January 19, 2018

Ms. Toni Lee-Andrews
Director, AICPA Professional Ethics Division
AICPA Professional Ethics Executive Committee
1211 Avenue of the Americas
New York, NY 10036-8775

Re: AICPA Professional Ethics Division, Proposed Revisions to the AICPA Code of Professional Conduct, *Leases Interpretation* (ET sec. 1.260.040)

Dear Ms. Lee-Andrews:

PricewaterhouseCoopers LLP appreciates the opportunity to provide comments on the AICPA Professional Ethics Executive Committee's (PEEC or the "Committee") proposed revised interpretation, "Leases" (ET sec. 1.260.040), under the "Independence Rule" (ET sec. 1.200.001) of the AICPA *Code of Professional Conduct* (the "Code of Conduct").

Principal comment and recommendation

We agree with the PEEC's position that the financial statement presentation of a lease should not result in a de-facto conclusion that the lease is permissible or impermissible from an independence perspective. Regardless of whether a lease is classified as an operating or a capital lease, we believe that independence should be evaluated on the basis of the lease's effect on the auditor's objectivity and professional skepticism. However, while we support a model that doesn't default to US GAAP classification, we do have concerns regarding the approach being proposed by the PEEC.

In our view, goods and services obtained as a consumer in the ordinary course of business do not, generally, impair an auditor's objectivity or professional skepticism. The current "Leases" interpretation implicitly recognizes this by permitting covered members to enter into an operating lease with an attest client, provided that the terms and conditions set forth in the lease agreement are comparable with other leases of a similar nature, and all amounts are paid in accordance with the lease terms and provisions.

Accordingly, our overarching recommendation is for the PEEC to align more closely with the IESBA *Code of Ethics for Professional Accountants* by establishing a more principles-based approach that treats leases as permissible provided they are entered into in the normal course of business and on an arm's length basis. Under a principles-based approach such as this, the materiality of the lease to the covered member would be one of the factors to be considered when evaluating threats to independence, rather than the automatic trigger for an independence impairment as is being proposed. Because of the pervasive use of leasing arrangements[1] to acquire a wide range of consumer goods, this approach would also help to mitigate the potential for any undue burden or hardship that a bright-line test might otherwise create. It would also ensure consistency with the current treatment of automobile leases in the Code of Conduct, which takes the preferred approach of exempting such transactions from the prohibition on loans without regard to materiality.

Appendix A expands on the principal suggestion described above, and also offers detailed comments and recommendations regarding other areas of the proposal. Appendix B includes our specific responses to the supplementary questions that the PEEC has raised in the exposure draft.

[1] According to the Office of the Comptroller of the Currency's (OCC) Comptroller's Handbook booklet, "Lease Financing" (Version 1.2, January 27, 2017), "[l]easing is the most widely used method of personal property financing in the United States."

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We would be pleased to discuss our comments and to answer any questions that you or the PEEC may have. If you have any questions regarding this submission, please contact David East at (646) 428-9085.

Sincerely,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

APPENDIX A

Detailed comments and recommendations

I. Align with international independence standards by treating leases as ordinary course of business transactions

The PEEC's proposal to establish a bright-line test that cites, in certain circumstances, a material lease as an unequivocal impairment of independence would be inconsistent with, and, in some cases, more restrictive than other auditor independence rule sets, in particular, the International Ethics Standards Board for Accountants' (IESBA) *Code of Ethics for Professional Accountants* ("IESBA Code of Ethics"). Pursuant to the requirements applicable to loans,[2] the IESBA Code of Ethics does not establish an outright prohibition on entering into a lease with an attest client that is a bank or a similar institution so long as the arrangement is made under normal procedures, terms and conditions.

In our view, routine consumer leases entered into at standard, customary terms on an arm's length basis do not generally impair auditor independence, nor do they otherwise adversely affect objectivity or professional skepticism. We believe that not only does the PEEC's proposal go beyond what is required under the IESBA Code of Ethics, but also what is necessary to safeguard auditor independence. Consistent with its ongoing efforts towards convergence, the PEEC should align with the IESBA Code of Ethics by establishing a more principles-based approach for evaluating the permissibility of leases. Specifically, we recommend that leasing arrangements between individuals included in the definition of "covered member" and attest clients (and their affiliates) be treated as permissible provided that they are in the normal course of business, entered into and maintained on an arm's length basis, and kept current on an ongoing basis in terms of the lease payments (i.e., payments must be made in accordance with the terms of the lease). This approach would be consistent in principle with the treatment of automobile leases in the Code of Conduct, as discussed in more detail in Section II. Significantly, in light of the widespread use of leasing arrangements, it would also be more practical in the circumstances and mitigate the likelihood of undue hardship that a restriction on material leases may create for covered members and their families, as described in more detail in our response to Question 6.

Rather than establishing a bright-line test for members of the attest engagement team and individuals in a position to influence the attest engagement, our recommendation is that materiality be identified as one of the factors to be considered when evaluating the impact of the lease on independence. Specifically, the materiality of the lease could trigger a "threats and safeguards" analysis under the Code of Conduct's "Conceptual Framework for Independence" interpretation (ET sec. 1.210.010), rather than cause an automatic impairment of independence. For example, under this approach, the independence evaluation would consider such factors as:

- Materiality to the covered member, addressing both qualitative and quantitative considerations;
- The category of the "covered member" that is the lessee;
- The covered member's role and level within the attest engagement team (e.g., the lead attest engagement partner versus an associate in an attest engagement team at an immaterial subsidiary);
- Where that leasing entity falls within the attest client's affiliate structure (e.g., a "sister entity" that is not subject to financial statement attest procedures versus a consolidated subsidiary); and
- Unique or unusual facts or circumstances (if any) specific to the particular leasing arrangement, such as complex or non-standard provisions.

[2] IESBA Code of Ethics, paragraphs 290.117 through 290.122.

Establishing a more principles-based approach, such as this, would allow for flexibility in the independence evaluation. It would still require consideration of the particular characteristics of a lease and their impact on independence, consistent with the Code of Conduct's Conceptual Framework approach, while also helping to avoid the disparate and overly prescriptive conclusions that might otherwise be reached under the proposal. For example, independence would be considered to be equally impaired irrespective of whether the holder of a material lease is an associate on the attest engagement team or the lead attest engagement partner (with both arrangements constituting breaches required under the Code of Conduct to be reported to those charged with governance at the attest client).

The proposed revised interpretation also prohibits leases that are material to the attest client. We are supportive of the application of a materiality bright-line test in this respect because the self-review threats to independence would be significant if (as explained in the exposure draft) a member is placed in the position of performing attest procedures with respect to the lease and evaluating the member's own solvency as it relates to the lease's collectability. Moreover, the appearance of independence might also be questioned. Even if the transaction is entered into at standard, customary terms on an arm's length basis, a lease that is material to the attest client could still give rise to insurmountable threats to independence in appearance. See our response to Question 4 for additional comments regarding the application of a materiality bright-line test with respect to certain affiliates of a financial statement attest client.

See Section III.C for our comments and recommendations regarding individuals who are covered members by virtue of providing more than 10 hours of non-attest services to the attest client, or being a partner (or partner equivalent) in the office in which the lead attest engagement partner primarily practices.

II. Reconsider the appropriateness of having a differential approach for car leases versus other types of leases

Automobile leases are currently permitted (and have been since the early 1990s) under the "Loans and Leases With Lending Institutions" interpretation (ET sec. 1.260.020) of the Code of Conduct. SEC Regulation S-X Rule 2-01, *Qualifications of accountants*, similarly exempts automobile leases from the prohibition on loans when the lease is collateralized by the automobile.[3] The SEC adopted this exemption, aligning Rule 2-01 with the Code of Conduct, ostensibly because the Commission believed that it was reasonable to converge with the AICPA approach in this respect.

If adopted as proposed, the revised interpretation would create a significant theoretical inconsistency in the Code of Conduct with respect to the treatment of leases. The "Loans and Leases With Lending Institutions" interpretation establishes a wholesale exemption for automobile leases obtained from a lending institution attest client, without regard to the materiality of the arrangement to the covered member (subject, of course, to further evaluation under the "Conceptual Framework for Independence" interpretation). However, pursuant to the PEEC's proposal, if you change the underlying asset being leased by the covered member – for example, from an automobile to an apartment, a computer, or a home appliance – the lease automatically impairs independence when the arrangement is material to certain covered members.[4] Why independence could be considered to be impaired in one case, but not in the other, is not clear to us.

As the exposure draft does not provide a rationale for treating certain leases differently, one is left to conclude that the PEEC believes the threats to independence to be different, depending on the nature of the asset being leased. We do not agree with this conclusion. Rather, we believe that all routine consumer leases should be evaluated in the same manner, consistent with the approach currently being followed for automobile leases. The Committee's basis for having permitted automobile leases obtained under normal lending procedures, terms, and requirements – perhaps, to mitigate any undue hardship or burden in light of the frequency of such arrangements and to recognize the reduced

[3] CFR § 210.2-01(c)(1)(ii)(A)(1)

[4] If the covered member is a member of the attest engagement team or an individual in a position to influence the attest engagement.

independence threats created by routine leases – should be equally applicable to leases for other consumer goods and housing.

Finally, using different criteria for determining the permissibility of leases, based solely on the nature of the asset being leased, has, in our view, the potential to create confusion among members, those charged with governance at the attest client, the public and other independence stakeholders, while also increasing the risk of the misapplication of, and non-compliance with, the proposed requirements.

III. Other comments and recommendations

A. *Limit prohibitions based on materiality to the firm and attest engagement partner or establish an ongoing exemption for primary residence leases*

1. If the PEEC ultimately determines to adopt a bright-line test based on materiality, rather than to reflect the recommendations we've proposed in Sections I and II, then we'd suggest that consideration be given to limiting any prohibition on material leases to the attest engagement partner (or partner equivalent) and the firm. We believe this modification would appropriately reduce potential unintended consequences and better match the proposed restriction with the applicable independence threats. It would also more appropriately focus the requirement on the covered member (i.e., the attest engagement partner) who has responsibility for the decision-making and judgments that affect the attest engagement.

2. Further, if the PEEC decides to retain the prohibition on material leases as proposed, we recommend that an exemption be provided for leases of primary residences entered into after the covered member is required to be independent of the lessor. Although it is not clearly articulated in paragraph .05 of the proposed revised interpretation, the Committee has only proposed to exempt those residential leases that already exist at the time that the relationship becomes subject to the AICPA independence requirements (i.e., by virtue of the circumstances described in paragraph .04, such as the lessor becoming an attest client or an affiliate thereof). However, the grandfathering provisions in paragraph .04 of the proposed revised interpretation do not provide the same level of relief as the grandfathering currently available for home mortgages under the "Loans and Leases With Lending Institutions" interpretation because residential leases, by their very nature, can be short-term relationships. A potentially significant hardship could still arise in the short term for any covered member subject to the prohibition on material leases if the residential lease comes up for renewal, but does not qualify for grandfathering under the proposed "automatic renewal" provision in paragraph .04 (see also our comments in Section D). Therefore, an exemption for new leases of primary residences would help to eliminate such hardship for covered members and their immediate family members who may otherwise see their range of options for housing in certain markets of the country considerably reduced by the independence restriction on material leases. Consistent with our previous recommendations, in order to qualify for this exemption, any new lease should be in the normal course of business, entered into and maintained on an arm's length basis, and kept current on an ongoing basis in terms of the lease payments.

B. *Apply a "knows or has reason to believe test" for leases entered into by certain covered members*

We recommend that, in lieu of paragraphs .02 and .03, the PEEC adopt a "knows or has reason to believe" threshold (currently utilized in several areas of the Code of Conduct) for evaluating the independence threats created by leases entered into by individuals who are covered members by virtue of providing more than 10 hours of non-attest services to the attest client, or being a partner (or partner equivalent) in the office in which the lead attest engagement partner primarily practices. Specifically, we agree that a leasing arrangement held by these two categories of covered member should be entered into on market terms and established at arm's length, consistent with the proposed requirements already incorporated into paragraph .02(a) of the proposed revised interpretation. Once the lease is entered into, we believe that all amounts should be paid in accordance with the lease terms and provisions. However, the covered member should only be required to consider any other independence threats that the covered member *knows or has reason to believe* may be created by the lease.

We believe that these two categories of covered member are sufficiently removed from the attest engagement such that an evaluation of additional independence threats need not be undertaken for all leasing arrangements.

C. *Consider whether the reference to materiality in the aggregate would benefit from further clarification*

Although the aggregate materiality of leases is addressed in paragraph .03 as a factor for consideration in evaluating threats to independence, if adopted as proposed, the revised interpretation would benefit from an explicit statement that the existence of multiple leases with the same attest client that are material *in the aggregate* also impairs independence. In other words, if the revised interpretation is to establish some form of a prohibition based on materiality, then it would be helpful to make clear that leases entered into with an attest client are prohibited when they are material as an individual lease, OR as a group of leases.

D. *Clarify the meaning of "automatic renewals" and "terms do not change in any manner"*

Paragraph .04 of the proposed revised interpretation grandfathers existing leases provided that, during the period of professional engagement, the terms do not change in any manner not provided for in the original lease. The proposal is not sufficiently clear as to what would constitute a change in lease terms for purposes of determining whether an existing lease continues to qualify for grandfathering. For example, as part of the renewal process, there could be an increase in the cost of the lease. A conclusion cannot be easily drawn from paragraph .04, as drafted, regarding whether an increase of this nature signifies a change to the terms of the original lease. It is important for the Committee to issue guidance to clarify the application of this provision in paragraph .04 so as to eliminate the current ambiguity and ensure consistent application of the grandfathering requirements. Ultimately, we do not believe that ordinary rent increases and lease extensions, or routine changes to standard terms and conditions (even if not provided for in the original lease agreement) create unacceptable threats to independence.

Paragraph .04 further explains that automatic renewals provided for in the original lease agreement are not considered to be changes in terms for purposes of applying the interpretation. As drafted, the proposal is also vague as to the meaning of the reference to "automatic renewals," and we recommend that the PEEC also develop guidance to clarify the scope of circumstances that, in practice, would be deemed to qualify as an automatic renewal of a lease. For example, certain apartment leases do not technically provide for an automatic renewal of the lease; the tenant has to sign a new agreement when the original lease term expires. It is unclear whether this renewal would qualify for grandfathering under the provisions of paragraph .04, or if it would be considered a new lease.

Appendix B

Responses to the supplementary questions posed by the PEEC in the exposure draft

1. **Are there any exceptions that should be extended to affiliates of financial statement attest clients?**

   Yes, we believe that exceptions should be extended to certain affiliates.

   Under the principles-based approach that we've recommended in Section I, a lease entered into with an unaudited affiliate under common control with (i.e., a "sister entity") or upstream of the financial statement attest client could be deemed to raise threats to independence that are less significant than those created by a leasing arrangement with a material subsidiary. This is because, among other considerations, the former would not be subject to financial statement attest procedures or financial statement disclosures. However, the proposal makes no such distinction. In this scenario, the impact on independence would be considered to be the same, incorrectly in our view, and would represent a breach of the Code of Conduct reportable to those charged with governance. Establishing a more principles-based approach for evaluating the permissibility of leases, as we've suggested, would allow for flexibility in the independence evaluation and help to avoid disparate and overly prescriptive conclusions relating to certain affiliates, such as those described above.

   If the PEEC decides to retain the prohibition on material leases with respect to members of the attest engagement team and those individuals in a position to influence the attest engagement, the prohibition should only apply to arrangements with the financial statement attest client and with those affiliates subject to financial statement attest procedures (i.e., downstream affiliates). Limiting the proposed prohibition as such would establish a more meaningful framework that appropriately restricts transactions based on whether they may be subject to financial statement attest procedures or financial statement disclosures.

2. **Are there any other situations or circumstances that should be grandfathered which are not grandfathered in the proposal?**

   As described in more detail in Section III.A, if the PEEC decides to retain the prohibition on material leases as proposed, we recommend that an exemption be provided for leases of primary residences entered into after the covered member is required to be independent of the lessor. An exemption for new leases of primary residences would help to eliminate a potentially significant hardship for covered members and their immediate family members who may otherwise see their range of options for housing in certain markets of the country considerably reduced by the independence restriction on material leases.

3. **Do you agree with the application of the materiality safeguard in paragraph .02? Specifically, do you agree that there are no safeguards available when a covered member specified in paragraph .02 has a lease with the attest client that is material to that covered member?**

   We do not agree with the application of the materiality safeguard in paragraph .02 as it relates to members of the attest engagement team and individuals in a position to influence the attest engagement for the reasons outlined in our detailed comments and suggestions above. However, as described in more detail in Section III.A, if the revised interpretation is to establish some form of a bright-line test based on materiality, we recommend that the PEEC give consideration to limiting that prohibition to those leasing transactions entered into by the attest engagement partner (or partner equivalent) and by the firm. Please refer to our detailed comments and recommendations in Section III.A.

4. **Do you agree that there are no safeguards that would reduce the threat to an acceptable level when the lease with a covered member is material to the attest client?**

   As indicated in Section I, we believe that independence would be impaired by a lease that is material to the attest client and agree that such leases should be prohibited.

   However, although we agree with the direction of the PEEC's proposal in this respect, we note that, for financial statement attest clients, a lease that is material to any affiliate of the financial statement attest client would also be prohibited under the proposal. As described in more detail in our response to Question 1, we believe that a lease entered into with an unaudited entity that is under common control with (i.e., a "sister entity") or upstream of the financial statement attest client raises threats to independence that can be less significant than those created by a lease entered into with the financial statement attest client itself or with a material subsidiary. Therefore, for the reasons outlined in our response to Question 1, we do not agree that a lease that is material to a sister entity or an upstream affiliate represents an unequivocal impairment of independence in all circumstances. A more principles-based approach that looks at whether the material lease could be subject to financial statement attest procedures or financial statement disclosures may be more appropriate.

5. **Do you agree that the requirements of the proposal should extend to immediate family, as proposed?**

   We agree that the provisions of the proposed revised interpretation should also apply to leases entered into by the immediate family members of covered members.

6. **What do you foresee as major obstacles to implementation or hardships? Do you expect significant changes in quality controls, procedures, tools, or technology to monitor leases?**

   Given the pervasive use of leasing arrangements, our main concern relates to the potential hardship and disruption that a bright-line test based on materiality would create for covered members and their immediate family members. Although real estate property and automobiles are perhaps the most prominent examples of assets available for leasing, the PEEC must recognize that leases are also widely utilized for a broad spectrum of other routine consumer goods, ranging from technology products – for example, cellular phones, tablets, computers, cable and internet equipment – to household equipment such as appliances, furniture, and power tools. A blanket prohibition on the basis of materiality could restrict the opportunities currently available to covered members and their immediate family members to acquire housing and personal consumer goods.

   As a practical matter, a prohibition based on the materiality of the lease would also disproportionately affect junior-level professional staff on the attest engagement team, in particular those persons with a high student loan debt burden. A junior-level staff person could easily find himself or herself running afoul of the materiality threshold, especially if leases have to be aggregated (such as may be the case, for example, if an associate on the attest engagement team and his or her spouse lease their personal cell phones, tablets, and cable and internet equipment from the same wireless service provider). Furthermore, this could also potentially have a detrimental effect on the ability of firms to attract and retain first-rate talent, such as interns, associates, and senior associates, increasing staff recruiting and retention costs for firms.

   The potential impact of a prohibition on these consumer relationships is exacerbated by the fact that the grandfathering provisions in paragraph .04 of the proposed revised interpretation do not provide the same level of relief as the grandfathering currently available for pre-existing loans, as discussed in more detail in Section III.A. While a firm could theoretically reassign a staff person holding an impermissible lease to a different attest engagement, this may not be a practical solution for certain firms, especially smaller firms (where the pool of available staff with the requisite expertise may be limited) as well as those firms with a large portfolio of attest clients from an industry involved in the business of leasing (such as real estate). This safeguard would likely also not be available to the firm if the staff person holding the impermissible lease is a covered member by virtue of being in a position to influence the attest engagement as it may not be feasible to "isolate" the individual.

7. **Do you agree that it is appropriate to grandfather primary residence leases in a similar manner to home mortgages, as proposed?**

   Yes, if the PEEC decides to retain the prohibition on material leases as proposed, it would be appropriate to grandfather leases for primary residences as these transactions would likely be material to covered members, particularly junior-level professional staff. Please also refer to our detailed comments and recommendations in Section III.A.

8. **Are there any other factors affecting the significance of the threats to independence that you believe should be added to paragraph .03? Do you believe any of the factors in paragraph .03 should be removed?**

   The possible factors to consider in evaluating the significance of the threats to independence created by a lease would vary based on the specific facts and circumstances of the leasing arrangement.

   Therefore, as it relates specifically to paragraph .03 of the proposed revised interpretation, a list of the most likely and relevant factors, that is not intended to be all-inclusive (as proposed by the PEEC in paragraph .03) should be sufficient.

   However, as it relates to the proposal as a whole (and as described in more detail in Section I), we recommend that the materiality of the lease to the attest engagement team member or to the individual in a position to influence the attest engagement be identified in the revised interpretation as one of the factors to be considered when evaluating the impact on independence. Under this approach, rather than cause an automatic impairment of independence in all circumstances, the materiality of the lease should trigger a "threats and safeguards" evaluation taking into consideration factors such as those we have suggested in Section I and others as relevant.

9. **Do you agree that an effective date consistent with the FASB Update effective date for private companies is appropriate (December 15, 2019)? If not, what is a more appropriate effective date?**

   Yes, we agree that the PEEC's proposed effective date of December 15, 2019 is appropriate, provided that, upon adoption of the revised interpretation by the PEEC, this date still allows members sufficient time (for example, 1 year) to make the necessary changes to their policies, processes and procedures to implement the interpretation.