Investor Advisory Committee

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Via Email

September 9, 2013

Technical Director
Financial Accounting Standards Board
File Reference No. 2011-230
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

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

Dear Technical Director:

The Investor Advisory Committee (IAC) ¹ appreciates the opportunity to comment on the FASB's *Proposed ASU-Leases (Topic 842): a revision of the 2010 proposed FASB ASU*, Leases (Topic 840). IAC applauds the efforts of both boards to develop a converged accounting standard for leases. IAC does not support the lease proposal because it is not an improvement to current US GAAP lease accounting for the following reasons:

- The lease liability number is based on the legal lease term and a company's discount rate. This is not decision useful information because it does not reflect the economic substance of a lease nor will it be comparable across companies.
- IAC does not consider the economic substance of an equipment lease and a property lease to be different, therefore, the income statement and cash flow measurement and presentation should be equivalent.

http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1175801857636.

¹ This letter represents the views of the Investor Advisory Committee ("IAC" or "Committee") and does not necessarily represent the views of its individual members or the organizations by which they are employed. IAC views are developed by the members of the Committee independent of the views of the Financial Accounting Standards Board and its staff. For more information about the IAC, including a listing of the current members and the organizations in which they are employed, see

- IAC does not support the lessor accounting for Type A equipment leases which provides for upfront profit recognition.
- The proposal substitutes a new rules-based accounting standard (equipment versus property leases, and legal lease terms) for the previous rules-based accounting standard (capital versus operating lease bright lines).
- The majority of analysts have traditionally viewed the current lease accounting's income statement and cash flow statement measurement and presentation as an accurate representation of the economic substance of a lease. The proposal is not an improvement to current accounting in these areas.

IAC understands the desire to reflect the lease liability on a company's balance sheet, however, we believe no single amount can provide a complete picture of these complex arrangements. FASB should not attempt a one-size-fits-all analytical solution for on-balance sheet presentation for leases without an accompanying comprehensive disclosure package that would allow investors to better understand the risks and uncertainties related to lease contracts. IAC recommends information about the range of possible cash flows related to all leases (short- and long-term aggregated by major lease type), taking into account management's expectations for renewal options and variable lease payments should be required.

Is a Lease Contract a Liability, an Executory Contract or a Financial Derivative?

The accounting for leases is a very controversial area. IAC believes a majority of investors view leases as a debt-like liability. However, there is a minority who view a lease similar to an executory contract because these contracts can be cancelled, sub-leased and have been abrogated in bankruptcy proceedings. Some consider leases to be executory contracts, and they are unconvinced why operating leases should be singled out to be treated as balance-sheet debt when other executory contracts do not receive this treatment.

Two IAC members believe leases are financial instruments even though the boards have specifically scoped them out of financial instrument classification and do not believe the boards have made an adequate argument to establish why leases are not financial instruments. These IAC members view operating leases as bundles of forward contracts and other financial derivatives (and thus financial instruments) which implies they should be on balance sheet, but the asset and liabilities should offset one another since only gains or losses on derivatives appear on balance sheets. These IAC members believe these types of derivatives are used for hedging purposes. These members acknowledge forward contracts have embedded commitments to make payments in the future, but forward contract payment commitments are not debt (they are the notional amount of the derivatives contract) and they do not produce interest expense. These IAC members do not believe it is appropriate to target a sub-class of forward contracts and other financial derivatives for debt treatment. A detailed explanation of this derivatives approach to leases is available in a separate comment letter previously submitted by one of our IAC members.

The lack of agreement among users about how to treat operating leases is a reality that shines a spotlight on what we perceive to be a fatal flaw of the proposed FASB and IASB lease model. The proposed model will result in some rather aggressive changes in the current accounting for leases, but

the changes the boards would impose on the financial statement users are not easy for users to compare across firms, manipulate for analysis and unwind. It is essential that those of us who do not agree with the accounting treatment created from this project are in a position to back it out and replace it with adjustments that we believe are more appropriate for our analysis purposes.

IAC members are not convinced the proposed model will produce decision-useful information and will create the need for investors and analysts to continue to make analytical adjustments to GAAP results. Our expectation is companies will provide pro forma numbers to eliminate the proposed accounting since many users will be dissatisfied with the decision usefulness of the new information.

Lessee Accounting

 The lease proposal calculates a lessee's lease liability based on the legal lease term and in most cases a company's incremental borrowing cost; in our opinion this is not decision useful information for analysts.

The majority of analysts will not use the proposal's lease liability number to calculate a company's total debt or enterprise value because the lease liability is based on an arbitrary, non-comparable legal lease term and a company's discount rate, not the economic substance of a lease.

Analysts do not believe the economic substance/debt equivalent liability of Company A with an average lease term of 10-years is different than Company B with an average lease terms of 5-years; analysts simply assume Company B will re-lease the property or equipment after the initial 5-year lease term.

The following chart calculates a company's lease liability assuming a \$200 million lease payment, an 8% discount rate and various lease terms.



Many analysts believe leases are a debt equivalent liability and a traditional adjustment is to capitalize the straight line rent expense at a 7x multiple. As seen in the chart above this calculation is similar to assuming a 10-year lease term with an 8% discount rate. The benefit of using a consistent 7x multiple is that it provides for a comparable lease liability number across companies.

In contrast, the proposal determines a company's lease liability on a non-comparable basis because the primary determining factor is an arbitrary legal lease term. Some IAC members are concerned the proposal will encourage companies to structure leases with shorter-term lease terms (1-3 years) or in the worse case recurring one-year leases such that the lease liability would be understated or avoid balance sheet recognition altogether. If this occurs, it could undermine investors' ability to assess the lease liability because footnote disclosures may become less useful as companies report no future minimum lease payments in the case of recurring 1-year leases or the average and median lease terms could be distorted lower compared to current accounting.

According to lease experts, lessees typically don't know the discount rate implicit in the lease; therefore, most companies will use their own incremental borrowing rate. The following chart compares the lease liability of companies across the credit quality spectrum (different discount rates) assuming an annual \$200 million lease payment and a 10-year lease term.



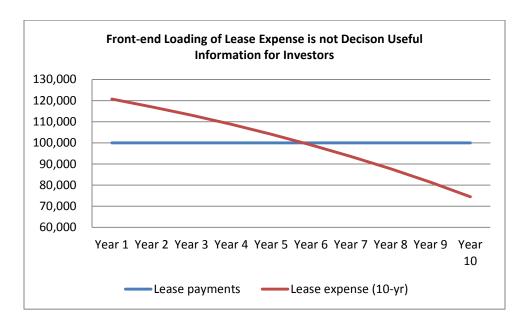
From an analyst's perspective a \$200 million annual lease payment for a financially distressed company represents a considerably greater liability than for a high quality company. However, the proposal's lease liability measurement is the opposite of what an analyst would conclude based on the risks associated with a lease contract.

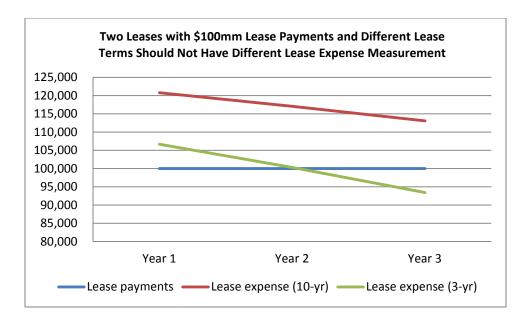
2) IAC does not believe the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lease is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

IAC does not believe the economic substance of an equipment lease and a property lease are different, therefore, the income statement and cash flow measurement and presentation should be the equivalent as occurs today. Although IAC understands the conceptual rationale behind the lease classification test (Type A and Type B) we do not support this accounting because it produces income statement and cash flow measurement and presentation results that are not decision useful information for analysts.

- a) IAC believes the current straight line rent expense accounting for lessees provides investors with decision useful information because this accounting reflects the economic substance of lease payments. IAC views operating leases as an operating expense for income statement presentation purposes.
 - IAC does not support the front-end loading of lease expense for Type A equipment leases as shown in the chart below.
 - IAC does not believe a company's lease expense income statement measurement and presentation should be different simply because leases have different legal lease terms.
 - IAC does not support different income statement measurement of lease expense for equipment versus property leases.

If the lease proposal is finalized, analysts will have to adjust their income statement models for Type A equipment leases to eliminate the front end loaded income statement presentation and substitute the straight line or cash rent expense that companies will provide in their earnings releases.





- b) IAC is concerned the accounting for Type B property leases which uses a balancing adjustment (accounting plug) that includes increasing amortization expense during the lease term is different than all other US GAAP amortization accounting. IAC doesn't understand the conceptual justification for this accounting.
- c) IAC does not agree with the different statement of cash flows presentation for equipment versus property leases. In our opinion, operating lease payments are an operating expenditure and should be reflected in the cash flow from operations section of the cash flow statement.
 - For Type A equipment leases, cash payments for the principal portion of the lease liability (the majority of the lease expense) would be presented in CFF and cash payments for interest expense would be included in CFO. A company's CFO and FCF would artificially increase versus current accounting because the majority of a company's lease cash payments would be included in the CFF section. In the example below, approximately 80% of the lease cash payment (principal paydown) would be included in CFF. IAC does not support this presentation. Analysts would have to eliminate the two accounting entries that result from this proposal in their cash flow models and substitute the straight line rent expense back into the CFO section so their cash flow models accurately reflect the economic substance of a lease which is the case with current accounting.
 - For Type B property leases cash payments would be reflected in the CFO section which most analysts believe is the appropriate accounting for leases.

Type A 3-year lease; \$100,000 annual payments; 8% discount

	Tale				
	<u>Initial</u>	Year 1	Year 2	Year 3	
Lease payments		100,000	100,000	100,000	
Lease expense					
Interest expense		20,640	14,291	7,434	
Amortization expense		86,000	86,000	86,000	
Total lease expense		106,640	100,291	93,434	
Balance sheet					
Right-of-use asset	258,000	172,000	86,000	0	
Lease liability	258,000	178,640	92,931	366	
					Cash Flow
					<u>Presentation</u>
Lease payment		100,000	100,000	100,000	Current: CFO
Interest		20,640	14,291	7,434	Proposal: CFO
Principal paydown		79,360	85,709	92,566	Proposal: CFF

Lessor Accounting

As is the case with lessee accounting IAC believes current lessor accounting is a better representation of the economic reality of a lease transaction than the proposal.

1) Similar to our thoughts on lessee accounting, IAC does not support having different lessor accounting for Type A equipment and Type B property leases.

Income Statement – IAC does not support the different profit-recognition timing for equipment versus property leases. IAC does not believe that upfront profit recognition for Type A equipment leases reflects the economics of a lease transaction.

The following charts highlight our concerns. The data and presentation is from an Ernst and Young report, *How the lease accounting proposal might affect your company*, (July 25, 2013).

Lessor Accounting for a Type A lease with profit at lease commencement

Assumptions: Lessor manufactures a machine for \$75,000 and enters into a 3-yr lease term with annual rent of \$24,000. The present value of the lease payments is \$62,000 (discount rate = 7.87%). The residual value of the equipment at the end of the lease is \$47,000.

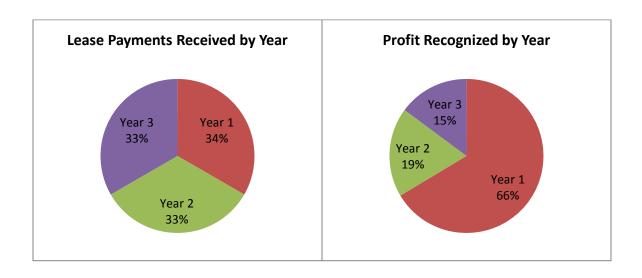
The following table illustrates the amounts recognized throughout the lease:

Period	Lease Receivable	Gross Residual	Unearned profit	Residual asset	Profit recognized	Cash received
Initial	\$62,000	\$38,000	(\$9,500)	\$28,500	\$15,500	
Year 1	\$42,880	\$40,990	(\$9,500)	\$31,490	\$7,870	\$24,000
Year 2	\$22,250	\$44,220	(\$9,500)	\$34,720	\$6,600	\$24,000
Year 3		\$47,700	(\$9,500)	\$38,200	<u>\$5,230</u>	<u>\$24,000</u>
	L			Total	\$35,200	\$72,000

Source: E&Y Accounting Link, How the lease accounting proposal might affect your company, 7/25/2013.

Similar to the front end loading of lease expense for Type A equipment lessees, lessors have up front profit recognition that IAC does not support.

- The lessor in the example above receives a \$24,000 lease payment from a lessee in year 1. However, the lessor recognizes a \$23,370 profit in year 1 for a 97% operating margin. In our opinion this accounting does not reflect the economic reality of the lease contract. The lessor should recognize one-third of its total profit from this lease in each year.
- As the pie charts below highlights two-thirds of the lessor's profit from the lease occurs in year 1 for income statement presentation purposes while only one-third of the rental income is received in year 1.



No Single Amount Can Capture the Economic Reality of Lease Arrangements - Disclosures Are Critical

Comprehensive lease disclosures are a critical facet in financial-statements users' ability to understand the risks and uncertainties related to lease arrangements. The majority of IAC members have expressed to the FASB that instead of the lease accounting proposal, which we do not support, that the FASB develop an improved lease disclosure package. Other IAC members believe the proposal contains some improvements (e.g., such as the removal of the distinction between operating and capital leases for balance sheet purposes); however, a more comprehensive disclosure package is still needed to complement these proposed changes. Regardless of the lease accounting on the balance sheet, no single amount can provide a complete picture of the economics of these arrangements. Many lease transactions are complex and commonly include options, guarantees and other contingent features. Some leases may be contingent on other financial statements items (e.g., revenue), while others contingent on variables which are seldom disclosed (e.g., performance or usage of an asset). Moreover, lease transactions have traditionally been – and will continue to be under the proposal – structured to achieve a desired economic and accounting result. For these reasons, it is imperative the Boards develop a reporting package that provides financial statement users with more robust insight into the amounts, timing and uncertainty of cash flows arising from leases.

We recognize, the Board has proposed some new – quantitative and qualitative – disclosures. These proposed new disclosures will likely add additional volume to financial statement reports. However, these proposed disclosures fall short in providing analytical value or decision-useful information to investors.

IAC recommends the following disclosures which we prefer to see in a tabular format:

- A range of possible cash outflows related to all leases (short- and long-term aggregated by major lease type), taking into account management's expectations for renewal options and variable lease payments
- Historical minimum cash rent payments over the periods presented
- Historical variable cash rent payments over the periods presented
- Average and median lease terms
- Disclosure of the incremental borrowing rate used (and inflation rate assumptions)

A range of possible cash outflows related to leases should be disclosed: lease commitments are just the starting point, not an end game — Because lease transactions could be structured innumerable ways with various contingent features, it would be helpful if lease disclosures include a range of plausible cash outflow scenarios (aggregated by major lease type) in addition to the minimum lease commitments and the amounts recorded on the balance sheet. These possible scenarios should be treated similarly to other contingencies and take into account expected option renewals and variable lease payments. This would provide financial statement user's with greater insight about the extent to which cash flows could meaningfully change from minimum lease commitments and allow users to conduct more informed scenario analysis.

Some IAC users suggest requiring tabular disclosure of lease payment schedules which depicts renewal options segregated by likelihood of payment amongst other key assumptions such as rental price inflation (see table below as an example). Sensitivity analysis over various discount rates should also be

considered. Because the board's conclusions on lease renewals and contingences would minimize the amount that is potentially capitalized, we believe, the Board should consider how most effectively the information should be presented.

	Year	Risk- free	Time Value of Money Discount	Rental Price	Minimum Lease Commitments		Renewal Options Likelihood of Payment									Undiscounted Cash Commitment Before Probability Weighting	Discounted Cash Commitment Before Probability Weighting	Discounted and Probability- Weighted Cash Commitment	Number of Stores in Total
		Rate	Factor	Inflation	100%	90%	80%	70%	60%	50%	40%	30%	20%	10%	0%				
Historical	2010				2,800	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	2,800	N/A	N/A	28
Payments	2011				2,987	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	2,987	N/A	N/A	29
	2012				3,183	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	3,183	N/A	N/A	30
Estimated	2013	4.00%	0.962	3%	1,858	-	1,311	-	-	-	-	-	-	-	-	3,169	3,047	2,795	29
Future	2014	4.02%	0.924	3%	1,351	-	1,801	-	-	-	-	-	-	-	-	3,152	2,913	2,580	28
Payments	2015	4.03%	0.889	3%	812	-	2,319	-	-	-	-	-	-	-	-	3,130	2,781	2,369	27
	2016	4.05%	0.854	3%	716	-	2,030	-	358	-	-	-	-	-	-	3,105	2,652	2,182	26
	2017	4.06%	0.821	3%	615	-	1,722	-	738	-	-	-	-	-	-	3,075	2,524	1,999	25
	2018	4.08%	0.789	3%	507	-	1,393	-	1,140	-	-	-	-	-	-	3,040	2,398	1,818	24
	2019	4.09%	0.758	3%	391	-	1,044	-	1,566	-	-	-	-	-	-	3,001	2,274	1,641	23
	2020	4.11%	0.728	3%	269	-	672	-	2,016	-	-	-	-	-	-	2,957	2,152	1,467	22
	2021	4.12%	0.699	3%	138	-	692	-	1,800	277	-	-	-	-	-	2,907	2,032	1,335	21
	2022	4.14%	0.671	3%	-	-	713	-	1,568	570	-	-	-	-	-	2,852	1,914	1,206	20
	2023	4.15%	0.644	3%	-	-	587	-	1,322	881	-	-	-	-	-	2,790	1,798	1,098	19
	2024	4.17%	0.619	3%	-	-	454	-	1,059	1,210	-	-	-	-	-	2,723	1,685	992	18
	2025	4.18%	0.594	3%	-	-	312	-	779	1,558	-	-	-	-	-	2,649	1,573	888	17
	2026	4.20%	0.570	3%	-	-	160	-	802	1,444	-	160	-	-	-	2,568	1,463	787	16
	2027	4.21%	0.547	3%	-	-	-	-	826	1,322	-	331	-	-	-	2,479	1,356	687	15
	2028	4.23%	0.525	3%	-	-	-	-	681	1,192	-	511	-	-	-	2,383	1,251	607	14
	2029	4.24%	0.503	3%	-	-	-	-	526	1,052	-	701	-	-	-	2,280	1,148	530	13
	2030	4.26%	0.483	3%	-	-	-	-	361	903	-	903	-	-	-	2,167	1,047	454	12
	2031	4.27%	0.463	3%	-	-	-	-	186	930	-	930	-	-	-	2,046	948	396	11
	2032	4.29%	0.444	3%	-	-	-	-	-	958	-	958	-	-	-	1,916	851	340	10
	2033	4.30%	0.426	3%	-	-	-	-	-	789	-	987	-	-	-	1,776	756	294	9
	2034	4.31%	0.408	3%	-	-	-	-	-	610	-	1,016	-	-	-	1,626	664	249	8
	2035	4.33%	0.391	3%	-	-	-	-	-	419	-	1,047	-	-	-	1,466	573	205	7
	2036	4.34%	0.375	3%	-	-	-	-	-	216	-	1,078	-	-	-	1,294	485	162	6
	2037	4.36%	0.359	3%	-	-	-	-	-	-	-	1,111	-	-	-	1,111	399	120	5
	2038	4.37%	0.344	3%	-	-	-	-	-	-	-	915	-	-	-	915	315	95	4
	2039	4.39%	0.330	3%	-	-	-	-	-	-	-	707	-	-	-]	707	233	70	3
	2040	4.40%	0.316	3%	-	-	-	-	-	-	-	485	-	-	-]	485	153	46	2
	2041	4.42%	0.302	3%	-	-	-	-	-	-	-	250	-	-	-	250	76	23	1
	2042	4.43%		3%	_	-	-	-	-	-	-	-	-	-	-	-	-	-	_ [
TOTAL					6,657	-	15,210	-	15,729	14,332	-	12,091	-	-	-	64,019	41,459	27,434	_

In addition, we would also suggest disclosure of the percentage of lease contracts with contingent/variable lease terms, including narrative disclosure if companies are anticipating transitioning from fixed payment leases to those on a variable basis.

Historical minimum and variable cash payments are relevant for understanding business prospects — Both minimum and variable cash rent payments should be disclosed over the periods presented in a financial statement. This information provides important insight about the nature of lease expense and allows financial statement user's to better forecast these commitments in the context of a company's business plans and strategy. For example, if projected growth or revenue is dependent on the cash generating ability of a leased asset, disclosure of the nature of lease expense is important for projecting more accurately expected margins and earnings.

Average and median lease terms provide useful information for peer comparisons – Companies can sometimes have dramatically different lease profiles relative to their peers. Because current disclosure (and the proposed maturity analysis) includes information about each of the next five years and a total

for the remaining years, information that could differentiate lease profiles is lacking. This disclosure is beneficial to financial statements user's because it provides information about the potential timing to market price exposure (i.e., renewal risk at spot rent prices) and possible operational disruption. Moreover, it would help identify those companies that have significant short – or long terms lease contracts which would allow for more straightforward peer comparisons.

We would also suggest that a breakdown of disclosures be provided of lease maturities that are between 6-10 years, and 11+ years. Such further granularity provides decision-useful information in sectors where the lease profiles are particularly relevant (e.g., retail, transportation) for analysis.

Disclosure of the assumptions used such as discount rate is relevant and meaningful – We believe information about the underlying assumptions used is important for analysis. Some financial statement users may want to derive their own computation of lease liabilities using a present value – rather than a rent multiple approach. The discount rate is rarely available and is unlikely to be available for all companies in a particular industry. Disclosure of key assumptions used would help refine analysis.

Additional disclosures requested would include the expected useful life of leased assets by category and leased assets segmented by the nature of the asset.

Whether in conjunction with the FASB's work on the Disclosure Framework project or separately as part of this project, we believe it is imperative for the Board, together with the IASB, to develop a comprehensive lease disclosure package.

Sincerely,

Investor Advisory Committee

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