

March 13, 2015

David R. Bean, CPA
Director of Research and Technical Activities
GASB
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: November 11, 2014 Preliminary Views of the Governmental Accounting Standards Board (GASB) on major issues related to Leases [Project No. 3-24P]

Dear Mr. Bean:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to speak on behalf of local and regional firms and represent those firms' interests on professional issues in keeping with the public interest, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the Preliminary Views (PV) and is providing the following comments for your consideration.

GENERAL COMMENTS

TIC understands the Board's rationale for undertaking a comprehensive re-evaluation of the existing leasing standard, including the need to recognize substantially all leasing obligations in the statement of net position. TIC believes the changes will have a disproportionate implementation cost for governments compared to the resulting benefits for financial statement users. In the existing financial statement model, the dollar amounts of commitments for operating leases are already disclosed in the notes. Therefore, changing the accounting for those lease commitments from disclosure only to liability recognition will not provide a significant amount of new information for many financial statement users. However, the proposed changes will require significant implementation challenges for state and local governments.

TIC has some significant concerns about the extra effort and cost involved in complying with some of the provisions of this proposal. Large governments have experience with the recognition, measurement and disclosures applicable to capital leases, but will incur significant time and expense (including system changes) to adopt the initial and subsequent measurement requirements for the myriad of operating leases on their books. Smaller governments don't have this expertise in-house, since most of their leases have been classified as operating leases under the extant standard. As complexity increases, more and more governments will be forced to hire outside help to provide the necessary assistance and expertise that is lacking in-house. TIC therefore encourages the Board to adopt simplified methodologies wherever possible to mitigate the additional burdens that governments will face with the new standard.

Chapter 1, par. 12, of the PV states that:

The changes being proposed also would provide preparers and auditors with less complex guidance to follow when reporting leases.

TIC acknowledges that certain simplifications have been incorporated into this PV. However, the Board has also introduced additional complexities in the following areas, which TIC opposes:

- leases with multiple components,
- the assessment of renewal options for inclusion in the lease term
- certain disclosures

In at least one other area (i.e., the accounting for bargain purchase options), the Board's simplification efforts have not gone far enough.

TIC believes additional simplifications in the above areas are critical to offsetting the inherent complexity of recognizing almost all lease liabilities on the statement of net position and complying with the related subsequent measurement requirements. TIC also believes that the proposed accounting for each of the above topics would not provide sufficient incremental benefits to financial statement users to outweigh the cost of implementation.

A number of the Board's proposals differ from the FASB's conclusions-to-date on the same topics. Some of the differences include:

- Lessee accounting for bargain purchase options,
- The exception provision to the proposed separation requirement for lease contracts with multiple components,
- The threshold for evaluating renewal options after the noncancelable lease term,
- A single lease expense for "rental arrangements" v. financings, and
- Accounting for related party leases.

TIC believes constituents who will be commenting on the future leases exposure draft would benefit from understanding the Board's rationale for any remaining differences between the two boards. Therefore, TIC recommends that the ED include a listing of the major GASB/FASB differences, along with a discussion of the Board's rationale for those differences. TIC also recommends that the Board defer issuance of a final leases standard until the FASB has issued its new leases standard.

The specific comments section below includes a discussion of TIC's opposing views on certain issues, recommended clarifications and simplifications regarding certain matters in the PV and thoughts on future transition and effective date provisions.

SPECIFIC COMMENTS

Scope Exclusions

During TIC's consideration of the scope exclusions in the PV, a few members questioned whether land that is leased out temporarily for the production of biological assets would be excluded from the scope of the proposal. For example, in rural areas, governments may acquire excess land surrounding their facilities and lease the excess acreage to farmers to grow crops until the land is ready for development.

During the lease term(s), the land is effectively being held for the production of income and would appear to meet the definition of an investment in GASB Statement 72, *Fair Value Measurement and Application*. If so, the land would be excluded from the scope of the Leases PV per Chapter 4, paragraph 18, and Chapter 5, paragraph 15. Once the land is developed, however, leasing activities would end, and the land would meet the definition of a capital asset, which would be used to provide services directly to constituents. This change in the usage of the asset may be relevant to whether the land in this example falls within the scope of the Leases PV or Statement 72.

The Basis for Conclusions in Statement 72 includes guidance relating to real property that TIC believes could be relevant to this issue:

Real Property

B43. One Preliminary Views respondent expressed concern about how the definition of an investment would affect the reporting of real estate assets and suggested the fair value model be extended to real property that can be converted into investments. The scope of this project related to the application of fair value is limited to assets and liabilities that are currently measured at fair value and investments that are not measured at fair value. To develop the accounting treatment for an asset that could be reclassified would not meet the agreed upon scope of this Statement. [Emphasis added]

The fact that the land in the above example could be converted from an investment to a capital asset seems to represent a scenario that was not contemplated when Statement 72 was deliberated. Therefore, TIC believes the Board's intent was to exempt such assets from the scope of Statement 72. If true, then the question is whether land temporarily held for lease falls within the scope of the Leases PV.

TIC therefore recommends that the Board address this issue in the next public document. If the Board decides not to do so, TIC requests that the Implementation Guide include a Q&A on this topic.

Bargain Purchase Options

The PV assumes that a lease containing a bargain purchase option will always be exercised by the lessee government. Therefore, the PV considers leases with bargain purchase options to be in substance the same as an outright transfer of ownership by the lessor to the lessee. Such leases are excluded from the scope of the PV and would be accounted for as financed purchases of the leased assets.

TIC disagrees with the Board's assumption that the lessee government would always exercise a bargain purchase option. TIC members have found that some of their clients, for various reasons, do not exercise bargain purchase options. In some cases, the decision to exercise the option will depend on the type of asset being leased. For example, bargain purchase options for copiers or police cars generally will not be exercised because the government is more likely to roll the old lease into a new lease for a newer asset. In contrast, bargain purchase options on leases of heavy equipment are more likely to be exercised.

Governments will weigh various considerations before exercising a bargain purchase option; a bargain for one government may not be a bargain for another. In situations requiring compliance with bid statutes, even though a government could sell an asset for more than the purchase option, it may opt not to do so because of the hassle involved in seeking bids for the sale or for coordinating a public auction. There also may not be an easy market for the used asset. Governments don't necessarily base their decisions on economics alone.

TIC also believes the proposed accounting for a financed purchase v. a lease is not sufficiently different to warrant the extra effort involved in requiring governments to remove leases with bargain purchase options from the lease accounting model. The PV requires all lessees to recognize an asset and an obligation on the statement of net position for all leases (except for short-term leases), whether or not bargain purchase options exist. Similarly, on the statement of activity, interest and depreciation expenses are recorded for a financed purchase, and interest and amortization expenses are recognized for a capitalized lease. Financial statement users are likely to be more interested in whether purchase options exist and the likelihood of exercise than in having certain leases presented on different line items of the financial statements.

Furthermore, under the Board's current proposal, the subsequent accounting for bargain purchase options is unclear. If lessees are required to recognize a financed purchase at the inception of the lease whenever a lease includes a bargain purchase option, it seems the lessee government would be required to recognize a loss whenever the bargain purchase option is not exercised (e.g., when the government decides to roll over the lease contract for a newer model of the leased asset, such as a copier or a police car). In these situations, the proposed accounting will add complexity and will be less relevant for financial statement users.

In place of the proposed accounting, TIC recommends that the Board adopt lease accounting principles for leases with bargain purchase options and limit financed purchases to those leases that automatically transfer title to the lessee at the end of the lease. Under this simplified approach, the accounting for bargain purchase options would be the same as the accounting for any purchase option that is probable of being exercised. That is, the exercise price of all bargain and nonbargain purchase options that are at least probable of being exercised should be included in the measurement of the lease liability.

TIC therefore requests that the Board reconsider its decision on bargain purchase options. TIC believes its alternative would simplify the accounting for bargain purchase options, avoid the subsequent measurement issues that could arise when bargain purchase options are not exercised and provide a more informative presentation for financial statements users.

TIC believes a number of governments could ultimately decide not to exercise bargain purchase options that are written into lease contracts. Therefore, if the Board decides to retain the proposed provisions on accounting for bargain purchase options, the next public document should provide guidance relating to subsequent measurement issues.

Contracts with Multiple Components

The Board's preliminary view is that a contract that contains both lease and service components generally should be separated so that each component is accounted for on its own. TIC supports this view only if the lease and service components can be clearly identified and quantified. The PV provides for an exception to the separation rule, but TIC believes the conditions for meeting the exception add unnecessary cost and complexity to the standard.

Many government lease contracts include the lease and service arrangements in one contract without separately identifying the prices of each component. Two common examples are copier leases with a service component and apartment leases with a maintenance component. Separation of the components of each lease contract often is difficult to determine, as confirmed by the TIC member who participated in the field test for the PV.

The exception provisions stated in the PV would require the lessee to determine if observable stand-alone prices are available for some or all of the components. The

contract would be accounted for as a single lease only if no observable stand-alone prices are available for any of the components. Even if the contract includes separate pricing for each component, the lessee would be required to determine whether the stated prices are reasonable based on observable stand-alone prices for identical or similar assets or services.

The flowchart for allocation of consideration to multiple components in paragraph 13 of Chapter 2 walks through the required steps that the lessee would have to follow to determine whether separate observable stand-alone pricing is available for each component of the contract. For each such contract, the lessee would be required to assess the reasonableness of any separate prices that are explicitly stated in the contract. When individual prices for each component are not separately stated in the contract, the lessee is required to seek out stand-alone pricing for each component, determine whether such prices are representative in the marketplace and allocate the contract price when some prices are unavailable.

The proposed requirements for contracts with multiple components would be onerous for governments, even if the information was readily available. The PV expects the governments to seek out sources for stand-alone prices and then apply the allocation criteria for every lease contract that has multiple components. In many cases, observable inputs for stand-alone pricing are not available. However, even if some inputs are available, determining whether the sources used would represent true marketplace prices would be difficult for governments and their auditors, since many prices are negotiated based on individualized needs, volume, etc. Each government also would have to prepare extensive documentation to retain a record of its process and to provide practitioners with the information they would need to evaluate the government's procedures and assessments.

This process would create an unreasonable amount of effort that smaller governments would not have the expertise or the time to perform. Many governments may refuse to perform the required steps, which would then require the auditors to perform the procedures to determine the materiality of the GAAP departure. Even with proper documentation available from governments that follow the required steps, auditors would have to verify the pricing obtained, re-perform any allocations and evaluate the government's conclusions. In addition, as indicated by the field test referenced above, all of the necessary information is not likely to be available, leading governments to default to a conclusion that the contract would be accounted for as a single lease contract.

Aside from the time and effort to perform the proposed steps, TIC believes neither the government nor the government's audit firm should take on the role of determining "representative" market prices for services, especially if the service piece is a required component of the contractual obligation. A vehicle lease, for example, often includes a service contract because the service is vital to ensuring that the car is protected over the course of the lease and will have adequate residual value at the end of the lease term. Determining the split between the lease and the service components will have no value to

the financial statement user, especially when the services are an inseparable obligation of the contract.

The PV also unnecessarily conflicts with the decisions reached to date by the FASB and the IASB on their leasing standard. They have decided to permit a lessee, as an accounting policy election by class of underlying asset, to not separate lease components from nonlease components. Those lessees that make this election would account for lease and nonlease components together as a single lease component.

TIC therefore recommends that the GASB reconsider its view on contracts with multiple components and adopt the FASB/IASB accounting policy election discussed above. The policy should be disclosed in the notes to promote comparability among governments.

If the Board decides not to adopt the FASB/IASB accounting policy election, TIC suggests that the Board take the guidance in paragraph 14 of Chapter 2 and provide a blanket exemption for these types of contracts. That is, the Board should allow a practical expedient that would automatically exempt the following contracts from the required steps in paragraph 13:

- A lease contract for an asset that is rarely leased without an accompanying service contract.
- The lease of a unique asset such that there are no comparable transactions to observe.

In those situations, the Board stated that the costs to estimate the stand-alone prices would outweigh the benefits and concluded that, in such circumstances, multiple component contracts may be accounted for as one lease, even though the accounting result may not be the same as if the components were covered by separate contracts.

Definition of Lease Term

This proposal significantly changes the criteria for including renewal periods in the lease term. The existing provisions of GASB Statement 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, for determining the length of the lease term are more definitive. Renewal periods with certain characteristics are required to be included in the lease term, and the criterion related to economic disincentives is based on the notion that renewal would be “reasonably assured.” Many of the specific factors have been dropped from the PV, and the Board has adopted a lower threshold for determining the likelihood of renewal (probable v. reasonably assured).

More judgment will be needed to calculate the lease term, and the same lease contract for a governmental v. nongovernmental entity may have a longer lease term under GASB standards compared to the future FASB/IASB standards. The PV effectively adds complexity at the inception of the lease, and potentially will require a longer period of subsequent measurement for many lease contracts. The lower threshold could force

governments to overestimate the length of the lease term and the lease liability, thus resulting in more accounting estimate changes in future periods for significant changes in the lease term.

TIC believes the criteria as written will be difficult to implement and are not sufficiently clear to promote consistent application in practice. The PV does not include enough guidance to differentiate a renewal option that is probable of occurring from one that is reasonably assured of occurring. For example, if one or more of the renewal terms include some uncertainty, it's unclear how much effort a government may be required to put forth in evaluating the uncertainty using a "range of probability" analysis.

Finally, paragraph 4 of Chapter 3 changes specific requirements from GASB Statement 62 to merely considerations as to which renewal/termination options are to be included in the lease term. TIC believes the factors in 4(a) – 4(d) should be included in the lease term, not just merely considered for inclusion.

TIC also noticed an inconsistency in Chapter 3, paragraph 4a, which represents one of the factors to be considered for including a renewal option in the lease term:

A significant economic incentive, such as contractual terms and conditions for the optional periods that are favorable compared with current market rates

If there has to be a significant economic incentive to renew the lease, it seems that the lease renewal amounts should be more than just favorable compared to the current market rates. The renewal amounts should be sufficiently lower than the fair rental value of the leased asset such that the renewal price would be considered a bargain rental.

For the reasons mentioned above, TIC believes the GASB standards should not differ from FASB/IASB standards on such a critical element of lease accounting. The new criteria are too ambiguous to be implemented in a cost effective and consistent manner. In addition, the established threshold is too low and, in TIC's view, will not result in an improvement in the lease accounting standards. TIC therefore recommends that the GASB change its criteria for the next public document to match the FASB/IASB criteria for determining the renewal/termination options that should be included or excluded from the lease term.

If the Board decides not to do so, the next public document should include the rationale for the Board's decision, including why the FASB/IASB criteria are not appropriate for the governmental arena. In addition, more guidance should be provided on the factors that need to be in place under the "probable" threshold, as discussed above, and should include the interplay between quantitative and qualitative factors. TIC believes numerous examples would be needed in the Implementation Guide to assist governments with the assessment of the lease term. Finally, the inconsistent language in Chapter 3, paragraph 4a, should be revised.

Disclosure of Short-Term Lease Expenditures

TIC recommends that the Board reconsider the proposed disclosure of short-term lease expenditures. Chapter 6, paragraph 9, states:

A lessee would be required to disclose the amount of expense or expenditure recognized during the reporting period related to short-term leases to provide information to users about the magnitude of a government's short-term lease activity. Because this disclosure would be similar to one currently required for operating leases, the Board believes that there would be little incremental cost to provide this information.

TIC believes there is no need to disclose the magnitude of a government's short-term lease activity since it is doubtful that financial statement users would be interested in that number. They are more interested in the government's long-term commitments. Also, disclosing the magnitude of the government's short-term lease activity would not necessarily be indicative of the entity's compliance with the leasing accounting standards. TIC believes it is more important to minimize the number of line items in the financial statements and note disclosures for unnecessary elements. TIC therefore recommends that this proposed disclosure be deleted from the PV.

Disclosures (Other Than Short-Term Leases)

The TIC member who participated in the field test discovered that the proposed disclosures for lessees were overwhelming. One of the participants in the field test was a medium-sized airport that has over 90 leases. Four vastly different types of leases out of the 90 were selected for disclosure. The description of the terms of the lease for just the four leases took up $\frac{3}{4}$ of a page. Some of the firm's larger government clients (i.e., cities, counties and schools) have large numbers of leases. If the required disclosures become too voluminous, important disclosures may be obscured by the sheer length of the notes. This outcome would decrease the usefulness of the notes, which would not be in the public interest.

Based on the reaction to the field test, TIC believes there may be some misunderstanding as to the level of detail required for the lessee disclosures, especially for the "general description" of the government's leasing arrangements. The next public document should include some guidance on the level of detail required and the extent to which the disclosures may be aggregated. Sample disclosures should also be provided.

Paragraph 22(g) of the PV would require the disclosure of:

Commitments under leases (other than short-term leases) that have not yet begun

The proposed disclosure is somewhat vague as to the details that should be included in the note. It is unclear whether the Board is looking for a brief narrative as to the nature and timing of the lease commitment or for quantitative disclosure of future minimum lease commitments separate from those of existing leases. TIC therefore recommends

that the future exposure draft provide more guidance as to the details to be disclosed and that the Basis for Conclusions explain why this disclosure is necessary.

TIC also believes that disclosure should not be required for every future lease commitment that has not yet begun. Rather, only significant lease commitments that would commence within one year from the financial statement date should be disclosed. Disclosure of future lease commitments that would commence more than one year from the financial statement date should be left to professional judgment. TIC believes limiting the disclosure to those future lease commitments that are significant to the government's operations would provide more relevant information to financial statement users and also provide some relief to governments from disclosure overload when compared to the proposed disclosure in paragraph 22(g).

Transition and Effective Date

In anticipation of the Board's upcoming deliberations on the future exposure draft, TIC would like to provide some input regarding the transition provisions and effective date. Assuming the PV is finalized as written, there are a number of reasons why governments will need additional implementation time. The PV introduces added complexity in the areas of determining the lease term and separating the lease and service components from a combined lease contract, to name a few. Governments with many operating leases will also need sufficient implementation time to make system and process changes as well as perform the required calculations and track the subsequent measurement of each lease.

A longer transition period will also be necessary to allow granting agencies time to adapt to the new liabilities that will be recognized under the new standard. Today, most grants will fund operating expenditures, but will not fund principal and interest payments on debt. Under the proposal, lease obligations recognized on the statement of net position will increase significantly with the addition of operating leases. Governments might discover that lease expenditures that were reimbursable under grants up until now might not be reimbursable under grants going forward. Grant funding could decline significantly if all future lease obligations are excluded from reimbursement. The extra implementation time is requested so that granting agencies can work through the necessary processes to address these changes. (Hopefully, the rules will be rewritten so that the additional lease obligations do not adversely affect reimbursements).

Another issue that could potentially require a lengthy transition period is the uncertainty as to whether lease liabilities that were previously excluded from the statement of net position will be scoped into the debt limit calculations in any given jurisdiction. For example, in Pennsylvania, capital leases are currently included in the calculation of excess debt limitations. Each jurisdiction, therefore, will need adequate time to evaluate the effect of the additional long-term liabilities on debt limits once the proposed standard is issued.

To accommodate the above concerns, TIC recommends a minimum transition period of 3 years, which would parallel the transition period given for GASB Statement 68, *Accounting and Financial Reporting for Pensions*. Therefore, if the final leasing standard were issued in June 2017, the effective date would be for periods beginning after June 15, 2019. TIC also recommends an early implementation option.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

A handwritten signature in black ink that reads "Scot Phillips". The signature is written in a cursive, slightly slanted style.

Scot Phillips, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees