Private Company Financial Reporting Committee
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Judith H. O'Dell CPA CVA
Chair

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Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Re: Leases: Preliminary Views

Dear Mr. Herz:

The Private Company Financial Reporting Committee ("PCFRC" or "committee") offers its recommendations and comments below on the FASB's Preliminary Views, *Leases*.

Key Points

1. The PCFRC recommends that the FASB address the lessor side of lease accounting in conjunction with the lessee side. Having both sides of lease accounting resolved at the same time is essential in the private company sector. This is because of the prevalence of related party leasing arrangements in the private company sector, often involving variable interest entities. Without resolving the lessor accounting along with the lessee accounting, uncertainty and misunderstanding may occur in trying to account for and report on these related party arrangements.
2. On the basis of cost-benefit considerations, the PCFRC recommends that arrangements in which the most likely term, including renewal clauses, is twelve months or less should not be required to be capitalized.
3. Describing the decrease in value of the right-of-use asset as rental expense is not supported by the PCFRC. The use of the rental expense description in conjunction with the recording of the obligation to make lease payments as a liability may affect key financial metrics such as the debt-to-EBITDA (earnings before interest, taxes, depreciation and amortization) ratio, which is an important measure in the private company sector.
4. The PCFRC recommends that amounts payable under contingent rental agreements and residual value guarantees should not be included in the lessee's obligation and should only be recognized when payment is probable.
5. The PCFRC recommends that the FASB consider adding guidance to the proposed standard that would address the accounting for leases with variable payments due to something other than a contingency or an index.

For example, copiers are sometimes leased based on numbers of copies made. Some equipment is leased based on hours of use. The usage can vary considerably from month to month. These types of leases are very common in the private company sector.

Specific Responses to Certain Questions Asked in the Preliminary Views

Q2) *Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.*

The PCFRC recommends that arrangements in which the most likely term, including renewal clauses, is twelve months or less should not be required to be capitalized. The pure volume of short-term arrangements can increase costs significantly if private companies are required to account for each short-term arrangement under the guidance proposed in the Preliminary Views. Furthermore, the financial statement users on the PCFRC see little benefit in accounting for and reporting short-term arrangements as leases. Such short-term arrangements are normally rentals and not leases and the PCFRC recommends that the FASB differentiate between the two.

Q4) *The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognize (a) an asset representing its right to use the leased item for the lease term (the right-of-use asset) (b) a liability for its obligation to pay rentals. Do you support the proposed approach?*

Yes, the PCFRC supports the proposed approach.

Q6) *Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate? If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.*

Yes, the PCFRC agrees with the boards' tentative decision. This approach simplifies the existing capital lease measurement process.

Q7) *Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost? If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.*

Yes, the PCFRC agrees with the boards' tentative decision. This approach will simplify the asset measurement by tying it to the liability measurement.

Q8) The boards tentatively decided to adopt an amortized cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do *you agree with this proposed approach? If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favor and why.*

PCFRC members expressed two viewpoints about the subsequent measurement of the lease obligation and right-of-use asset.

- Some PCFRC members support the FASB's tentative decision to require a non-linked approach to the amortization of the lease asset and liability. Although the right-of-use asset and the obligation to pay rentals are linked at the inception of the lease, that is not necessarily the case after inception. Once the leased asset is in place, it may or may not match the amortization of the related liability. These members believe it is a discrete asset. For example, the right-of-use asset could become impaired or undergo significant depreciation early in the lease term, but the lessee would still be required to make the same rental payments. Therefore, these PCFRC members believe that economic reality would be better reflected if the lease asset and liability were not linked.
- Other PCFRC members disagreed with the FASB's preliminary view to not adopt the linked approach to subsequent measurement. These members believed that not pairing the amortization of the asset and liability would cause distortion in the statement of financial position. The right-of-use asset is a contractual asset and it should be matched with the related contractual lease liability. The physical asset underlying the lease should not determine the amortization of the right-of-use asset. In addition, under the proposed approach a distortion could occur between the income statement and cash flows.

Q12) *Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortization or depreciation in the income statement. Would you support this approach? If so, for which leases? Please explain your reasons.*

The PCFRC does not support this approach. The use of amortization or depreciation expense is consistent with the existing capital lease classification and, therefore, will be more intuitive to private company financial statement users. The use of rental expense would give the appearance of mixing the attributes of capital leases and operating leases, which could cause confusion. Moreover, the proposed approach could have the unintended consequence of negatively affecting certain key financial metrics (for example, debt-to-EBITDA (earnings before interest, taxes, depreciation and amortization) ratio) by increasing liabilities through the recording of previous operating lease obligations while continuing to report rent expense, which reduces EBITDA. The debt-to-EBITDA ratio is a key metric utilized in the private company sector.

Q13) *The boards tentatively decided that the lessee should recognize an obligation to pay rentals for a specified lease term, i.e. in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely* *lease term. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.*

Yes, the PCFRC supports the proposed approach, being a simpler approach than trying to deal with the uncertainty in the lease term through measurement and employing probability. However, the PCFRC does not agree with the preliminary view expressed in paragraph 6.41 that the lessee's intentions and past practices would not be factors to be considered in determining the most likely lease term. The PCFRC supports the view stated in paragraph 6.40(d) that would require lessees to consider all relevant factors in determining the lease term.

Q14) *The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognized as an adjustment to the carrying amount of the right-of-use asset. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.*

Yes, the PCFRC supports the proposed approach and believes that paragraph 6.46 is well-stated. Requiring reassessment of the lease term at each reporting date could add significant cost for preparers. However, this cost may be justified if such reassessments provide financial statement users with more relevant information.

Q16) *The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements. Do you support the proposed approach? If you disagree with the proposed approach, what alternative approach would you recommend and why?*

The PCFRC does not support the approach in the Preliminary Views to include amounts payable under contingent rental agreements in the lessee's obligation to pay rentals, primarily for the reasons stated in paragraph 7.7. Committee members are of the opinion that the lessee's obligation to pay contingent rentals does not exist until the future event requiring the payment occurs. Particularly when payment is linked to usage or performance of the lessee, the obligation to pay rentals should exclude the contingent element. The PCFRC supports the existing approach, which recognizes an obligation only when the contingency is resolved or the achievement of the target is considered probable (FASB ASC 840-10-25-35). Additional disclosure may prove useful, if desired by financial statement users.

Q17) *The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. Which of* *these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.*

If contingent rental obligations are to be recognized, the PCFRC supports FASB's measurement approach as preferable to IASB's, primarily because it is simpler and less costly to implement.

Q19) *The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments. Do you support the proposed approach? If not, please explain why.*

If contingent rental obligations are to be recognized, the PCFRC would support the proposed approach if it were determined that the benefits to financial statement users justified the additional cost for preparers. The PCFRC is prepared to do outreach to our constituents on this issue if needed.

Q20) *The boards discussed two possible approaches to recognizing all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:*

(a) recognize any change in the liability in profit or loss

(b) recognize any change in the liability as an adjustment to the carrying amount of the right-of-use asset.

Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

If contingent rental payments are to be recognized, the PCFRC supports approach (b) because it is consistent with other remeasurement changes and therefore avoids any confusion.

Q21) *The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?*

Similar to its view about contingent rentals, the PCFRC is of the opinion that amounts payable under residual value guarantees should only be recognized when payment under the guarantee is probable. The PCFRC agrees with FASB's tentative decision not to require residual value guarantees to be accounted for as derivatives. Any change in the liability should be an adjustment to the carrying amount of the right to use asset.

Q22) *Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons. What additional information would separate presentation provide?*

Yes, the PCFRC believes the lessee's obligation to pay rentals should be presented separately in the statement of financial position. Lease obligations are inherently different in nature from other debt obligations. Separate presentation would provide useful information to users.

Q23) *This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position. How should the right-of-use asset be presented in the statement of financial position? Please explain your reasons. What additional disclosures (if any) do you think are necessary under each of the approaches?*

The PCFRC recommends that the right-of-use asset should be presented in the statement of financial position in accordance with the views expressed in paragraph 8.16. In accordance with that view, the right-of-use asset should be presented in the statement of financial position on the basis of the nature of the leased item. As noted, this approach provides users of financial statements with more information about the leased item than other possible approaches. In addition, the PCFRC believes leased assets should be presented separately from owned assets.

Q24*)* *Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.*

The PCFRC suggests that the FASB consider adding guidance to the proposed standard that would address the accounting for leases with variable payments due to something other than a contingency or an index. An example would be units of production which can vary considerably from month to month or year to year. The presence of variable payments in a lease contract will present practical implementation issues for "value of use" treatment. These types of leases are very common in private companies.

For example, a lessee enters into an agreement to 'rent' equipment for a term of hours with a maximum number of months. The lessee makes monthly payments based on the actual number of hours used at a fixed rate for usage and a fixed rate per month for maintenance. In this example, neither a contingency (as the Preliminary Views contemplates contingencies) nor an index is involved. What is involved is a difference in an estimate of the timing of the payment stream and therefore the value of the asset and liability. Guidance on this "unit of production" type lease example and other leases with variable payments would be helpful.

The document does not seem to address implementation issues with respect to existing leases. A retroactive approach for short term leases (5 years or less) would be very costly for private companies.

Q29) *Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.*

The PCFRC recommends that the FASB should address the lessor side of lease accounting in conjunction with the lessee side. The private company sector is heavily involved in related party lease arrangements. Given the nature of related party leases, the PCFRC believes that resolving lessor accounting simultaneously with lessee accounting is necessary. If the related party lease is capitalized under the new standard and the lessor accounting is not addressed in the final document, consolidating the variable interest entity could lead to strange results in the consolidated financial statements.

The PCFRC appreciates the FASB's consideration of these comments and recommendations. As we receive additional input from our constituents, we will work with that information and provide the FASB with additional feedback, as appropriate. Please feel free to contact me if you have any questions or comments.

Sincerely,

Judith H. O'Dell
Chair
Private Company Financial Reporting Committee