpose Entities (QSPEs, which were eliminated with FASB Statement No. 167 and resulted in the consolidation of the vast majority of such assets on bank balance sheets), and they believe the proposed accounting better reflects the risks involved to the lessor. This analogy is false, because there is no practical magnification of impairment risk related to the lease receivable within a leveraged lease agreement as there was related to the recorded balance of many mortgage securities formed through QSPEs.

²¹ Due to factors that include anticipation of the ED as well as the current environment related to federal tax policy, the leveraged leasing market has been relatively inactive for the past several years. Thus, the majority of existing leveraged leases are likely to expire over the next several years.

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A Minimum Three Year Transition Will be Required.

The systemic impact of the changes proposed in the ED should not be underestimated, as these changes will impact how lenders calculate the creditworthiness of their customers. Further, the proposal will require companies to often maintain information they have never maintained.

Because of the significant impact on the accounting for the majority of businesses in the U.S. and the potential for changes in loan covenant status for many borrowers, we believe that a minimum of two to three years after issuance will be required to transition to the new standard. Implementation will be especially complicated for lenders who will likely need to examine customers' preliminary financial statements in order to determine how covenants will need to change. Due to the complexities and judgments required in the ED, these preliminary results may change, as adjustments are likely to be made during the initial audit process subsequent to implementation. Analyses that are based on current industry norms will also need to be reevaluated, as those norms are likely to change. These are merely a few factors in the transition process that must be considered so that the bank customers are not in default and the business of lending is not subject to unnecessary delays.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,



Michael L. Gullette