financial executives international

COMMITTEE ON CORPORATE REPORTING

September 17, 2013

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Submitted via electronic mail to director@fasb.org

Re: File Reference: No. 2013-270, Exposure Draft: *Leases (Topic 842)*

Dear Sirs:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to provide its views on the Proposed Accounting Standards Update (Revised), *Leases* (ASC Topic 842) (the "ED"). CCR does not support the ED because it does not meet a cost-benefit test. We believe that the views of financial statement users on what to do with lease accounting are highly fragmented and there does not appear to be a significant group that supports the principles the Boards have proposed. The ED will impose significant costs, require substantial interpretive effort, and divert valuable financial resources from other more pressing and important changes in financial reporting such as revenue recognition and financial instruments. If the Boards are unable to fashion a simple, cost-effective response to perceived issues with lease accounting, such as those we propose below, we believe that the Boards should drop the project.

FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is a technical committee of FEI that reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

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Overview

Overall, CCR does not believe that the proposal produces financial reporting that is consistent with the economics of lease transactions and we do not believe that it meets investor needs. Further, we find the ED to be unnecessarily complex and expect that it will be costly to implement across the thousands of small dollar leasing transactions that corporations have dispersed throughout their global organizations. After taking into consideration the lack of user support for the revised conclusions, we do not believe that the current proposal satisfies a cost-benefit test. We therefore recommend that the Boards' adopt a simplified approach that: (1) directly accomplishes the primary objective of this project, (2) avoids imposing undue operational complexity on preparers, and (3) minimizes the initial and ongoing costs of this proposed standard. Our proposal is discussed below. If the Boards are unable to agree on our model or on another simplified approach, we also could support enhancing disclosures as a pragmatic way to meet investor needs, provided such disclosures do not require management to provide forward-looking information in the financial statements. Our proposal and the basis for our views are discussed further below.

CCR's Position on the ED

CCR observes that the economic characteristics of lease arrangements are defined by the legal and tax frameworks in each jurisdiction and, as a result, the nature of these arrangements varies across a broad spectrum. At one end of that continuum there are lease transactions that are legally and economically debt. However, these represent a small fraction of the total number of leasing transactions. At the other end of the continuum are leases that are simply executory contracts (essentially rentals) which are difficult to distinguish from service contracts. For these assets, which often consist of non-core support equipment, the lessee desires more than simply financing: ease of acquisition, disposition (i.e., remarketing the equipment at end of the lease), and often times maintenance. Such elements are the typical benefits afforded by these leases and represent the value provided by lessors in these arrangements.

The ED proposes a model that considers leases to be "equivalent to" the acquisition of an asset and the separate incurrence of debt. However, CCR believes that this treatment should only apply to those arrangements in which the lease obligation is legally debt (in-substance purchases). Distinguishing these leases often can be accomplished by reviewing how they are treated in bankruptcy; Some transactions are accepted as debt under the law while others will be rejected/extinguished, leaving the lessor to recover its economics from the underlying asset. It is CCR's view that if transactions are to be accounted for as in-substance purchases financed with debt, they should be economically and legally equivalent to the separate acquisition and financing of such transactions. We therefore believe that lease transactions that are not recognized by the courts in bankruptcy are not in-substance debt and the accounting should reflect that fact, as this distinction has meaning to users of financial statements. If separate display is provided for these in the statement of financial position, as we propose in our simplified model, we believe that it should be as a non-debt liability.

Because the ED's principles focus on the consumption of the underlying asset, it does not appropriately segregate on the basis of these economics. Nor do the recognition and measurement provisions provide information that is consistent with the needs of a majority of investors. In part, that is due to the fact that financial statement users all want something different: equity analyst needs differ from those of credit analysts and even within those groups each investor has their own way of looking at leases and the methodologies used by a particular analyst may also vary across the companies they follow. Some analysts even employ more than one technique for the same companies (i.e., they reflect the same lease in two different ways). It is therefore not surprising that financial statement users have rejected the Boards' proposal: recognition and measurement is inherently limiting – there can only be one answer and one approach to displaying the components of the lease contract.[1] CCR believes that the Boards should adopt one of two approaches: (1) implement a highly simplified approach that makes only slight modifications to existing leasing guidance but displays the lease asset and liability in the statement of financial position, or (2) focus on enhancing existing disclosures and leave existing guidance unchanged.

CCR believes that if the Boards conduct a rigorous cost versus benefit analysis of the proposal they will concur that the only reasonable path forward to a final standard involves one of these two approaches. For leases, the incremental benefit for investors is the recognition of lease assets and lease liabilities that were previously disclosed in the notes to financial statements. This incremental benefit needs to be judged against the costs to preparers of adopting and complying with the proposed standard, as they move from a model based primarily on disclosure. In evaluating the costs for preparers the Boards need to consider the complexity of a recognition-based model and the economic impact that results from the proposed lease accounting model.

As FEI stated in its letter of May 22, 2013, the management of complexity and cost should be a central focus as the Board considers how to move forward with this project. We believe there are a series of issues that need to be reconsidered if the Boards are to develop a model that is representationally faithful and cost effective to apply. Some of the more significant matters that should be considered are as follows:

- Contrary to what is stated in the Basis for Conclusions [BC 331] the classification criteria employed in the ED, will not reduce costs and complexity as each lease will require a qualitative and quantitative assessment to determine the correct classification at lease inception. The adoption of a classification approach based upon the nature of the underlying asset may not have the desired effect on application costs compared with the purely quantitative approach that is required under existing lease accounting standards.
- The requirement that the unit of account for Type A leases will generally be the individual leased asset rather than the lease contract will have the effect of increasing the cost of complying with the standard. This requirement will cause preparers to incur additional costs when leases are classified, recorded in accounting systems and reassessed. This additional cost is imposed on the types of lease transactions that most likely will not have a material impact on the financial statements. Further, requiring the unit of account to be based on an individual leased asset will not increase the usefulness of financial statements, as we do not believe that users are interested in this level of detail.
- The need to reassess the term of a lease and variable lease payments each reporting period will place significant additional burdens on lessees. It is not likely that reassessment of variable lease payments will significantly change the amount recognized for lease liabilities, and the qualitative factors to be considered at each reporting period when assessing lease term do not provide clear guidance for the reassessment process.
- The changes to the definition of lease term and lease payments will impose an additional cost on preparers. While the new definitions are designed to mimic existing requirements, the use of new words to describe and explain the requirements will require new interpretations that will need to be applied to each lease throughout its life. If the goal of the Boards is to retain the concepts that exist in accounting today, the same descriptions and terms that exist under current pronouncements should be employed.

Given the divergent views of users of financial statements on the measurement of the lease obligation, the allocation of lease costs in the statement of earnings and the presentation of leases in the statement of cash flows, we do not believe the proposals improve financial reporting. As a result of

[1] See summary of Investors Advisory Council meeting on August 25, 2013.

this conclusion on the relevance of the proposed standard, coupled with the fact that the proposal also will be costly and complex to apply, we do not support the issuance of a final standard in this form.

CCR's Proposed Alternatives

The stated goal of the project is the inclusion in a lessee's balance sheet of a lease obligation and a lease asset. This objective should be met using an approach that imposes the lowest cost and complexity on preparers given the lack of user consensus regarding how to improve the existing lease model. There are several ways this goal could be achieved without the consequential negative effects to financial reporting we have observed with this ED. We also believe that a simpler approach could substantially reduce the implementation and ongoing costs for preparers.

Display Approach

Of the possible alternatives, we believe the most promising is to adopt a more limited approach that focuses on changing the display of the contract in the statement of financial position. The recognition and measurement approach in the ED is unnecessarily complex, costly and invasive to existing reporting and does not appear to meet the needs of investors. Under a display model the lessee would record a leased asset and a lease obligation at the end of each period based upon the present value of the remaining lease payments, adjusted for any prepaid or deferred rent recorded under existing GAAP. Importantly, the liability recognized under this approach should not be characterized as debt because, as discussed above, we believe such obligations are not legally or economically debt equivalents. This treatment also would alleviate concerns that have been expressed about loan covenants on transition. The statement of financial position would always be prepared using this methodology, and the statement of earnings would reflect the rent expense during the period in accordance with existing GAAP. While this approach does not allow for articulation of the statement of earnings with the statement of financial position (the statement of earnings would simply reflect rent expense in each period), we have not observed a consensus among users that they wish the expense pattern and categorization in the statement of earnings to change. In fact, many users object to the ED's principles because it would make it harder for them to reverse out the impact of the proposed standard on financial statements.

Our proposed model would achieve the enhanced balance sheet display which is the primary goal of this project while avoiding the artificial allocation of costs in the statement of earnings that is proposed for Type A leases. We believe that our proposed model would also eliminate the amortization computations required for Type B leases under the proposed recognition model, which could be challenging to implement across the broad spectrum of lease arrangements. While some may find conceptual fault with this approach because it eliminates the direct connection of the balance sheet to the statement of earnings, we believe that it is these accounting conventions related to the traditional recognition and measurement framework that are the source of a substantial portion of the complexity and cost associated with the proposed model.

We believe that our proposed approach achieves the desired transparency that was the primary goal of this project. Unlike virtually any other alternative considered by the Boards, the display approach has other advantages that serve to bring the cost of adoption in line with this principal benefit. These include the following:

- It is relatively straightforward to implement and could be adopted more quickly than any of the recognition and measurement alternatives under consideration by the Boards.
- It greatly simplifies lessee accounting by eliminating the necessity to classify leases;
- It allows lessees to retain their current unit of accounting for all leases;
- It avoids the distortive cost allocations that arise in many Type A leases;
- It eliminates the need for systems changes required for Type B lease accounting

- It avoids the distortion and complexity that would arise with foreign currency leases when translating nonmonetary assets and monetary liabilities into the entity's functional currency;
- It simplifies transition substantially; and
- It clearly separates the lessee model from lessor accounting and eliminates any need for symmetrical results.

The display approach discussed above also resolves the conceptual inconsistency that has plagued the Boards' model: that it is not clear whether the lease model is -- or should be -- based upon the accounting for the lease contract or the accounting for the underlying asset. In certain circumstances, the Boards' proposed model determines the accounting by reference to the underlying asset; in other circumstances, it determines the accounting by reference to the lease contract. For example, the ED's scope is based upon the lessee's evaluation of its relationship with the underlying asset, recognition of the lease asset and obligation is based upon the accounting for the contract, amortization methodologies are determined by reference to the underlying asset and remeasurements are based upon the contract. Our proposed model would focus lessee accounting on the contract, which is where we believe the focus should be, other than for matters involving whether a leased asset is within scope. We believe that the benefits of a focused approach based on the lease contract would be significant, particularly in improving the consistency and simplicity of application of the proposed requirements.

Disclosure Approach

If the Boards do not accept the display approach, or some other simplified accounting model, and assuming that the diversity of investor views regarding lessee accounting persist, we would recommend that the Boards adopt an enhanced disclosure approach. This approach would better meet the needs of all financial statement users as compared with the recognition and measurement approach in the ED. This approach recognizes the fact that there is no consensus among investors on how to measure a lease liability, and that the views of users become even more fragmented on the allocation of lease costs and their classification in the statement of earnings and statement of cash flows. We believe that disclosure is an appropriate resolution for circumstances in which there is no consensus among users of financial statements about the desired outcome, when the application of the accounting framework produces results that are not representationally faithful to the economics of the contract and when the costs of a proposal are significantly in excess of the perceived benefits.

Lessor Accounting

In our comment letter on the first exposure draft, we stated that although we were open to improvements in lessor accounting, we believed that the existing guidance in ASC 840 and IAS 17 has many strengths, including: the fact that the guidance is well understood by preparers, users and auditors; it is considered to provide adequate financial information to users of financial statements and investors; and it reflects the underlying economic substance of transactions. We also observed that any change to lessor accounting should be judged on whether it demonstrably improved financial reporting at a reasonable cost. The suggested changes to lessor accounting proposed in the ED do not appear to meet this requirement and we believe any needs by users for additional information could be met on a more cost effective basis through enhanced disclosure.

The ED's focus on lessee-lessor symmetry is understandable, but symmetry should not be a primary objective of the project. Symmetry does not exist today in leasing and in many other areas of the accounting literature, including revenue recognition. The objectives of lessee and lessor accounting are very different, even if the accounting is operating on the same transaction. Lessee accounting addresses issues related to the display of lease assets and liabilities and how the cost of the lease arrangement should be recognized in subsequent periods. Lessor accounting is concerned with the accounting for the lessor's investment in a leased asset and how the income from that investment should be recognized. These are two very distinct sets of objectives and considerations and the pursuit of symmetry between the two is not, in our view, necessary or desirable.

Other Matters

If the Boards decide to proceed to a final standard based on the principles in the ED, which we strongly oppose, we have highlighted other concerns that would need to be addressed in the following paragraphs:

1. Scope: Definition of a Lease

   The proposed approach to the separation of leases from service arrangements represents an improvement over the scope in the first exposure draft, which was overly broad, but the criteria to be used for separating leases from service arrangements are new and will require further interpretative guidance. This is necessary to limit diversity in practice. We urge the Boards to provide further guidance on the factors to be considered and how those factors should influence decisions. Specifically, how the asset should be identified, what substitution rights are substantive and how control should be evaluated.

2. Unit of Account

   The ED proposes to significantly change the unit of account for lease accounting. For equipment/Type A leases, the unit of account will generally be the individual leased asset even if the lessee leases multiple units under a master lease. Today, the unit of account is typically the schedule in a master lease contract and not the individual leased assets.

   Making the unit of account the individual leased asset will require lessees to record each asset and compute a corresponding lease liability for each leased asset. This will impose a significant burden on lessees, as the equipment leased under master leases are typically of lower value items and a master lease may have hundreds or even thousands of individual assets included. This requirement will not improve financial reporting and is unrelated to the needs of financial statement users. Preparers should be allowed to aggregate assets under a master lease and account for them in the most cost effective manner possible. We also suggest that companies be allowed to aggregate similar assets and account for them on a portfolio basis if that will reduce compliance costs.

3. Lease Classification: Consumption Approach

   The question of how leases should be viewed is complex and there is no clear answer. The Boards have noted that there is perhaps a preference for a one-lease model for lessees, but there is significant disagreement as to what that model is. The feedback the Boards received on the first exposure draft has led the Boards to consider separating leases into two categories based upon whether the underlying asset is "consumed" by the lessee during the lease term. We do not support this approach. There is no similar concept elsewhere in the accounting literature, in the conceptual framework or in corporate finance literature.

   The core concept behind Type A lease accounting is the treatment of a lease as if it were the "same as" or "equivalent to" the acquisition of an asset and the incurrence of debt in separate transactions with different counterparties. The ED proposes to use a consumption concept to determine which leases are equivalent to purchases with debt financing and which leases are not. In essence, consumption is used as the basis for bifurcating a contract into two components and as an indicator of an asset acquisition and financing. The accounting literature generally calls for bifurcation when economically different elements of a contract are in place that influence how that contract is settled. We do not believe consumption is related to this concept and do not see how it can be used to create two units of account.

If the Boards continue with a model that separates leases into different classes of transactions, we believe a more reasonable approach would be basing the separation on qualitative or quantitative differences in contracts. An accounting model that is based upon equating one series of transactions to another should be based upon whether or not the transactions are in fact the same or very similar.

We also believe the move to a consumption-based approach to lease classification does not significantly simplify the accounting for leases. The separation of leases into Type A and Type B leases will always require an accounting analysis. While that analysis may be straight forward in some circumstances, it will require additional detailed analysis in other circumstances and the conclusions will require documentation.

Finally, regarding the transition requirements proposed in the ED, we are uncertain if classification is to be performed as of the date of lease commencement, as of the date of first application of the model in the financial statements or as of the effective date of a final standard. This matter should be clarified in a final standard.

4. Lease Expenditures that are Recapitalized

While one of the Boards' objectives has been to reduce the diversity of reporting that is perceived to exist for leases, the resulting proposal actually creates diversity. The exposure draft attempts to impose a "one size fits all" approach across a broad spectrum of contractual and operational situations. As an example, the proposed standard contains very little discussion on the topic of lease expenditures that are re-capitalized as property, plant and equipment, in the course of building another asset. Financial statement users will not be well-served by the proposed accounting which requires the present value of such lease costs to be initially "capitalized" onto the statement of financial position, attract deferred taxes, subsequently amortized into yet another asset, and then be bifurcated (for Type A leases) in the statement of earnings but never recognized in the cash flow statement.

5. Applying Capitalization Thresholds to Leases

While BC405 in the IFRS Exposure Draft *Leases* states it is expected that lessees will apply a capitalization policy to lease transactions as is done today for owned property, plant and equipment, we are not certain how this will apply in practice in the U.S. reporting environment. Capitalization thresholds are generally applied to purchases of assets at the time an asset is paid for. In a lease, there will be both an asset and a liability to consider, and the accounting for the liability component of the lease is not clear in this situation.

We have found that preparers and auditors do not know if the application of a capitalization threshold means preparers will continue operating lease accounting for these assets (and not recognize a liability for lease payments) or whether it will require the recognition of a lease liability for the asset and full expensing of the asset as would be done in a cash purchase. Continuation of operating lease accounting is the most cost effective way of accounting for these low value items, and adoption of our proposal renders this issue moot. If the Boards decide to proceed with a recognition and measurement approach, we urge the Boards to include specific guidance as to the accounting for leases when the underlying asset has a value that is less than a company's capitalization thresholds.

6. Lease Term

When evaluating lease term, lessors and lessees are to consider whether the lessee has a significant economic incentive to renew the lease. The factors that are to be considered are meant to mirror the evaluations that are made under existing requirements, but the description of the factors to consider is new. This will result in additional transition costs, as preparers and their auditors apply the new descriptions and factors. Since the goal of these definitions is essentially to replicate existing requirements, we suggest the existing requirements be carried forward as originally worded in order to avoid interpretive ambiguity and reduce the cost of transition.

7. <u>Impairment</u>

   The interaction of the lease model with the impairment literature should be given additional consideration. It is difficult for us to imagine a situation where a leased asset is impaired, as most leased assets are grouped with other assets for impairment purposes and are generally not revenue generating assets. When a leased asset is impaired, however, we are uncertain how a measurement of a leased asset to fair value is possible. It would appear that the most that could be determined is the fair value of a similar asset leased for the remaining lease term. In addition, further guidance on transition related to losses on sublease arrangement and property abandonments should be considered.

8. <u>Disclosures</u>:

   The ED proposes that lessees provide extensive disclosures regarding leases, including a number of separate disclosures related to Type A and Type B leases. The usefulness of these disclosures is not always certain and some appear repetitive. For example, the ED proposes that lessees provide a reconciliation of Type A and B lease liabilities and supplemental cash flow disclosures for leases. We urge the Boards to perform further outreach jointly with investors and preparers, similar to what was done in the revenue recognition project, in order to identify which of these disclosures are meaningful and useful to investors.

9. <u>Leveraged Leases</u>

   We believe additional consideration should be given to either maintaining existing leveraged lease accounting or grandfathering at transition existing leveraged leases, especially those acquired in purchase business combinations. Leveraged leases are unique vehicles and are critical to the financing of many types of capital assets and, as recognized by the FASB 35 years ago when SFAS No.13 was issued, there are reasons why an exception was made in the accounting literature. Given their importance to certain sectors of the economy, we continue to recommend the Boards engage in targeted field testing and research for this particular type of structure before the conclusions on the accounting for leveraged leases are determined.

10. <u>Further Preparer Outreach</u>

    We urge the Boards to perform further outreach on implementation costs, more critically examine its assessment of the benefits of each element of the proposal, and consider substantive changes to the proposed standard that will reduce implementation and ongoing costs to preparers and shareholders. These steps are critical to ensuring a reasonable balance of costs and benefits. We are not convinced that the complex accounting and presentation required by the ED will improve the users' ability to understand the financial statement taken as a whole.

11. <u>Codification</u>

    The structure of the FASB's ED based upon changes to the codification is difficult to read and understand. We would urge the FASB to issue future exposure drafts and final standards in format similar to the IASB's ED and separately include the changes to the codification.

12. <u>Transition</u>

If the Boards adopt a final lease standard that does not follow our simplified approach, or some variation of that approach, we believe companies will need significant lead time to develop the systems and processes necessary to implement these new requirements. We are unaware of any system that has been developed for broad application, or is currently available for use, that can systematically and accurately account for leases in the manner proposed in the exposure draft. In addition, both transition approaches offered in the current exposure draft will be exceedingly difficult to implement for companies with a large number of diverse leases. Since these changes will be required just as companies are preparing to adopt other significant accounting standards, we believe an extended transition period of four or five years will be required.

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We appreciate the opportunity to participate in the roundtable session for the Proposed ASU on September 23rd and we have asked the Chairman of our Leasing Working Group to represent CCR's views at the meeting. Please contact Lorraine Malonza at (973) 765-1047 with any questions.

Sincerely,

Stephen J. Cosgrove
Chairman, Committee on Corporate Reporting
Financial Executives International