LEASING 101

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30 Cannon Street
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Sent Via Email

December 17, 2013

Re: Comments re: Joint board meeting of November 20, 2013 on the re-deliberation plan for the Leases Project

Dear Chairman Golden and Chairman Hoogervorst:

I submit these comments as a member of the Leases Project Working Group. I have read 140 of the comment letters (about 22%). I participated in a round table meeting in Norwalk and I observed three other roundtable meetings. I also listened to the Lease Project discussion portion of the FASB/Small Business Advisory Committee (SBAC) meeting of November 7, 2013. I observed the November 20, 2013 joint board meeting that gave a summary of the comment letters, roundtables and outreach meetings. In my opinion the staffs' presentation of the feedback was detailed and objective. The meeting covered a discussion of the re-deliberation plan.

I am encouraged that there appears to be a suggested way forward to a timely and successful conclusion of the project that addresses the issues raised in the extensive outreach efforts of the Boards and staff. The suggested way forward does not compromise the initial objective of the project of capitalizing operating lease obligations. The way forward suggested by the FASB board members at the meeting was to leave lessor accounting largely as is (with adjustments based on decisions made in the project such as regarding variable lease payments and lessee residual guarantees) and to retain the current classification criteria to classify leases as type A (capital leases for lessee accounting with a front ended cost pattern comprised of asset amortization and imputed interest) or type B (operating/executory leases for lessee accounting with a straight line rent expense). Unfortunately, it seems there is not agreement between the two Boards on such an approach.

I respectfully offer the following approach, in line with the FASB approach, which is supported by commentary and analysis from objective stakeholders that I believe will help move the project forward.

My suggested way forward:

1) **We should acknowledge that there is no "right" answer to capitalizing operating lease obligations to satisfy all analysts and user's needs** and the Boards should decide what the proper accounting for operating (executory) leases should be. I suggest it should be to account for leases according to their substance using existing GAAP classification criteria (that usually would follow the legal view of capital leases and operating/executory contract leases in most countries) while providing footnote information to help analysts make their unique adjustments to satisfy their specific needs. Analysts will continue to make adjustments no matter what the final outcome of the Project. The Big 4 audit firms' comment letters say that they conclude that analysts will continue to adjust the lessee lease accounting as proposed by the ED. Analysts and lenders have different analytical objectives and one could say they are doing financial modeling and not accounting. Analysts have spent years developing their approaches to include the impact of operating leases on their analysis. The following is a relevant quote from **Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations – Part I: *Standardized Adjustments to Enable Global Consistency for US and Canadian GAAP Issuers* Product:** "Our adjustments do not imply that a company's financial statements fail to comply with GAAP. Indeed, many of our adjustments are inconsistent with current accounting principles. Our goal is to enhance the analytical value of financial data and not to measure compliance with rules."

   We should not think that analysts' calculations are wrong.

2) **Start re-deliberation by using the current GAAP classification tests,** as they are designed to account for leases by lessees according to their substance – either as a capital lease (tangible asset and debt that both survive bankruptcy as an asset of the lessee and a claim on the assets of the bankrupt estate) or an operating lease (an executory contract that does create an "contract" asset and liability to a going concern ***<u>but</u>*** they are intangible assets and "non-debt" liabilities. The ROU asset represents undelivered services, and, as such, the ROU asset and lease liability related to operating/executory leases do not survive a bankruptcy liquidation. The leased asset is returned to the lessor and the ROU asset and lease liability disappears.) Current GAAP is well understood and has been operating for over 35 years in all parts of the world that follow US and IFRS GAAP despite different tax, legal and bankruptcy regimes and business environments. Since leasing is pervasive and involves all types of business assets, it is ingrained in the

business process at many levels based on the current GAAP risks and rewards classification criteria.

The American Accounting Association comment letter #396 provides the following insight as to lessee lease classification and balance sheet presentation: "**B. How Lenders and Rating Agencies Treat Lease-Related Assets and Liabilities -** Empirical evidence suggests that banks and credit rating agencies adjust for off balance-sheet lease obligations in their credit assessments. For example, Altamuro et al.(2012) report that lease-adjusted financial ratios are more closely associated with loan spread than unadjusted ratios, especially for larger lenders. In fact, lenders appear to be skilled at assessing which lease contracts are more like rental agreements than financed purchases. Similarly, credit rating agencies appear to capitalize operating leases; however credit rating agencies seem not to distinguish between leases that are more similar to rental agreements than financed purchases. These results suggest that lenders and credit rating agencies already appear to capitalize operating leases in their calculations and models, with lenders even distinguishing between finance-type and rental-type leases. The fact that lenders can distinguish between finance-type and rental-type leases using the current standards leads Altamuro et al. (2012) to question whether the proposed new standard is warranted. In fact, if all lease obligations were reported together on the balance sheet without a clear distinction between Type A (equipment/vehicle) and Type B (real estate) leases, the results in Altamuro et al. (2012) might imply that the standard is moving in the wrong direction for lenders and rating agencies. Said more forcefully, this study seems to suggest that lenders and credit rating agencies (obviously both sophisticated users of financial statements) already distinguish between finance- and rental-type leases using the lease guidance that exists today. If future standards make it more difficult to distinguish between these two types of leases because both are capitalized, lenders may consider themselves ill served."

Further to this point, the AIPCPA Private Companies Practice Section comment letter #614 says their Technical Issues Committee (TIC) "recommends that private entities be allowed an exemption from adopting the new model and be permitted to retain the guidance in extant standards. Some of the TIC members discussed the proposal with lenders in their communities and did not find support for putting operating leases on the balance sheet. These lenders would ignore a right-to-use asset because such assets cannot serve as collateral on loans. They have their own lending models, which allow them to derive information about the lease obligation from the commitments note in the financial statements and from direct interaction with management, and analyze cash flow sensitivity without considering the lease commitment a liability."

My conclusion is that ***only*** the current risks and rewards classification criteria can provide the information that lenders and credit analysts need to do the bankruptcy risk part of their financial statement analysis upon which they base their lending and rating setting decisions.

3) **Once we have leases classified by their substance we need to worry about balance sheet presentation for lessees.** The SBAC/FASB meeting was very revealing as one

speaker said small business may not follow the proposed new lease accounting rules and accept a qualified audit opinion (they apparently did this with the issuance of Fin 46) so that their lenders would get the balance sheet "right" for debt limit covenants and for tangible net worth covenants). With regards to the debt limit covenants, operating/executory lease obligations are not debt in bankruptcy so they should not impact debt limit covenants that are designed with bankruptcy risk in mind. With regards to tangible net worth calculations, capitalizing an operating/executory lease should also not impact the calculation but there are two issues. First, if the ROU asset is considered an intangible asset, as it arguably is, it would be removed from the asset side of the tangible net worth equation. Secondly, the Type A cost allocation for executory leases amortizes the asset at a faster pace than the liability creating a negative net worth impact. If small businesses will not follow the requirement to capitalize leases so that their lenders best understand the substance of leases reported in their financial statements, that has to be saying the proposed accounting in the Exposure Draft (ED) is not presenting the ROU asset and lease liability correctly.

The Boards should define debt more tightly to help lenders in their analysis. Merely defining debt as what is owed does not help users understand how a lease liability will be treated in a bankruptcy liquidation. A liability that results from capitalizing an executory contract is a new type of liability. In my opinion the Boards should be concerned with debt limit and tangible net worth covenants as they are common in leases and loan agreements. Small and medium sized companies are heavy users of leases and are more prone to bankruptcy so it is most important to properly classify and label the executory lease ROU asset and liability for the benefit of their lenders.

4) **For the lessor**, the current lease classification and lessor accounting works for most leases. The exception is for those leases written by "financial" lessors that fail the classification test as a finance lease. The "financial" lessor is viewing the lease as a discreet investment and plans to sell the asset when returned at the end of the lease (not to continue to re-lease the asset). Currently, financial lessors in the US often buy residual value insurance to convert operating leases to direct finance leases so that when the guaranteed/insured residual is included in the PV test it makes the PV of the minimum lease payments hit 90%. They prefer not to purchase residual value insurance but the cost is low in most cases – when the cost is too high, they reluctantly accept operating lease accounting. Analysts of financial lessors (banks and finance companies) expect to see finance income as in direct finance lease accounting rather than rent income and depreciation expense as in operating lease accounting. On the other hand, analysts of "operating" lessors expect to see rent and depreciation. So, the preferred solution to lessor accounting is to use the business model approach and that is an answer that does satisfy all users' needs.

The AIPCA Financial Reporting Executive Committee (FinREC) comment letter #615 supports this point: "FinREC believes that the emphasis on recognition of the liability by the lessee, and the desire for symmetry, creates significant challenges for lessors—notably the notion that recognition of the right to use a small portion of a non-property asset represents a sale on the part of the lessor of a corresponding portion of the leased asset. FinREC understands the desire for symmetry between lessors and lessees, but we believe this has complicated efforts to achieve consensus on a new standard that meets the key objectives laid out in the discussion paper while providing users with improved relevant and representationally faithful information. While symmetry is a desirable goal it is not a requirement, particularly when it could result in financial reporting that is less relevant to financial statement users than that provided today. Even under today's model, leasing often results in asymmetrical results (e.g., built-to-suit leasing, real estate sale-leaseback transactions, sales type leases of real estate). Nor is this confined to leasing. Asymmetrical accounting between the parties involved in a transaction is pervasive. The introduction of the dual model goes some way toward mitigating concerns expressed by property lessors, but does not go far enough for certain lessors of other long-lived assets that they believe share many economic characteristics of property leases. We also have concerns that a model requiring classification based on the nature of the leased asset, rather than the economics inherent in the contract, may not provide users with the most decision-useful information—particularly with respect to lessors."

I agree with Tom Linsmeier's analysis that symmetry is not the right approach as lessors and lessees view a lease differently. The lessor has residual risk. Financial lessors price residual values assuming they will sell the asset when returned while operating lessors assume they will continue to manage and re-lease the asset when the lease expires. On the other hand, the lessee views a lease as either a financed purchase or a rental (executory/operating lease) regardless of the lessor business model or the lessor pricing philosophy.

5) **Complexity is a serious issue**. With regards to Type B accounting, some Board members expressed concern with the amortization of the ROU asset. They do not recognize that capitalizing an executory contract is a new concept and methods of amortizing tangible assets and imputing interest to financial liabilities may not apply. I suggest using the much simpler method recommended by several comment letters (the FEI and ELFA comment letters as well as my letter). The Grant Thornton letter #117 also supports a "new" method as per the following quote: "We also do not agree with the accounting model proposed for Type B leases. At this time, we are not convinced that accounting for a right of use asset as tangible property is always representationally faithful. While amortization and impairment testing may be appropriate when control of the underlying asset has transferred to the lessee, we are not convinced that either is appropriate when it has not, nor would revaluation under IFRS be the appropriate model. When control of the underlying asset has not transferred to the lessee, we believe that the resulting assets and liabilities are better represented by a new accounting model that would reflect their nature as fully or partially executory contracts. The same is true of the related obligation."

With regards to complexity in lessor accounting, the Receivable and Residual method is only cosmetically different from the current Direct Finance Lease method. It seems that the ED changes the lessor accounting approach for the sake of change and it will be costly and complex for lessors to revise their accounting systems. Additionally, the Direct Finance Lease method provides more useful information, as in my opinion, presenting the residual asset gross gives users better information regarding the absolute amount of financial risk than reporting the present value of the residual as per the R&R method.

I value the relationship built over the years with the FASB and IASB. The Boards and staff have always given me access and allowed me to provide my views on various accounting and financial reporting matters. In the past, members of the Boards and staff have given my input consideration, which I appreciate. In some cases, the decisions and outcome have reflected this consideration. I hope that my input here is valuable to furthering the mission of the Boards to help improve transparency in financial reporting. I look forward to continuing to work with the Boards and staff on this matter and stand ready to assist in any way I can.

Sincerely,

William Bosco
Leasing 101