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December 28, 2010

Technical Director
File Reference No. 1850-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Sir:

The Financial Reporting Executive Committee (FinREC) of the American Institute of Certified Public Accountants (AICPA) is pleased to offer its comments on the FASB's and IASB's (the boards) draft standard on leases, as presented in the FASB's Exposure Draft of a proposed Accounting Standards Update (ASU) *Leases (Topic 840).* We support the boards' effort to improve and converge their standards for accounting for leases.

We support the boards' overall objective to develop a single approach to lease accounting and to require assets and liabilities arising under leases to be recognized in lessees' statements of financial position. However, we believe there are fundamental application issues not addressed by the Exposure Draft, and revisions that need to be made to various aspects of the boards' proposals, including those related to the right-of-use approach to lessee accounting. If these matters are not addressed during the boards' redeliberations, additional standard setting will be needed to make the final standard operational. The issues that we believe are most critical for the boards to address are included throughout our responses to the detailed questions in the Exposure Draft.

We do not support the boards' approach to accounting for lease renewal options and contingent rents. We believe that the lease term should be defined as the lessee's (lessor's) best estimate of the lease term. We believe contingent rents and expected payments under residual value guarantees should be included in the measurement of assets and liabilities based on management's best estimate of payments to be made (received) under the lease. Our views are explained in our responses to Questions 8 and 9.

The majority of FinREC members do not support the boards' hybrid (lease classification) approach to lessor accounting—instead they support the derecognition approach as the single lessor accounting model. Those members believe the performance obligation approach is inconsistent with the boards' exposure draft on revenue recognition and the right-of-use model for lessees, as explained more fully in our response to Question 2.

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A minority of FinREC members, and FinREC's Leases Working Group, support a hybrid approach to lessor accounting. However, they believe the boards have not adequately explained how both approaches in the Exposure Draft reconcile with the boards' Conceptual Frameworks. Of equal importance, the guidance for distinguishing between the two approaches in the Exposure Draft is unclear and is likely to result in inconsistent application in practice.

FinREC recommends that the "in-substance sale" criteria be eliminated from the Exposure Draft. Because the derecognition approach allows for an accounting treatment that is similar to sales-type lease accounting under current GAAP, it is unclear why the "in-substance sale" guidance is necessary. In addition, the complexity of assessing additional criteria does not seem necessary to distinguish "in-substance purchases" from leases that lessees account for under the right-of-use model, because there is not a significant difference between accounting for the purchase of an asset and the accounting under the right-of-use model (at least for the types of transactions that would appear to fall into the "in-substance purchase" criteria).

We commend the boards for eliminating most of the differences between the IASB and the FASB that were present in the Leases Discussion Paper. However, we strongly encourage the boards to eliminate the few remaining differences within the Exposure Draft.

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We appreciate the opportunity to provide comments on the Exposure Draft. In addition, we are available to discuss our comments with board members or staff at their convenience.

Sincerely,

Jay D. Hanson, CPA Chair Financial Reporting Executive Committee	Jeffrey T. Nickell, CPA Chair Leases Working Group

Question 1: Lessees

(a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We agree with the boards' conclusion that a lessee should recognize a right-of-use asset and a liability to make lease payments.

(b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments.

Question 2: Lessors

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

The majority of FinREC members do not support the boards' hybrid (lease classification) approach to lessor accounting—instead, they support the derecognition approach as the single lessor accounting model. The majority of FinREC members believe the performance obligation approach is inconsistent with the boards' exposure draft on revenue recognition and the right-of-use model for lessees as it would treat the lease arrangement as an executory contract from the lessor's perspective. That is, under the performance obligation approach, the lessor's delivery of the right-of-use asset to the lessee would be recognized over the lease term rather than at lease commencement. This is inconsistent with the statement in paragraph BC7(b) of the Exposure Draft that, "a simple lease is not an executory contract after the date of commencement of the lease." In addition, the majority of FinREC members believe a two-model approach to lessor accounting would result in the same cost and complexity as the current lease classification guidance. Further, the use of a two-model approach (or a three-model approach if the "in-substance sale" requirement is maintained) would likely result in some economically similar arrangements being accounted for differently—a carryover of one of the primary shortcomings of the current lease accounting model.

A minority of FinREC members, and FinREC's Leases Working Group, believe that a hybrid model for lessor accounting is necessary and appropriate. Those individuals believe that neither the performance obligation approach nor the derecognition approach appears to work well across all leasing transactions, and that the boards' hybrid approach is a practical solution to issues associated with adopting a single approach to accounting by lessors for all leases. While those individuals understand the need for a practical solution in this area, they believe the boards need to more adequately explain how both approaches reconcile with the boards' Conceptual Frameworks (or more clearly identify areas in which practicality concerns are outweighing the desire for conceptual purity).

While those FinREC members supporting a hybrid approach agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise, they also believe additional refinement and application guidance is needed regarding the assessment of whether "significant risks or benefits associated with the underlying asset" have been retained by the lessor. The application guidance in paragraphs B22 – B27 of the Exposure Draft is not clear or robust enough to expect that consistent conclusions will be reached regarding which lessor model to apply. For example, is it the boards' expectation that leases previously classified as operating leases will follow the performance obligation approach? Similarly, would leases previously classified as sales-type, direct financing, or leveraged leases follow the derecognition approach? If not, have the boards discussed how they expect the classification conclusions to differ?

Under either approach to lessor accounting, we believe that the Exposure Draft needs to provide guidance for lease modifications. For example, when should modifications or changes to the original lease agreement be accounted for as part of the original lease as opposed to being treated as a new lease for accounting purposes? If the boards proceed with a hybrid approach to lessor accounting, the final ASU should also make clear whether the prohibition in paragraph 29 against changing the lessor accounting approach after the date of inception of the lease applies even if a lease has been modified substantially, or whether there are any situations in which a substantial modification may warrant a change in the lessor accounting approach.

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

We agree with the boards' proposals for the recognition of assets, liabilities, income, and expenses for the derecognition approach.

Those who support a hybrid lessor accounting model believe the boards should more clearly articulate how this approach reconciles with the right-of-use approach for lessees. If the boards believe it is not consistent with the lessee approach or the Conceptual Framework, then they should acknowledge that it is not and further explain why they decided on a hybrid approach or consider other approaches that would address (what some believe) are the shortcomings of the derecognition approach for certain types of leases.

(c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

We agree that there should be no separate approach for lessors with leveraged leases. However, the boards should consider further outreach to determine whether additional transition guidance is warranted for leases previously accounted for as leveraged leases (e.g., which of the lessor approaches leveraged leases would fall under if a hybrid approach is maintained, whether the

nonrecourse debt should be recorded at the current balance or at its fair value on the transition date)

Question 3: Short-term leases

This exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65).

(See also paragraphs BC41−BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

We agree with the proposed simplified accounting for lessors.

We disagree with the proposed accounting by lessees. We believe that a lessee that has a short-term lease should instead be permitted to elect not to recognize a liability to make lease payments or a right-of-use asset. Such an election would be consistent with the simplified requirements for lessors.

The assets and liabilities arising from short-term leases (given the narrow definition of short-term leases in the Exposure Draft) are likely to be insignificant as the boards note in paragraph BC46. However, this statement applies to both lessors ***and*** lessees. We do not believe the scope exception for lessees should differ from that being provided by the boards to lessors.

We also recommend that the boards clarify whether recognizing lease payments in the income statement “over the lease term” (for both lessees and lessors) requires recognizing expense or income on a straight-line basis or another systematic and rational basis, or whether rental may be charged to expense or recognized as income over the lease term as it becomes payable/receivable.

Definition of a lease

This exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1−B4 and BC29−BC32). This exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59−BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29−BC32).

Question 4

(a) *Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?*

We agree that a lease is appropriately defined as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration.

(b) *Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?*

We do not agree with the criteria in paragraphs B9 and B10 as we do not believe guidance is needed to distinguish a lease from a purchase or a sale. We understand this guidance was developed prior to the boards' deciding on a "hybrid approach" to lessor accounting. Because the derecognition approach allows for an accounting treatment that is similar to sales-type lease accounting under current GAAP, it is unclear why the "in-substance sale" guidance is necessary. In addition, the complexity of assessing additional criteria does not seem necessary to distinguish "in-substance purchases" from leases that lessees account for under the right-of-use model, because there is not a significant difference between accounting for the purchase of an asset and the accounting under the right-of-use model (at least for the types of transactions that would appear to fall into the in-substance purchase criteria). In addition, we believe the elimination of the in-substance purchase/sale criteria, and the similar treatment of renewal options and purchase options (as we recommend in our response to Question 7), is more likely to result in economically similar transactions receiving similar accounting treatment.

From a lessors' point of view, the Exposure Draft (as currently written) would essentially result in three potential accounting models for leasing transactions (the performance obligation model, the derecognition model, and the "in-substance sale" model). In addition, distinguishing between the derecognition model and the in-substance sale model would require a lessor to distinguish between the retention of a "trivial" amount of risks and benefits as opposed to the retention of a "more than trivial" but less than "significant" amount of risks and benefits. Such a nuanced difference in risk retention encourages the establishment of bright-lines to distinguish between the two – an aspect of current lease accounting that has plagued the boards. As noted in our response to Question 2, this is one of the reasons that a majority of FinREC members believe the derecognition approach should be applied by lessors to account for all leases.

If the boards decide to retain the criteria in paragraphs B9 and B10, then we believe the boards should reconsider the criteria as they can produce anomalous results as illustrated by the following two fact patterns:

Fact Pattern #1 - Synthetic Lease
The lessee in a synthetic lease substantively has all of the risks and rewards of ownership of the leased property (through a fixed price purchase option and a residual value guarantee). In addition, the lessee typically controls what will happen to the leased property at the end of the lease. Notwithstanding this, such a lease would not be treated as an in-substance sale/purchase because ownership will not automatically transfer to the lessee and the lessee does not have a "bargain" purchase option.

Fact Pattern # 2 - Lease with Bargain Purchase Option
On the other hand, consider a more traditional lease structure that provides the lessee with a purchase option for which the strike price is a clear bargain but more than a de minimis amount. The guidance in the ED seems to indicate that such a lease would be treated as an in-substance purchase/ sale, even though the lessee can effectively "put" the leased property back to the lessor by forgoing exercise of the purchase option.

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

Although we agree with the overall framework in paragraphs B1–B4 for distinguishing leases from service contracts (that is, the same framework currently included in EITF Issue No. 01-8 and IFRIC No. 4) we note that numerous practice issues have developed in the application of EITF 01-8 and IFRIC 4 since their original issuance. Those practice issues are not as pressing under the current lease accounting model because the difference between operating lease accounting and executory contract accounting is often not significant. However, the difference between the right-of-use model and executory contract accounting is far more significant and requires that the board resolve these practice issues prior to finalizing the guidance in the Exposure Draft.

The following concepts in paragraphs B1-B4 should be further clarified as we are aware of significant diversity in practice in how these concepts are applied under EITF 01-8 and IFRIC 4:

- The term "output." For example, in certain power purchase agreements "outputs" may include physical outputs (such as electricity) as well as intangible outputs (such as renewable energy credits, the right to the plant's capacity, and production tax credits). Differing interpretations exist in practice as to whether "outputs" should be limited to physical outputs only, or whether certain intangible outputs should also be included in this evaluation.
- The phrase "contractually fixed per unit." For example, certain arrangements may contain a fixed escalator clause in which the price per unit of output increases by a fixed amount or percentage each year of the arrangement (e.g., price per unit of $5, $7, and $9 in years 1, 2, and 3 respectively). Other arrangements contain different fixed rates per

unit of output depending on when the output is produced (e.g., different pricing for peak and off-peak usage periods). Differing interpretations exist in practice as to whether these arrangements represent pricing that is considered "contractually fixed per unit."

- Whether LILOs (lease-in/lease-out transactions) should be accounted for on a gross basis (as two leases) or on a net basis (as a financing prior to the point in time, if any, that the user of the asset is not the legal owner of the asset). ASC 840-10-15-16 currently contains guidance indicating that separate contracts with the same party or related parties that are entered into at or near the same time give rise to a presumption that the contracts should be treated as a single arrangement in considering whether there are one or more units of accounting. SIC-27 currently has similar guidance. Inasmuch as the entire current version of Topic 840 and SIC-27 would be replaced by the new leasing standard, there is a need for clarification regarding accounting for LILOs and similar transactions.

We note that the Exposure Draft removes the provision in EITF 01-8 concerning conveyance of the right to control the use of the underlying property, plant, or equipment if "it is remote that one or more parties other than the purchaser will take more than a minor amount of the output." We recommend that this provision be carried forward to the final Standard; otherwise, the boards' should articulate the reason for its removal. In addition, paragraph B2 notes that "an asset is implicitly specified . . . if a lessor can substitute another asset for the underlying asset **but rarely does so in practice**". [Emphasis added] The highlighted phrase is an addition to the guidance in EITF 01-8 and IFRIC 4, but it is not discussed in the basis for conclusions. While we would support clarifications of the guidance, the reason for this addition should be discussed further.

We also recommend that the boards conduct additional outreach to determine whether there are practice issues that require clarification in addition to the ones identified above.

Scope

Question 5: Scope exclusions

This exposure draft proposes that a lessee or a lessor should apply the proposed guidance to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33−BC46).
Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

We agree with the proposed scope of the proposed guidance. However, we note that the proposed scope includes what some believe is an important change from the existing scope of current U.S. GAAP. The transition guidance in paragraph 16 of EITF 01-8 allowed for certain arrangements to be grandfathered and not evaluated under the EITF 01-8 framework unless they were subsequently modified. The transition and scope provisions of the Exposure Draft appear to eliminate these grandfathering provisions. If this was the boards' intent, we recommend that that decision be stated explicitly in the Basis for Conclusions of the final ASU. In addition, we

believe the boards should articulate more clearly the reason for excluding intangible assets from the scope of the exposure draft.

Question 6: Contracts that contain service components and lease components

This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, Revenue Recognition (Topic 605): Revenue from Contracts with Customers, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5−B8 and BC47−BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) The IASB proposes that:

(i) A lessee should apply the lease accounting requirements to the combined contract.

(ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.

(iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We believe that all service components should be accounted for separately (in accordance with other GAAP) by both lessees and lessors. Service components should be separated regardless of whether they meet the definition of a distinct component of the contract – similar to the IASB's approach for lessors under the derecognition approach. The treatment of a service component should not differ simply because it is included within a lease arrangement.

We suggest that the boards use the wording currently in U.S. GAAP (previously included in EITF 01-8) to describe the allocation between lease and nonlease components. ASC 605-25-55-3 states, "The arrangement consideration should be allocated between the deliverables subject to the guidance in [the lease accounting literature] and the other deliverables using the relative selling price method."

Regardless of which approach the boards choose to deal with service components, we believe that executory costs as currently defined under U.S. GAAP (that is, insurance, maintenance, and taxes) should be accounted for separately from the lease component of the arrangement. Inclusion of executory costs as a lease element could produce anomalous results. For example, if the payment of property taxes was considered a lease component, then the property taxes would be capitalized as part of the right-of-use asset for a lessee. The capitalization of future property taxes is a different result than if the asset were purchased. It is unclear why the accounting for property tax payments should differ for leased property and owned property.

If the boards' retain the current guidance in the exposure draft and do not provide an exception for executory costs, then we would recommend implementation guidance to illustrate how the "distinct service component" concept applies to maintenance, insurance, and taxes in a gross real estate lease (that is, leases that include reimbursement in the monthly rental payment for maintenance, insurance, and taxes even though those costs may not be separately identified). These provisions are common in real estate leases, and our outreach indicates significant confusion in practice as to how this concept would be applied to typical common-area maintenance charges in a real estate lease.

Question 7: Purchase options

This exposure draft proposes that a lease contract should be considered terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).
Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

We do not agree that purchase options should be accounted for only when they are exercised. We believe that purchase options should be accounted for in the same way as options to extend or terminate the lease. We observe that providing a purchase option is not substantively different from providing renewals that extend over the entire economic life of the leased item.

Measurement

This exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

(a) assumes the longest possible term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease (paragraphs 13, 34, 51, B16−B20 and BC114−BC120).

(b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121−BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be reliably measured.

(c) is updated when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments, including expected payments under term option penalties and residual value guarantees, since the previous reporting period (paragraphs 17, 39, 56 and BC132−BC135).

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

We do not agree that a lessee or lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease.

We believe that the lease term should be defined as the lessee's or lessor's best estimate of the lease term. We believe the quantitative approach suggested in the exposure draft implies a level of precision that does not exist. In addition, we believe an approach the requires the assignment of probabilities is more subject to abuse than a principles-based approach that requires management's best estimate of the lease term. To discourage a purely quantitative approach, we believe the final standard should indicate that management's best estimate of the lease term does not require a formal and comprehensive quantitative approach and that such an approach, if utilized, should not be the sole determinant of the lease term.

In addition, it is not clear what options are to be considered in the determination of the lease term. Paragraph B16 of the Exposure Draft indicates that an entity must consider explicit and implicit options when assessing the lease term. It is unclear what the boards' intent was when requiring a consideration of implicit options. Would that include options that are not in the contract but are implied through common business practice, the legal/regulatory environment, or a history of granting renewals in the past? We believe renewal options should be considered only when the lessee is unilaterally entitled, contractually and legally, to extend the lease term. The final standard should be clear on this point as the "hunt for implicits" has caused significant practice issues and confusion when used in other areas of GAAP (for example, the consolidation literature). If the board is concerned about leases between related parties (and that leases between related parties may include nonsubstantive terms that could circumvent the guidance in the Exposure Draft), then specific guidance should be provided to address that topic.

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Contingent Rentals, Residual Value Guarantees, and Term Option Penalties

We do not agree that contingent rentals and expected payments under residual value guarantees should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique. Similar to our recommendation for determining lease term, we believe contingent rents and expected payments under residual value guarantees should be

included in the measurement of assets and liabilities based on management's best estimate of payments to be made (received) under the lease.

The phrase "term option penalties" is not one that we see in practice, but we assume the boards' are referring to payments that a lessee would be required to make if the lease is terminated prior to the end of the fixed, contractual term or payments for failure to renew a lease. That should be clarified, however, as the term is unfamiliar to some readers.

In addition, it is not clear how term option penalties should be treated based on the guidance in the Exposure Draft. Paragraph 14 states that "a lessee shall determine…the present value of lease payments payable during the lease term…on the basis of expected outcome . . . . The expected outcome is the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes . . . . In determining the present value of lease payments payable, a lessee shall include . . . an estimate of expected payments to the lessor under term option penalties." This wording makes it appear as though a lessee would probability weight the likelihood that a term option penalty payment will be made when measuring the lease liability (unless the boards are just referring to term option penalties that are not for a fixed amount, in which case that should be clarified). However, the example in paragraph B19 indicates that a lessee should first determine the lease term, and then record a liability that is consistent with that outcome. Assessing whether or not a lease will be terminated is part of assessing the lease term. Thus, if a lessee concludes that it is more likely than not that they will terminate the lease early, a term option penalty should be included at its full amount in the lease liability (the measurement of the lease liability would not include probabilities that the lessee would or would not early terminate the lease—it is assumed that the lease will be early terminated and that the term option penalty will be paid). We recommend that this point be clarified, and that paragraphs 13 and 14 should state clearly what is illustrated through the example in paragraph B19 (that is, that term option penalties and residual value guarantees would be included in the measurement of the lease liability only if they are consistent with the lease term).

Rentals Contingent on an Index or Rate

Paragraph 14(a) provides that, if contingent rentals depend on an index or a rate, the lessee shall determine the expected lease payments using readily available forward rates or indices. Paragraph 14(a) also provides that, if forward rates or indices are not readily available, the lessee shall use the prevailing rates or indices. We believe that if contingent rentals depend on an index or rate, then the lessee should determine the expected lease payments using the spot rate on the measurement date. We believe it would be very difficult to estimate (and verify) the index or rate that will exist in the future, and we believe the use of forward rates or indices adds unnecessary complexity as there is significant debate regarding whether and when forward rates or indices are "readily available" and some preparers will be less likely to have access to such rates than others.

If the boards do not accept our recommendation related to contingent rentals that depend on an index or rate, then we believe the boards should clarify the statement made in paragraph BC 131 of the Exposure Draft. Paragraph BC 131 states, "Therefore, this exposure draft proposes that if lease payments are contingent on changes in an index or rate, **such as the consumer price index** or the prime (basic) interest rate, the entity should measure the present value of lease payments

using readily available forward rates or indices." This wording seems to state as fact that a forward rate or index is readily available for the consumer price index. Our outreach has indicated that, although there are predictions of the future consumer price index, there are differing views as to whether there is a readily available forward rate or index. As consumer price index escalation provisions are common in many U.S. leases, we believe the boards should clarify this statement and perform further outreach on whether such a forward rate or index exists and is readily available.

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured? Why or why not?

We agree that lessors should include contingent rentals and expected payments under residual value guarantees in the measurement of the right to receive lease payments only if those contingent rentals and expected payments under residual value guarantees can be measured reliably. However, we believe that the term "reliably measure" in paragraph 35 should be clarified. We believe that "reliably measure" should connote a reasonable estimate and not a precise amount.

In addition, the question indicates that payments under term option penalties are subject to the "reliably measure" threshold; however, paragraphs 35(c) and 52(c) do not indicate that payments under term option penalties are subject to the reliability threshold. See our earlier comments on term option penalties and our comments on term option penalties in Question 10.

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

<u>Reassessment</u>

The majority of FinREC members agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period. However, they believe that it should be made clearer that reassessment is required only in circumstances in which an indicator shows that a change to the lease term or contingent payments since the previous reporting period exists and that that change will have a significant impact on the liability to make lease payments or in the right to receive lease payments. In addition, they believe the following statement from paragraph BC133 in the Basis for Conclusions should be elevated to the final ASU as it appears critical to understanding the boards' intent: "[A] detailed examination of every lease is not required unless there has been a

change in facts or circumstances that would indicate that there is a significant change in the lease asset or lease liability."

A minority of FinREC members believe that, for contingent rents and residual value guarantees, any differences between estimated and actual payments should be reflected in net income as they occur. Changes in lease term should be treated as a new lease (extensions) or a lease termination. Those members believe the significant additional costs of reassessment are not supported by a significant increase in financial reporting benefits. In addition, those members observe that a requirement to remeasure the right-of-use asset is inconsistent with the historical cost basis of accounting for the right-of-use asset.

Changes as a Result of Reassessment

Those FinREC members who support reassessment agree that changes in the lease liability arising from changes in the lease term should be recognized as an adjustment of the right-of-use asset. They also agree that changes in the liability arising from changes in contingent rentals or residual value guarantees should be recorded in net income to the extent that those changes relate to current or prior periods, and as an adjustment to the right-of-use asset to the extent that those changes relate to future periods. They do not agree, however, with the Exposure Draft's proposed treatment of changes related to term option penalties, and they also believe that further clarification is needed around the phrase "changes relate to current or prior periods."

Term Option Penalties

Those FinREC members who support reassessment believe that changes in the expected amount of term option penalties should be treated the same way as changes in the lease term. To illustrate, a lessee enters into a five-year lease with an option to renew for an additional five years. The contract specifies a penalty for failing to renew. The lessee originally expected to renew the lease at the end of five years but at the end of Year 4 concludes that it is not more-likely-than-not that the lease would be renewed. Accordingly, the lease term changes from ten years to five years.

In accordance with paragraph 17(a), the lessee would adjust the right-of-use asset to reflect the change in the liability to make lease payments (a decrease from a 10-year term to a 5-year term). In accordance with paragraph 17(b), however, the change in the liability to make lease payments related to the term option penalty would be recognized either in net income or as an adjustment of the right-of-use asset, depending on whether the change relates to the current or future periods. FinREC members that support reassessment believe it is inappropriate to recognize these two elements of the change in the liability differently (that is, the change in the base rent payments and the change related to the term option penalty). Accordingly, they believe that changes in the liability to make lease payments that relate to term option penalties should result entirely in an adjustment of the right-of-use asset.

"Changes Relate to Current or Prior Periods"

Paragraph 18 states, "A lessee shall distinguish changes in contingent rentals and expected payments under term option penalties and residual value guarantees that relate to current or prior periods from those that relate to future periods." Paragraph 18 goes on to state that changes related to current or prior periods are recognized in net income, while changes related to future periods are recorded as an adjustment to the right-of-use asset. We believe that the distinction

between changes that "relate to" current or prior periods on the one hand and future periods on the other hand should be clarified, perhaps through an illustrative example(s).

Consider the following example:

> A contract provides for contingent rent based on sales. Under the contract, once rent is increased by contingent payments, it can never go down below that increased level. The lessee originally estimates rents as follows: Year 1 – CU100; Year 2 – CU110; Year 3 – CU120; Year 4 – CU130; Year 5 – CU140. The Exposure Draft appears to require that, if rents increased to CU150 in Year 1 because of an unexpected increase in sales, the difference between CU150 and the CU100 estimate in Year 1 would be recognized currently in net income. However, the Exposure Draft also could be read to require that the upward increase from the originally estimated rents (from the original estimates to the new minimum of CU150) for all remaining years be recognized currently in net income.

A similar type of rent adjustment provision often exists in leases with Consumer Price Index (CPI) escalators: once the rent is increased over the base year rent as a result of an increase in the CPI, the increased rent creates a new "floor" such that rent in all future years can never decrease below that level. This is a common fact pattern.

We believe that, absent clearer guidance, there is a significant risk of misapplication of paragraph 18.

Sale and leaseback

This exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents a sale of the underlying asset, the leaseback also would meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66−67, B31 and BC160−BC167).

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

We agree that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset. However, as noted in our response to Question 4, we do not agree with criteria in paragraphs B9 and B10 as we do not believe guidance is needed to distinguish a lease from a purchase or a sale.

We do not object to the boards' including additional criteria to help distinguish whether continuing involvement in a sale-leaseback transaction should preclude sale treatment; however, we believe the boards need to further deliberate the criteria in paragraph B31. That paragraph includes many of the same concepts that exist in current U.S. GAAP to evaluate whether a sale of real estate or integral equipment has occurred. The boards should be mindful that, as written,

the Exposure Draft would now expand these concepts to all sale leaseback transactions (not just those involving real estate or integral equipment). We believe the boards should further deliberate these criteria and also consider whether (and how) those deliberations should interact with their deliberations in the revenue recognition project.

Furthermore, we believe many of the criteria that have been carried over from the current sale-leaseback guidance were written strictly as antiabuse guidance; as such their application could produce results that are not intuitive. For example, it appears that under paragraph B31(j), if the seller/lessee had an option to purchase a 20 percent interest in the buyer, the transfer would not be considered a sale. It is unclear to us why this should be the result, and we encourage the boards to critically evaluate each of the criteria before carrying them forward to the final ASU.

Presentation

This exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25−27, 42−45, 60−63 and BC142−BC159).

Question 12: Statement of financial position

(a) *Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease (paragraphs 25 and BC143−BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?*

We agree that right-of-use assets should be presented separately from owned items. However, we believe this can be done either on the face of the statement of financial position or in the notes.

Some FinREC members do not believe that a lessee's obligation to pay rentals should be required to be presented separately in the statement of financial position because reporting this information separately provides no incremental benefit in most circumstances. Entities could separately report this information if they choose to do so.

Other FinREC members believe that entities should separately present their obligations to pay rentals either in the statement of financial position or in the notes. Those FinREC members believe that, considering the subjectivity and judgment involved in establishing the related assets and liabilities, it would be helpful for financial statement users to be able to identify those items so that they can stress test them and consider a range of plausible outcomes (e.g., different renewal periods, probabilities).

(b) *Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or*

why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

We agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments, and lease liabilities gross in the statement of financial position, totaling to a net lease asset or lease liability.

(c) *Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?*

Some FinREC members do not believe that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and they also do not believe that a lessor should present residual assets separately within property, plant, and equipment. Entities could separately report this information if they choose to do so.

Other FinREC members believe that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant, and equipment. Those FinREC members believe that, considering the subjectivity and judgment involved in establishing the related assets, it would be helpful for financial statement users to be able to identify those items so that they can stress test them and consider a range of plausible outcomes (e.g., different renewal periods, probabilities).

(d) *Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?*

We agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position.

Question 13: Income statement

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

We believe interest expense on the obligation to pay rentals should not be required to be presented separately in the income statement, even if the obligation is presented separately on the balance sheet.

We believe that lessors should not be required to present interest income on a right to receive lease payments, lease income resulting from satisfaction of the lease liability, and depreciation expense on an underlying asset separately in the income statement. If such amounts were presented separately, we do not agree with the FASB's requirement to have those amounts totaling to a net lease income or net lease expense amount as we do not believe such a total presents useful information.

Question 14: Statement of cash flows

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

We agree that cash flows arising from leases should be presented separately from other cash flows either on the face of the statement of cash flows or in the notes to the financial statements. We note however, that the classification of cash payments for leases entirely as financing activities is inconsistent with the treatment of interest payments on other financings as operating cash flows. We believe interest payments for leases should be treated consistent with interest payments on other financings (that is, as operating cash flows).

Disclosure

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:
(a) identifies and explains the amounts recognized in the financial statements arising from leases; and
(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows?
(paragraphs 70−86 and BC168−BC183)? Why or why not? If not, how would you amend the objectives and why?

Although we have provided comments on the proposed disclosures, and some FinREC members have suggested additional disclosures, we believe the development of a comprehensive disclosure framework is necessary in order to provide decision-useful information for users of financial statements, and we encourage the boards to develop such a framework for future projects.

We agree that lessees and lessors should disclose quantitative and qualitative information that (a) identifies and explains the amounts recognized in the financial statements arising from leases and (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows.

Comprehensive disclosure will be a critical facet in financial-statement users' ability to understand the application and consequences of the new leasing standard and leasing arrangements. In addition, comprehensive disclosure would help the financial statements better depict the underlying economic benefits and obligations associated with lease arrangements and also allow for improved comparability between companies.

In addition, some members of FinREC believe additional disclosures could be added to provide more relevant information for users of the financial statements, specifically:

- For right-of-use assets, other relevant note disclosures similar to those required for purchased fixed assets should be considered, such as aggregate breakdown of leased asset by type, life, etc. This information becomes particularly meaningful as leases for all asset types will fall under this proposed model (e.g., helpful for users to distinguish between core assets such as retail stores vs. noncore assets such as computer leases).
- To provide more meaningful information that would allow users to better understand the amount, timing, and uncertainty of an entity's future cash flows, consider disclosures that would provide meaningful insight into the potential cash flows that the company believes as of the period date are *not* expected to occur. These disclosures could be both qualitative *and* quantitative, with the quantitative aspect being the aggregate amount of lease renewal payments that are not "expected" to occur (these could be further broken down by likelihood of occurrence). This would help address the subjectivity inherent in determining lease term under the new guidance; it would also address that the "longest lease term that is more likely than not to occur" relies on a 50 percent bright-line threshold.
- The nature of contingent rentals and their estimated amounts or ranges of estimates (with key assumptions applied) are important for users. The type of lease information disclosed should be no different from disclosures of estimates used to derive information for other accounts—particularly accounts that use estimates that are sensitive to various assumptions applied (e.g., pensions and discount rates). For instance, with leases the incremental borrowing rate is sensitive to the measurement of the liability and more information regarding the sensitivity of the asset and liability to this assumption may be helpful. Changes in estimates or key assumptions period over period should also be required disclosure in a narrative.

Transition

Question 16

(a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88-96 and BC186-BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

We agree that the full retrospective approach should be permitted because it is more representationally faithful and it may be easier for some entities, particularly lessors, to apply. In addition, we believe the boards should clarify that under the full or simplified retrospective approach companies should use the most current information they have when booking estimated amounts such as contingent rents for prior periods (rather than requiring a company to determine an estimate as if they did not know what their actual results had been).

We believe the following issues are not addressed by the transition guidance:

Sale Leasebacks
It is not clear whether sale-leaseback transactions in prior periods must be reevaluated at transition utilizing the revised sale-leaseback guidance in the Exposure Draft (this applies to both sale leaseback transactions that achieved sale accounting and those that did not) or whether prior sale-leasebacks should be evaluated within the transition provisions of the revenue recognition guidance.

Lessor: Determination of Which Model to Apply
The final standard should indicate whether a lessor should account for a preexisting lease at transition under the performance obligation approach or the derecognition approach based on an assessment done as of inception of the lease or as of the date of initial application.

Lessor: Determination of Fair Value Under the Derecognition Approach
Paragraph 95(b) states that for a lessor applying the derecognition approach the lessor shall, "recognize a residual asset at fair value determined at the date of initial application." We note that fair value measurements for purposes of lease measurement are excluded from the scope of ASC Topic 820, "Fair Value Measurements and Disclosures." As such, it is unclear whether the measurement of the residual asset at transition (and other fair value measurements required under paragraph 50 for the derecognition approach) is within the scope of Topic 820 (and, if not, what measurement guidance applies). Practice issues associated with the measurement of lessor residual values was one of the reasons the FASB excluded leasing measurements from the scope of Topic 820.

Lessor: Transitioning Out of Leveraged Lease Accounting
The final standard should indicate whether a lessor that ceases to apply leveraged lease accounting in transition should record the related nonrecourse debt at the current balance of the debt or at its fair value on the transition date.

Other comments

Question 18

Do you have any other comments on the proposals?

Paragraph B65 states, "This exposure draft proposes that a lessee should measure the liability to make lease payments at the present value of the lease payments **at the date of inception of the**

lease.” [Emphasis added] This wording implies that lease payments would be required to be discounted to the date of inception of the lease, rather than to the date of commencement of the lease. We believe the boards’ intent was for lease payments to be discounted to the date of commencement of the lease. To do otherwise would give rise to significant computational issues, such as whether the interest related to the period between lease inception and commencement of the lease should be (a) expensed during that period, (b) expensed as a lump sum at the commencement of the lease, or (c) expensed during the term of the lease through amortization of the lease obligation using an interest rate that is higher than the rate used to measure the asset and obligation at inception. This should be clarified within the final ASU (and the ambiguous wording cited above should be clarified in the Basis for Conclusions to avoid confusion).

In addition, it is unclear why the lease inception date should drive measurement of the lease under U.S. GAAP (which would not contain an accounting requirement related to onerous contracts). As such, the boards should consider whether a commencement date approach is more appropriate (considering the remeasurement requirements currently in the exposure draft). If the boards retain their current approach, they should address issues such as measurement changes between lease inception and lease commencement.

The following additional matters should be addressed in the final ASU:

- The treatment of lease incentives
- Lessee involvement in asset construction (e.g., build-to-suit transactions)
- Interaction with the literature on asset retirement obligations
- Allocation of leases involving land and buildings in the statement of financial position
- Leases with related parties
- Interaction with asset impairment literature (including in retrospective application periods)
- The accounting at transition for lease intangibles arising from prior business combinations
- The impact of allocating lease assets and liabilities to reporting units and how any related goodwill impairments should be reflected at transition

Nonpublic entities

Question 19

Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

Some FinREC members believe that having different standards for public and nonpublic entities adds additional hurdles and complexity for analysts. Not only would comparability be challenged but many companies transition from public to private quickly. It would be more useful analytically if all companies applied a uniform standard. Recognizing the many valid challenges of implementation, it would be preferable if a limited effective date extension were

provided to the extent necessary for private companies—but only if certain note disclosures were provided as well (e.g., incremental borrowing rate) that would allow financial statement users to adjust financial statements to better depict the economics of lease transactions for these companies.