Mind the GAAP
Making the Complex Understandable

September 3, 2013

Financial Accounting Standards Board
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Attn: Technical Director
File Ref: 2013-270

Thank you for the opportunity to comment on the Proposed Accounting Standards Update entitled "Leases (Topic 842)", reissued on May 16, 2013 and hereafter referred to as the "Updated Lease Proposal".

Who We Are

At Mind the GAAP, we deliver U.S. GAAP and IFRS training to financial statement preparers, users, and auditors. Our clients are diverse, including:

- Global Fortune 500 organizations,
- Big Four audit firms,
- Major credit rating agencies,
- Small private companies, and
- Regional accountancy practices.

One of our most frequent training topics is around lease accounting.

Mind the GAAP has provided training services to our clients for over eleven years. Prior to the formation of Mind the GAAP, a number of our principals served in the national offices of global accounting firms, responding to technical accounting queries and developing accounting training for the firms' assurance practices.

Executive Summary

We acknowledge that applying some aspects of ASC Topic 840 (and IAS 17), as currently written, can be challenging for preparers. For this reason, we support the FASB and IASB making targeted improvements to the existing leasing literature. The final section of this letter outlines the types of changes we believe would be beneficial

to users of financial statements, yet would not be overly burdensome to preparers and auditors.

However, we are opposed to wholesale and fundamental changes to the lease accounting principles that have been in place since the 1970s. For example, we see no good reason to abandon the operating lease/capital lease delineation in favor of a classification approach, as outlined in the Updated Lease Proposal, that:

- For balance sheet purposes, is based on whether a lease is twelve months or less in duration, while

- For income statement purposes, is based primarily on whether the asset underlying the lease is property or equipment.

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Based on our experiences, the investing community and other users of financial statements generally understand and appreciate the logic behind demarcating operating lease versus capital leases. And because existing lease accounting guidelines have been place for years, financial statement users have extensive experience with – and knowledge of – the accounting presentation for each type of lease.[1]

Perhaps most importantly, the principles underlying Topic 840 (and IAS 17) seem to be sound and consistent with business reality. In our view, there truly are two disparate types of leasing arrangements:

- The first type – designated as an operating lease under Topic 840 and IAS 17 – results when a lessee borrows a lessor's property for a relatively short period of time, and compensates the lessor through periodic rental payments. In other words, the lessee consumes some, but not a significant portion, of the economic utility of an asset owned by the lessor.

- The other type of leasing arrangement – a capital or finance lease – occurs when a lessee consumes most of the economic utility of an asset. In substance, the

[1] To the extent that some users might prefer a different accounting treatment than prescribed by ASC Topic 840 or IAS 17, they have developed mechanisms to make adjustments to the basic financial statements based on relevant information disclosed in the footnotes. For example, we work with some credit analysts that prefer companies to reflect a liability for future payments due under operating leases. Thus, they adjust the U.S. GAAP or IFRS balance sheet to reflect a liability for future minimum lease payments, using figures disclosed in the notes.

lessee is purchasing an asset, with the lessor providing financing. Another way to view this type of arrangement is that the lessee has economically entered into a secured borrowing, paying for an asset over time through periodic payments of principal and interest to the lessor.

In real life, operating leases can occur when the underlying asset being rented is equipment, property, or other types of assets. Similarly, capital or finance leases also can involve any type of underlying property.

Hence, we do not support changing the delineation for lease classification (at least for income statement purposes) to be one primarily based on the asset underlying the lease.[2] Classifying a lease in this manner is inconsistent with commercial reality and would not faithfully represent certain leasing arrangements in the financial statements.

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Under today's current accounting requirements, a lease is classified using a set of rules/conditions set out in ASC 840-10-25 and IAS 17. Depending on the results of this analysis, a lease is either presented as operating or capital/finance consistently throughout all of the financial statements.

As noted previously, the Updated Lease Proposal uses one set of criteria to determine whether the leases are recognized on the balance sheet, and a completely disparate set of criteria for classifying leases for income statement and cash flow statement presentation. We believe this will result in confusion for users of financial statements.

- To demonstrate, under the Updated Lease Proposal, equipment leases would typically be classified as "Type A" for income and cash flow statement purposes. Under a Type A lease, lessees recognize **amortization** of the right-of-use asset (often using a straight-line method) and **interest charges** on the lease liability, based on applying an effective interest method.

[2] From a balance sheet perspective, classifying a lease based on its maximum possible term (e.g., a "capital" lease results if the lease term is for more than 12 months) has a bit more conceptual merit in our view. However, using a "bright line" cut-off of 12 months still could cause some lease arrangements to be misclassified. As a simple example, assume that a leased asset has a remaining useful economic life of 13 months, and a maximum lease term of 11 months, 29 days. It seems incongruous to us that the Updated Lease Proposal would allow for this lease to be bookkept off balance sheet – akin to today's operating lease accounting – when the lessee would consume virtually all of the economic benefits of that asset.

  - For the vast number of industrial companies that report a non-GAAP measure of EBITDA (earnings before interest, taxes, depreciation and amortization), 100% of the cost associated with leasing equipment would be excluded from this very important metric.

  - In addition, the cash outflows associated with a Type A lease would be split apart and presented as components of financing, operating, and (under IFRS) possibly investing activities in the Statement of Cash Flows.

- In contrast, the Updated Lease Proposal would classify most property leases as "Type B" for income statement and cash flow statement purposes. Under Type B leases, lessees would present the costs of entering into a lease as one figure in the income statement, presumably in a line item other than amortization or interest expense.

  - Accordingly, lease-related costs from Type B leases would in fact be reflected in most EBITDA measures.

  - Also, cash outflows from Type B leases are presented in their entirety in the operating activities section of the Statement of Cash Flows.

We believe that the operating performance of most industrial companies should reflect the costs of using leased equipment and property, as such costs are directly related to an entity's ongoing and central activities. However, the income statement and cash flow statement presentation requirements in the Updated Lease Proposal obfuscate this commercial reality, as highlighted in the table below:

	Updated Lease Proposal	Current U.S. GAAP
Short-term equipment lease	• Election to report off-balance sheet • Straight-line rental expense • Reflected in EBITDA • Operating cash outflow	• Usually an operating lease, off-balance sheet • Straight-line rental expense • Reflected in EBITDA • Operating cash outflow
Typical equipment lease	• Asset/lease obligation on balance sheet • Accelerated expense recognition • Not reflected in EBITDA • Partially a financing cash outflow	• Often an operating lease, off-balance sheet • Straight-line rental expense • Reflected in EBITDA • Operating cash outflow
Typical plant lease	• Asset/lease obligation on balance sheet • Straight-line rental expense • Reflected in EBITDA • Operating cash outflow	• Typically an operating lease, off-balance sheet • Straight-line rental expense • Reflected in EBITDA • Operating cash outflow

In contrast, we believe that current GAAP is far more consistent in presenting the effects of leased property and equipment – both of which are central and necessary to the generation of operating income for the lessee – in the basic financial statements. In other words, current U.S. GAAP (and IFRS) produces more meaningful, and less confusing, financial information versus how the Updated Lease Proposal would be applied at most industrial companies.

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Additionally, we have other operational and conceptual concerns with the Updated Lease Proposal, including the following:

- Amortization of a ROU asset in a Type B lease.
    - To force a straight-line expense recognition pattern for Type B leases, the Updated Lease Proposal requires that lessees amortize a right-of-use asset on an increasing basis over the term of the lease. Using the figures in Example 1 and paragraph 842-20-55-18 of the Updated Lease Proposal, the amortization of the ROU asset would be CU 31,424 in Year 1, CU 33,180 in Year 2, and continue to increase throughout the term of the lease.
    - This amortization pattern does not reflect the economic reality of how the underlying benefits of a leased asset are utilized. Simply, it's hard to imagine the lessee consuming more and more economic utility from a property as it ages. If anything, a lessee would typically consume this type of asset evenly over the lease term, or possibly at an accelerated rate in the *earlier* years of the lease term.
        - To demonstrate, consider a residential home. When the home is first built, all of the materials and structures are new. As these structures and materials age, they start to break down, necessitating repairs or capital improvements.
        - Therefore, as the home gets older, the owner (or lessee) is arguably consuming less of the home's economic utility, not more of it. At best, the consumption is occurring evenly over the life of the home.

- In fact, existing U.S. GAAP already bans increasing rate methods of depreciation. See, for example, ASC 360-10-35-10. The SEC has also previously indicated its concerns with companies trying to justify increasing rate amortization methods for intangible assets[3]. Given these historical precedents and the above discussion around economic reality, we do not believe that using an increasing rate method of amortization would be conceptually appropriate for a ROU asset – apart from "making the math work" to achieve a desired outcome of straight-line expense recognition for Type B leases.

- Obligations and Assets for Lease Contracts.

  - We actually are not averse to having lessees recognize assets and liabilities for lease contracts. However, we are concerned that the thresholds for doing so – as set out in the Updated Lease Proposal – are inappropriate. As noted previously, we don't believe the cut-off should be based on whether he maximum lease term is for 12 months or greater.

  - We believe that there are two reasonable views on when assets and liabilities should be recognized by lessees:

    - *The conceptual model* – This model follows from our earlier comments in this letter. Again, consistent with current U.S. GAAP and IFRS, there are economically two types of leases. The first type of lease is one in which the lessee does not consume a substantial portion of the economic utility of an asset. A lessee should not recognize an asset or lease obligation in this instance. However, a lessee should recognize an asset and obligation in the second type of lease, in which the lessee is in substance acquiring most of the economic utility of a leased asset through a de facto financing arrangement.

    - *The more pragmatic model* – This model would require recognition of assets and liabilities for all types of leases. The theoretical underpinnings for this model are similar to those identified in the Updated Lease Proposal – that the lease conveys the exclusive use of an asset to the lessee for a period of time; in exchange the lessee commits to make periodic lease payments.

[3] See speech by Chad Kokenge at the 2003 Thirty-First AICPA National Conference on Current SEC Developments.

- If this "more pragmatic" model is utilized, though, we stress the importance of retaining consistency with the subsequent measurement and derecognition principles for similar types of assets and liabilities.

- Specifically, the asset recognized in the "more pragmatic model" should be amortized/depreciated over its expected useful life considering its pattern of consumption (as mentioned previously, generally straight-line or accelerated). It should also be periodically tested for impairment.

- The obligation should be measured/derecognized like all other interest bearing liabilities – i.e., with interest recorded based on the effective yield method.

- Therefore, the main differences between the Updated Lease Proposal and our views are as follows:

  - In regards to our "conceptual model", we are in essence supporting a complete abandonment of the ROU approach outlined in the Updated Lease Proposal, and endorsing the retention of existing U.S. GAAP and IFRS with some targeted improvements (discussed in more detail later in this letter).

  - In the case of our "more pragmatic model", we are more closely aligned with the ROU proposition contained in the Updated Lease Proposal, but would allow for no "short-term lease" exemption to recognizing lease assets and liabilities. Also, in all cases we would mandate an income statement presentation akin to that prescribed for Type A leases.

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In summary, we have significant concerns around the conceptual underpinnings of the Updated Lease Proposal, and don't believe the changes resulting from its adoption would be an improvement to existing U.S. GAAP or IFRS. Perhaps most importantly, we feel that the Updated Lease Proposal would confuse, rather than enhance, financial statement users' understanding of a reporting entity's lease arrangements.

Instead, we feel that the Boards should focus on implementing targeted improvements to the existing lease accounting guidance in Topic 840 and IAS 17; in fact, certain of these potential improvements arise from ideas contained in the Updated Lease Proposals. Please see our detailed recommendations in the next and final section of this correspondence.

If you have any questions or require further information regarding the contents of this letter, please contact Scott Ehrlich, President and Managing Director of Mind the GAAP, at +1 (773) 732-0654 or by email at sehrlich@mindthegaap.com.

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Enhancements to the Existing Lease Accounting Guidance

In lieu of making wholesale changes to existing GAAP around lease accounting, we would instead encourage the Boards to focus on targeted improvements to ASC Topic 840 and IAS 17. Potential areas for consideration are as follows:

- Lease Classification:
    - Once again, we do believe that there are economically two types of leases, which should be accounted for in different ways. Thus, it's important to have robust guidelines for assessing whether a lease should be classified as operating or capital/finance.
    - Existing U.S. GAAP has been criticized as being too "rules based" or prescriptive in identifying the lease type. In contrast, IAS 17 has been critiqued for being too "principles" based, using terms like "the major part of the economic life of the underlying asset" and "substantially all of the fair value" in evaluating whether a lease should be classified as operating or finance.
    - If the Boards do decide to revert back to a "operating vs. capital model" for classifying and accounting for leases, we would suggest that the Boards improve the principles and factors companies should use to determine lease-type. We actually feel that the discussion contained in paragraph 10 if IAS 17 would be a good starting point for any revised guidelines, but would ask the Boards to use more precise wording and/or

provide implementation guidance to help preparers better apply these principles and concepts.

- Lease Inception vs. Commencement Date:

    - We support the suggested amendments in the Updated Lease Proposal to revise the recognition date of a lease from lease inception to lease commencement.

    - Doing so would represent an improvement to current GAAP because it would result in the elimination of the complex "in-substance owner" rules. These complicated guidelines are definitely expendable. As noted in the Updated Lease Proposal, they were created prior to the issuance of U.S. GAAP guidance around variable interest entities, and the refinement of the notion of control set out in IFRS 10. These more recent guidelines are adequate in determining whether a lessee ought to consolidate a lessor prior to and/or after the commencement of a lease, making the "in-substance owner" rules contained in paragraphs 2-15 of ASC 840-40-55.

- Sale-leaseback Accounting:

    - We support the suggested changes within the Updated Lease Proposal related to the accounting for sale and leaseback transactions.

    - It makes sense to align the sale and leaseback guidance with the anticipated revenue recognition improvements expected to be issued later this year. In addition, the Boards' sale-leaseback recognition approach outlined in the Proposed Lease Updates is far simpler relative to (yet as conceptually sound as) the current requirements outlined in ASC Subtopic 840-40.

- Significant Economic Incentive:

    - We support the Boards' proposal to assess whether optional lease extensions and/or termination periods should be included within the lease term based on whether the lessee has a significant economic incentive to exercise the extension option or to not exercise a termination option. We believe this guidance better allows for objective judgment to be incorporated into the determination of the lease term versus the comparable concepts currently contained in ASC Topic 840.

- Also, while we support a periodic reassessment of the lease term, we would suggest limiting this assessment to once per fiscal year, as an operational simplification for preparers. We don't think curbing the frequency of the evaluation would compromise the delivery of timely, relevant and decision-useful information to financial statement users, but it would save substantial time and cost to practitioners and auditors.

- We note that a "once per annum" assessment is consistent with other GAAP guidelines for longer-term assets/arrangements – such as the provisions of ASC 350-20-35-28 and paragraph 96 of IAS 36 related to the timing of testing goodwill for impairment.

- Variable Lease Payments:

  - We agree with the alternative views of Mr. Siegel described in BC384. In addition, we would go one step further, and propose that lessees estimate all types of variable lease payments, including those related to changes in a future index, for purposes of lease classification and recognition/measurement.

  - In a vast majority of lease arrangements, payments increase for inflation over the lease term. Often, the increase is tied to a published index, such as the U.S. Consumer Price Index or CPI.

    - This type of index has been issued since 1913.

    - In addition, in today's economic climate, forecasts of inflation are made frequently by governmental officials and corporate economists.

  - Hence, there is a tremendous amount of observable and reliable data by which companies can make forecasts about future inflation rates and, by definition, lease payments. We believe that lessees should be required to make these estimates for purposes of (a) lease classification and, as necessary (b) recognition and measurement of lease assets and obligations.

  - Said another way, we consider that all variable lease payments would meet the definition of a liability (or asset in the case of lessor accounting) at lease commencement and therefore should be included within the

measurement of the lease liability or receivable. In particular, we would suggest that there is sufficient historical data to be able to determine a reliable estimate of inflation – based on changes in an index like CPI – rather than applying the current rate for that index.

  - We also believe that in most instances, lessees would be able to reliably estimate variable payments based on something other than an index. Otherwise, they wouldn't have agreed to the variable lease provisions in the first place.

  - Accordingly, these variable payments should also be included the measurement of the lease liability, and estimates should be reviewed/revised once per annum, consistent with reconsideration of the lease term.

- Leveraged Leases: We support the official elimination of the leveraged lease concept. We feel that a lessor should only classify a lease in one of three ways, consistent with underlying economics – operating, direct financing, or sales-type.

- Transition and Effective Date:

  - We do not support the transition guidance outlined in the Updated Lease Proposal. While we acknowledge that a retrospective or modified retrospective form of adoption would provide important comparative information for financial statement users, the costs and challenges to preparers of restating past results would outweigh these benefits.

  - We instead would suggest allowing for preparers to record a cumulative catch-up adjustment at the beginning of the year of adoption to give effect to any new lease accounting guidelines that are promulgated.

  - Similar to the revenue recognition guidelines that the Boards expect to issue later this year, we feel that pro forma comparative information could be included in the footnotes to help financial statement users assess the impact adopting any new leasing standards.

  - In terms of timing, we believe that companies will need sufficient time to fully comprehend and implement the necessary system and process changes required to adopt any new lease accounting requirements. Furthermore, the interaction between the guidance for lessors and the

forthcoming amendments to the revenue recognition literature should mean that both pieces of guidance are effective at the same date (i.e., in 2017 for calendar year public entities).