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Sent Via Email

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Re: Comments re: Joint board meeting of January 23, 2014 on the re-deliberation plan for the Leases Project

I observed the January 23, 2014 joint board meeting that began the re-deliberations on the Leases project. I also listened to the IASB/ASAF meeting on March 3, 2014. As a member of the Leases International Working Group I offer my comments on the issues of: **symmetry, lessee accounting, basis for lessee accounting, small ticket/immaterial lease portfolio solution, lessor selling profit and complexity**. My comments follow:

-**Symmetry** - Users of lessor financial statements and lessor preparers do not favor symmetry as business model based classification best reflects the business of financial lessors versus operating lessors. The AIPCA Financial Reporting Executive Committee (FinREC) comment letter #615 provides further support for this point.

-**Lessee accounting** – The accounting methods proposed in ED1 and ED2 did not find significant support during outreach. It is difficult to understand why these approaches are still being considered after all the outreach meetings, roundtables and 1400 comment letters. Of the 641 comment letters received re ED2, I personally read 142 (22%). I found that 75% of the letters were negative, including the comment letters from the Big 4 Audit firms, Grant Thornton, and Mazars. Many of these letters from the accounting firms observe the ED lacks conceptual grounding, will not provide improved relevant information and analysts will still have to adjust financial information for their analytical needs. In general these commentators support using current GAAP as the basis for lease classification. In fact in their comment letter #641 Mazars questioned the ROU method as the proper starting point for the project.

I find it difficult to understand the position of several board members that the approach in ED1, Type A accounting for ***all*** leases, is simple, results in the "purest" accounting and provides the most relevant information (meaning an improvement over what information analysts have to work with under current GAAP). With regards to simplicity, the ED1 classification is simple as all leases are treated as though they are the same yet preparers will have the complexity and costs to continue to keep information on leases based on current GAAP classification tests for tax compliance and to answer questions of lenders and credit analysts regarding the nature of the lease assets and liabilities. Type A accounting is even more complex than current capital lease accounting due to the changes in definition of lease payments to include variable payments and the need to re assess and adjust Since many leases have CPI adjustment clauses it means annual complex adjustments that are handled on a cash basis today. In terms of accounting purity and conceptual soundness it fails in my opinion as it does not account for the rights and obligations created by leases that transfer ownership rights versus those that are executory contracts and only transfer rights of use. In terms of relevance, many comment letters from independent stakeholders also state that critical information regarding the nature of the lease assets and liabilities currently available will be lost if differences in leases are not recognized. If ED1 Type A accounting is adopted for all leases, lenders and credit analysts will still have to adjust financial results and avoiding the need for analysts' adjustments was the prime objective of the project.

-**Basis for lessee accounting** – In my opinion Approach 3 (based upon current GAAP) is the only sound basis for differentiating leases as it attempts to account for the leases according to their substance. The only conceptual grounding that works for ED1 and the Right of Use concept is that ***all*** leases are the same (many, if not the majority, of commenters disagree) and an operating lease is no longer an executory contract upon delivery of the asset for use. I submit that an executory lease is not like "other" transactions. The contract is part completed and part executory and that makes it unique versus a straight forward purchase. The fact that an operating lease involves an underlying asset makes it different from other executory contracts and is a factor in determining the appropriate accounting treatment. The remaining lessor performance obligations may not be meaningful enough to change the accounting view that an asset and obligation exists to a going concern but we must consider the users' needs to understand nature of the capitalized asset and liability, in particular that they arise from a contract (the unit of account), are inextricably linked and have a unique treatment in bankruptcy.

The issue as I see it is we want to capitalize a lease executory contract (while we do not capitalize any other type of executory contract) for the reason that virtually all users adjust financials by capitalizing the future operating lease payments in a manner that suits their particular analytical/modeling purposes. Using current GAAP classification concepts to capitalize and separately account for operating leases results in recognizing 2 types of lease assets and 2 types of lease liabilities according to their nature (important information for preparers' compliance and users' understanding). Not ***all*** leases merely transfer a ROU as is the concept used in presentation in ED1 and ED2, many transfer ownership rights and as a result many users, notably all lenders, need to know the capitalized amount for each type of lease in lessees' financial statements.

The differences between leases based upon the substance of the transaction are of meaning to management and users of financial statements. This has been noted by other commentators. The American Accounting Association comment letter #396 states, "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."

In a similar vein, the AIPCPA Private Companies Practice Section comment letter #614 says their Technical Issues Committee (TIC) 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 are able 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.

The SBAC/FASB meeting discussion regarding the lease project was very revealing as one speaker said small businesses may not follow the proposed new lease accounting rules and will accept a qualified opinion so that their lenders would get the balance sheet "right" for debt limit covenants (operating/executory lease obligations are not debt in bankruptcy) and for tangible net worth covenants (operating/executory leases create intangible assets and the liability is not debt). 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 providing the most relevant information to suit lenders' needs.

In my opinion the Boards should also refine the "official" stated definition of debt in your glossary of terms 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. It seems that the Boards and lenders do not have the same definition of the word "debt". The Boards should be concerned with the impact on debt limit and tangible net worth covenants as they are common in lease 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.

- Small ticket/immaterial lease portfolio solution – A portfolio approach to small ticket leases will still be complex. Not all master leases have homogeneous assets with one delivery date and one lease term. Also the leases in the immaterial portfolio group may have reassessment issues such as variable rents, residual guarantees and renewal/purchase options. The individual leases will have different incremental borrowing or implicit rates and lessees will have to establish a convention with regards to the discount rate used versus the portfolio. The portfolio will need continual adjustment when the leases in the portfolio are added, drop out, or change. I suggest the elimination of the need to reassess those leases considered to be immaterial. I also suggest field testing of the portfolio concept prior to further review.

As an alternative for small ticket/immaterial operating lease accounting simplifications I suggest using the accounting method for ***<u>all</u>*** operating leases recommended by comment letters from me, the ELFA and FEI which may be called the "Display" method. In that case one can use an Excel spread sheet to capture future lease payments of each lease, material or not, and, using the unique discount rate for each lease, discount them to calculate the amount/value of the lease asset and liability to be reported on balance sheet. The lease cost recognized would be the accrued average rent which is easily calculated in the Excel spread sheet. Using this "Display" method is very simple and would use an Excel file as most preparers currently use to capture future operating lease obligations for footnote reporting. Merely "displaying" the value of the assets and liabilities on the balance sheet would achieve the goal of capitalizing operating lease assets and obligations while preserving the lease accounting regime in current GAAP. More importantly the "Display" method handles initial direct costs, landlord concessions, rent free periods, impairment, variable payments and changes in assessment of the lease term easily compared to both Type A & B accounting where complex recalculations of the asset, liability and future amortization are required. The Boards should understand that it is very common to have CPI variable adjustments in leases that will result in high costs to adjust under both Type A and B methods often occurring on an annual basis for ***each*** lease.

- Lessor Selling Profit – I ask the Boards to view when a lessor can record a sale from the lessor's perspective rather than the lessee perspective as is proposed. In my opinion, a lessor can sell /give up control of the various rights inherent in an asset (an asset is a bundle of rights – rights of use and rights of ownership) to more than one entity. I suggest that you consider third party residual buy back agreements, third party guarantees and residual insurance as factors in lessor revenue/sale recognition as they are a factor in whether a lessor has sold the ownership rights in the asset. As proposed only residual guarantees from the lessee are considered in determining lessor revenue/sale recognition.

- Complexity – Complexity depends on what your definition of complexity is and what the amount of work/cost that results from the complexity is. I think the issue is to analyze and weigh complexity in lease classification vs. complexity in ongoing accounting. Current GAAP lease classification may be complex (until you learn the tests) but it is well understood, has been in effect and working well since 1976 and it is in line with the legal and tax view of leases. I do not view that as being bad or complex - rather the approaches in ED1 or ED2 add complexity for users in ongoing compliance (reclassifying leases based on current GAAP for tax compliance and user/lender questions (see the AAA comment letter #396)) as well as the P&L accounting for Type A accounting and ED2 Type B when you have a variable rent or reassessment adjustment. CPI adjustments alone will mean complex adjustments will be an annual event for many leases. Also the ED2 classification tests are more complex than current GAAP as they differ by asset type, one needs to define what assets are property versus equipment and there are leases with both property and equipment components that have to be dealt with. All things considered, in my opinion, using current leases GAAP lease classification methods plus the "Display" method for accounting for former operating leases as a framework would reduce complexity in classification and ongoing accounting for preparers and users compared to the ED1 and ED2 choices.

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
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