

Investor Advisory Committee

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Via Email

November 5, 2014

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

Re: Leases Accounting Project

Dear Technical Director:

The Investor Advisory Committee (IAC)¹ previously commented on the FASB's *Proposed ASU-Leases (Topic 842): a revision of the 2010 proposed FASB ASU, Leases (Topic 840)* (2013 Exposure Draft) in our letter dated September 9, 2013 (September 2013 Letter). IAC members have been following the Boards' redeliberations with great interest considering the implications it could have on investors and financial statement users' analyses.

Overall, the IAC is pleased with the progress by the FASB on this project because the decisions reached thus far would be an improvement to current US GAAP lease accounting. Specifically, we view the recognition of operating leases on the balance sheet as an improvement to US GAAP. For the general investor population, the recognition of operating leases (in addition to presently recognized capital leases) on the lessee's balance sheet is a better representation of an entity's contractual obligations and assets. This is preferable to continuing to have these arrangements not recognized on a company's balance sheet. Additionally, the recognition of operating leases on the lessee's balance sheet should make capital ratios more informative, particularly when analyzing a company's contractual obligations.

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

While IAC Supports the Key Objective of the Lease Accounting Project, A Robust Disclosure Package Is Needed

Important to the utility of these proposed changes are the disclosures that the FASB incorporates in the final standard. IAC continues to believe that comprehensive lease disclosures are a critical facet in financial-statements users' ability to understand the risks and uncertainties related to lease arrangements. Considering the myriad of ways that leases could be structured (including embedding contingent features), no single amount can provide a complete picture of the economics of these often complex arrangements. Still, we support the Board's key objective of the lease accounting project – to bring operating leases on balance sheet.

The IAC is divided in its support of the Board's decision to have a dual model approach (Type A/ Type B) for the lessees. Those that support the dual model approach believe that the two different methods of income statement and cash flow presentation better reflect the intended use of the underlying leased asset in commonly-used metrics for analysis, which may take into account the duration of the lease and/or ownership consideration. Those that do not support the dual model approach believe that it adds unnecessary complexity to financial reporting. Those members believe that ultimately, even if not in the next iteration, the distinction between leases should be removed. As investors, analytical efforts focus on (1) the reliability of the financial performance and valuation metrics and (2) their comparability. Under the proposed dual model approach, financial statement users will likely be presented with transactions where the underlying economics are roughly the same, but where the accounting could create materially different financial statements. IAC members who do not support the dual model approach believe these differences undermine the quality of financial reporting, and do not see adequate justification for maintaining these differences.

While the committee supports the progress the Board has achieved through its recent tentative decisions, we believe there is room for improvement. Below are our suggestions for comprehensive disclosure requirements for the proposed leasing standard and our views on the specific decisions that have been reached by the FASB in their redeliberations.

Comprehensive Disclosures are Critical to Success of this Project

As we do for all financial statement line items requiring some form of estimation and use of judgment by preparers, investors need to understand the assumptions used to derive those values on the financial statements so that we can assess the implications of embedded assumptions and estimations in the resultant financial statement values. Whenever assumptions are required in financial reporting, intelligent minds can disagree as to how those assumptions are formed. Naturally, investors would like to understand the basis for those assumptions so they can form their own, fully-informed opinions on the assumptions and the resulting financial statement line item.

To better provide financial statement users with decision-useful information into the amounts, timing, and uncertainty of cash flows arising from leases, it would be helpful to us if the Board requires the following disclosures for lessees (which we would prefer to see as tables):

- **An expected 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. We believe that lease contingencies are no different, from an analytical perspective, from other loss contingencies which the Board has sought to improve in the past. The definition of ‘possible’ could be aligned, perhaps, within the context of other contingencies in U.S. GAAP. This would provide users with greater insight about the extent to which cash flows could meaningfully change from minimum lease payments.

- **Historical minimum and variable cash rent payments over the periods presented.** This information provides important insight about the nature of lease expense and allows financial statement users to better forecast these commitments in the context of a company’s business plans and strategy.
- **Weighted-average remaining useful lives of assets, lease term and economic life (if different).** Useful life could be defined as the period over which an asset is expected to contribute directly or indirectly to future cash flows. Economic life could be defined as either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users. Companies sometimes have dramatically different lease profiles relative to their peers and this information is valuable because it allows financial statement users to identify significant short- or long term-lease obligations.
- **Disclosure of the incremental borrowing rate used.** Some financial statement users may want to calculate their own computation of lease liabilities, including variable rents and payments expected in additional renewal periods, using a present value approach. In addition, it is useful to understand the effect on the lease liability from potential changes in the borrowing rates because of changes in creditworthiness or other factors.
- **Disclosure of the amounts and classification of leases on income statement (amortization and interest) and cash flows (operating and investing) disaggregated for Type A and B leases.** These disclosures will allow users to understand the cash flow and performance impact of these different types of lease obligations. As noted above, while the IAC agrees with bringing operating leases on balance sheet, some IAC members continue to reject a classification model that distinguishes between Type A and Type B leases. However, robust disclosures will enable those of us who do not agree with the distinction to be in a position to utilize both the accrual and cash flow disclosures and make adjustments that we believe are more appropriate for the purpose of our analysis.
- **Qualitative information about use of leased assets.** Disclosure about a company’s general use of the leased assets also would be very helpful. For example, the expected duration of use of a building for office headquarters could be expected to go on indefinitely, versus a piece of equipment that will be used to build a plant. That information would be useful in reconciling whether the use of the leased assets is incongruent with the amounts recognized on the balance sheet. It also would help investors understand when a company changes its business model and begins to either sign new leases, or make capital purchases.

Additional IAC Views on FASB Redeliberations

- **The income statement and cash flow measurement and presentation.** If the dual model approach for lessees is included in the final standard, the IAC agrees with current decisions to retain the same treatment on the income statement and cash flow statement for an equipment lease and a property lease. In our September 2013 letter, the IAC urged the FASB to make this equivalent. In that letter, the IAC also observed that “the majority of analysts have traditionally viewed the current lease accounting income statement and cash flow statement measurement and presentation as an accurate representation of the economic substance of a lease.”
- **The retention of the existing lease classification requirements for lessee accounting.** The current decisions would retain the concept underlying existing U.S. GAAP/IFRS for lease classification. In our September 2013 letter, the majority of IAC members disagreed with the proposal because it substituted 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). As noted above, some IAC members prefer no distinction between Type A and Type B leases, however, if there is to be a distinction, we agree with the retention of the existing lease classification requirements for lessee accounting.
- **Changes to the lessor accounting model.** The most current decisions would retain a model for lessors that would be very similar to existing GAAP, rather than having different lessor accounting for Type A equipment and Type B property leases as proposed in the 2013 Exposure Draft. The September 2013 IAC Letter supported that view, indicating that “current lessor accounting is a better representation of the economic reality of a lease transaction than the [2013 Exposure Draft] proposal.” That change is also responsive to IAC members concerns about up-front profit recognition for Type A equipment leases.
- **Convergence.** Some IAC members are concerned if the Board’s proposed dual lease model moves forward (and the IASB retains its single model approach), this will create global divergence in the way leasing transactions will be presented in companies’ income statements and cash flows. As a result, this will hinder comparability unless additional disclosure (as those suggested above) is provided to allow users to reconcile these disparate presentations. However, all IAC members support the Board’s decision not to include an exception to the standard for small-ticket items to conform to IASB decisions. We believe that a small-ticket exemption could result in potentially material lease obligations being omitted from the lease measurement. The IAC believes a picture of a company’s obligations would be deficient if many individually immaterial assets could be exempted regardless of the aggregate amount of leases.

- **Disagree with use of issuer incremental borrowing rate to determine lease liability and income statement and cash flow classification.** Consistent with our September 2012 letter, the IAC continues to disagree with the decision to discount lease payments at an issuer's incremental borrowing rate. If discount rates are going to be used to discount the lease obligations, then a common discount rate should be used for all firms. The current proposal has each firm using their own unique discount rate. The problem with this is that lower quality firms will discount their lease liabilities at a higher rate and so the present value will be less for a lower quality company. This is counter-intuitive to what investors would expect. Use of an incremental borrowing rate would also affect interest expense, depreciation and cash flow classification, decreasing comparability. If lower quality companies were forced to also pay higher lease payments by the lessor, due to their lower quality, this would offset this effect. However, it is not clear that there is evidence that supports the concept that higher lease payments are required for lower quality companies. As such, we would recommend that companies have a common discount rate. Discount rate guidance in US GAAP varies by topic and is not always tied together from a holistic measurement and presentation perspective. The IAC suggests requiring a common discount rate until such time as the Board is able to consider the use of discount rates as part of a broader project, such as measurement guidance or as part of the conceptual framework.

Sincerely,

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