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November 30, 2010

VIA EMAIL TO: director@FASB.org

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

Re: Proposed Accounting Standards Update, *Leases*

To Whom It May Concern:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions. We appreciate the opportunity to provide comments on the FASB's Proposed Accounting Standards Update, *Leases* (Topic 840) (the ED).

We believe that the current model for a lessee's accounting for leases does not accurately reflect the underlying economics of the lease arrangement and therefore agree that accounting by lessees for their lease arrangements is in need of improvement. We believe the ED is an improvement in accounting by lessees for their lease arrangements although we do have concerns about some aspects of the manner in which the FASB proposes that a lessee measures its assets and liabilities for its lease arrangements. We do not believe that the FASB's proposal with respect to lessor accounting is an improvement over current accounting. As you will see, we have suggested major changes to the ED's proposed accounting by lessors.

The remainder of the body of our letter discusses our main concerns about the ED and our suggested changes to address those concerns. Attachment A responds to the questions in the ED and Attachment B lists a number of other issues for the FASB's consideration.

Major Concerns

Treatment of Optional Renewal Periods

The ED proposes that all renewal period options that are more-likely-than-not of being exercised be included in the lease term for accounting purposes. We believe that including renewal periods that are only 51 percent likely of being exercised in the lease term creates a number of problems:

- The lessee's liability is overstated. One of the essential characteristics of a liability is that the obligor has "little or no discretion to avoid the future sacrifice."¹ Under the FASB's proposal, renewal periods will be included in the lease term that do not meet that characteristic. We understand the need to consider uncertain amounts in the measure of the liability, as discussed in BC123. However, we do not believe that need extends to amounts that can be avoided by simple choice where that choice would involve no significant economic penalty. Consider, for example, a lease of office space that contains a renewal period option that is priced at then market rates. The lessee may conclude, based on its intentions, that it is more-likely-than-not to renew the lease but at the same time conclude it has the discretion to avoid that obligation. For the same reasons, the lessor's receivable is overstated.
- It makes unlike lease arrangements look alike. Consider, for example, the following two lease arrangements—lease 1 has a 10-year term with no option to terminate early and lease 2 has a 5-year term with an option for the lessee to renew for an additional 5 years at a fixed rate that, at inception of the lease, is not a bargain rate. If the lessee concludes it is more-likely-than-not of renewing lease 2, the financial reporting for the two lease arrangements will be identical under the ED. However, the underlying economics of the two arrangements may or may not be similar. If the lessee in lease 2 is economically compelled to renew (for example, the leased asset is unique and the lessee desires to insure no competitor would have access to the leased asset), then lease 1 and lease 2 are comparable and it makes sense that the financial reporting would be similar. However, if the lessee in lease 2 is not economically compelled to renew, then lease 1 and lease 2 are economically quite different yet the ED would make them appear to be the same. In assessing the characteristics of financial reporting, the Conceptual Framework states "[g]reater comparability of accounting information, which most people agree is a worthwhile aim, is not to be attained by making unlike things look alike any more than by making like things look different. The moral is that in seeking comparability accountants must not disguise real differences nor create false differences."²
- The unavoidably frequent changes in estimates about inclusion of renewal periods will increase the cost of complying with the standard while creating questions about the usefulness of the reported information. Long-term business plans and intentions often change in response to environmental factors, new ideas, new opportunities, and other reasons.

¹ Paragraph 36 of FASB Concepts Statement No. 6, *Elements of Financial Statements*. Paragraph BC123 of the ED implies that the "little or no discretion to avoid" notion applies to non-financial liabilities but does not apply to financial liabilities. We do not see that distinction in the Conceptual Framework.

² Paragraph 119 of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*.

- It is intellectually inconsistent with the conclusion that purchase options should not be included in the measurement of a lease obligation. In practice today, a series of renewal options that extend for substantially all of the useful life of a leased asset are treated the same as a purchase option (this issue arises in current practice in sale-and-leaseback transactions of real estate as a purchase option precludes sales accounting but a renewal period option does not). We believe that practice is appropriate as both a purchase option and a series of renewal options for substantially all of the useful life of the underlying asset give the lessee the ability to control the underlying asset for the remainder of its useful life. Accordingly, we believe the ED creates “false differences” by including more-likely-than-not renewal period options but excluding more-likely-than-not purchase options.

We believe that retaining the current definition of a lease term alleviates the above problems. The current definition of a lease term includes all renewal period options that the lessee is reasonably assured of exercising as well as any renewal periods that are at the lessor’s option. In practice, this results in all renewal period options which the lessee is economically compelled to exercise being included in the lease term. Under the current definition of a lease term:

- Only liabilities for renewal periods for which the lessee is economically compelled to exercise are recognized as part of the lease liability. Renewal periods are included in the lease term under current GAAP when the renewal price is a bargain, the lessee would lose the use of valuable tenant improvements if the renewal period option was not exercised, or otherwise would suffer a penalty such that it is reasonably assured the renewal period option will be exercised. We believe including reasonably assured renewal options and excluding other renewal options is consistent with the Conceptual Framework’s definition of a liability.
- Similar lease arrangements are accounted for similarly. We believe a 5-year lease with a 5-year renewal period option that a lessee is economically compelled to exercise is quite similar to a 10-year lease and therefore should receive similar accounting treatment.
- There will be less frequent changes in the estimate of the lease term.
- The result is intellectually consistent with the conclusion that non-bargain purchase options should not be included in the measurement of the lease obligation. We have further thoughts on the treatment of bargain purchase options that are set forth in the next section of this letter.

The FASB states in the ED that “the other approaches that the boards considered for determining the lease term, including a qualitative assessment, determination based on a probability threshold or a components approach would either create significant structuring opportunities or be complex to apply.”³ We believe that a reasonably assured of exercise threshold would reduce structuring opportunities as compared to the more-likely-than-not threshold (it does not materially change the economics of a lease to eliminate a renewal option that is only 51 percent likely of being exercised based on the lessee’s intent, but it does materially change the economics of a lease to eliminate a renewal period that would have been reasonably assured of being exercised). Because practice is familiar with the reasonably assured threshold and because we believe it would be less frequent that a renewal period option will change from being reasonably assured to not reasonably assured (and vice versa), we believe the reasonably assured threshold will be less complex for entities to apply.

³ Paragraph BC117 of the ED.

In-Substance Purchases and Sales

We agree that certain lease contracts are in-substance purchases and sales of the underlying asset and should be excluded from the scope of the ED. However, we have concerns with the criteria used in the ED to distinguish in-substance purchase and sale transactions from leases.

Paragraph BC60 states “[t]he boards propose that an entity should determine whether a contract transfers the underlying asset to another entity using the principles developed in their projects on revenue recognition and consolidation.” However, paragraph 8 of the ED makes a distinction between a lease and a sale based on whether or not “all but a trivial amount of the risks and benefits associated with the underlying asset” is transferred to the counterparty. To the best of our knowledge, there is no comparable requirement for recognition of revenue in the proposed standard on revenue recognition or in Topic 810, Consolidation. In fact, there is not even a requirement that a majority of risks and benefits be transferred in order to consolidate a controlled entity. Further, it strikes us that a provision could be added to a lease contract such that the lessor would retain more than a trivial amount of risk and that such a provision may not be of any economic consequence to the parties to the lease. If that is true, the in-substance purchase and sale provision as proposed becomes somewhat of an “option” to either be in or out of the leasing literature (despite the important consequences in accounting and disclosure). Further, consider a lease in which the only risk retained by the lessor relates to a warranty on the asset transferred. The risk retained by the lessor under the warranty could be more than trivial and therefore preclude in-substance purchase and sale accounting. However, the same warranty would not preclude sale accounting under the proposed standard on revenue recognition.

We believe what distinguishes a lease from a sale is the fact that a lessee obtains control of an underlying asset, compensates the lessor for its use of the underlying asset, and has the ability (and/or obligation) to then return the underlying asset to the lessor at a future date. That is, in a lease, control of the underlying asset is intended and expected to pass from lessor to lessee at the beginning of the lease, and then back to the lessor at the end of the lease. Accordingly, rather than use a risks and benefits criterion, we believe paragraph 8 should focus on the likelihood the underlying asset will be returned to the control of the transferor. For example, paragraph 8(a) could be modified to read “a contract that results in an entity transferring control of the underlying asset with no more than a remote likelihood that control of the underlying asset will revert to the transferor.”

Subparagraph B10(b) states that a bargain purchase option normally transfers control of an underlying asset and therefore lease contracts with a bargain purchase option should be considered in-substance purchase and sale contracts. For the reasons stated above, we believe this subparagraph should focus on the likelihood that control of the asset will revert to the transferor rather than focus on risks and benefits. Further, this provision appears to be in conflict with the requirement in paragraph 8 to transfer all but a trivial amount of risks and benefits to the counterparty. A purchase option that is set at a price expected to be 10 to 20 percent less than the fair value of the underlying asset at the time the option is exercisable is normally considered a bargain purchase option. However, the transferor in this situation could still be exposed to more than a “trivial” amount of risk as it is always possible that the asset could significantly decline in value before the option exercise date. In other words, it is possible that (1) the purchase option is a bargain and (2) the transferor is exposed to more than a trivial amount of loss. A change to focus on the likelihood of control reverting to the lessor would resolve this conflict.

We recommend that subparagraph B10(b) be revised to use an example of a contract with a fixed price purchase option, a first dollar residual value guarantee, and a provision that requires the transferee to market the asset on the transferor’s behalf if the transferee elects to not purchase the underlying asset. Although the transferor may be at risk for some variability in proceeds, we believe it would be remote

that the underlying asset would revert to the transferor in this situation and therefore the contract should be considered a sale and purchase contract and be outside the scope of the ED.

Finally, we believe that the definition of a lease payment in paragraph 15 of the ED should be revised to exclude only the exercise price of non-bargain purchase options. The exercise price of a bargain purchase option should be considered a lease payment. In our view such a change would make the treatment of purchase options consistent with both our suggestion with respect to renewal options and our suggestion with respect to in-substance purchases and sales.

Sale-and-Leaseback Transactions – Seller/Lessee Accounting

We agree with the conclusion in paragraph 67 that the critical issue is whether or not the transfer meets the conditions for a sale. We also agree with the conclusion in paragraph BC162 that the same criteria used to distinguish a sale from a lease should be used to determine whether the transfer of the underlying asset in a sale-and-leaseback transaction should be treated as a sale. Those criteria in turn are derived from the FASB's projects on revenue recognition and consolidation.⁴ However, we disagree with the guidance in paragraph B31 on how to evaluate whether the transfer meets the conditions for sales treatment.

If the Board accepts our suggestions with respect to defining an in-substance purchase and sale transaction, then we suggest the following approach to determining whether the transfer of the underlying asset in a sale-and-leaseback transaction should be treated as a sale. Consider all of the provisions of the transfer contract and the lease contract together with the exception of the basic lease agreement (by basic lease agreement, we mean the right to use the asset in exchange for compensation). Accordingly, the guidance in the proposed standard on revenue recognition would be used to determine if any purchase options, guarantees, financing, variability in future payments, sharing of future profits or appreciation in the underlying asset, and so forth, contained in the contracts should preclude the transfer of the underlying asset from being treated as a sale. If any provision or combination of provisions, excluding the basic lease agreement, would preclude sales treatment under the proposed standard on revenue recognition, the sale-and-leaseback would be accounted for as a financing. Our understanding of the proposed standard on revenue recognition leads us to believe that a purchase option (even at then determined fair value) would preclude sales accounting,⁵ but guarantees, financing, variability in future payments, sharing of future profits or appreciation in the underlying asset likely would not necessarily preclude sales accounting as those provisions involve shifting of risks and benefits between the parties to the agreements, not shifting of control.

⁴ Arguably the application of the proposed standard on revenue recognition to sale-and-leaseback transactions would preclude sale accounting until the end of the lease term as control of the asset does not transfer to the buyer/lessor until the end of the lease term. Such an approach has conceptual appeal, but we do not recommend that approach primarily because of the differences in reporting that would occur depending on whether or not the lessee had previously owned the leased asset. That is, two lessees with identical lease rights and obligations would have dramatically different accounting if one lessee had previously owned the leased asset and the other lessee had not previously owned the leased asset.

⁵ Paragraph B31(a) of the ED implies that an option to repurchase an asset at fair value would not preclude sale and leaseback accounting. However, paragraph 67(a) of the ED states the transferor shall account for the sale "in accordance with applicable Topics." The proposed standard on revenue recognition (paragraph IG49) would preclude sale accounting if the seller has an option, even at fair value, to repurchase the asset being sold.

If the Board does not accept our suggestions with respect to defining an in-substance purchase and sale agreement, we still believe that paragraph B31 of the ED will need to be significantly revised. That paragraph asserts that the listed provisions normally preclude the seller/lessee from transferring more than a trivial amount of risks and benefits to the buyer/lessor. That is simply not true for the majority of the listed provisions. For example, assume the seller/lessee provides non-recourse financing for a portion of the sale price—say 20 percent of the sales price. In such a situation, the buyer/lessor has far more than a trivial amount of risks and benefits related to the underlying asset—the buyer/lessor has all of the benefits (all of the upside in potential appreciation of the asset) and a significant amount of the risks related to unexpected declines in value of the underlying asset. As another example, assume the buyer/lessor is obligated to share a significant portion (say 40 percent) of the appreciation of the underlying asset with the seller/lessee. Again, in this situation, the buyer/lessor has far more than a trivial amount of risks and benefits related to the underlying asset.

One additional concern we have related to lessee accounting in sale-and-leaseback transactions is that the ED is silent with respect to lessee involvement with construction. Subtopic 840-40, *Leases—Sale-Leaseback Transactions*, currently addresses issues related to lessee involvement with construction (originally, EITF Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction*), but the ED is silent with respect to these issues. Such build-to-suit lease arrangements are common, and the ED, consistent with current guidance, will require much different accounting for the overall arrangement in many situations depending on whether the lessee has been deemed the owner of the asset during its construction. Accordingly, we believe it is important that the final leasing standard provide guidance on determining whether a lessee should be deemed the owner of an asset during its construction.

Sale-and-Leaseback Transactions – Buyer/Lessor Accounting

We do not agree with the guidance in subparagraph 68(a) that requires that a buyer/lessor use the performance obligation method to account for its lease. We do not see why the lessor in this situation should apply the guidance in the ED any differently than any other lessor. That is, the buyer/lessor should use the guidance in paragraphs 28, 29, and B22 through B27 to determine whether it should apply the performance obligation or derecognition approach.

We do not agree with the guidance in subparagraph 68(b) that a transferee (buyer/lessor) in a “failed” sale-and-leaseback should always treat the amount paid as a receivable. Although we generally applaud symmetry in financial reporting, we believe such symmetry could be dangerous in this situation. We can envision any number of situations in which the buyer/lessor’s investment has many more of the attributes of ownership of the underlying asset than of a receivable. For example, assume the transaction fails sale-and-leaseback accounting because the seller/lessee has a fixed price non-bargain purchase option. In that situation, the buyer/lessor is the legal owner of the underlying asset and has all of the risks of an owner of the underlying asset. We believe it would be misleading for the buyer/lessor to account for its investment in this situation as a receivable.

Accounting by Lessors

We think of the lease transactions within the scope of the ED as being of two types—leases that are substantially the same as selling the underlying asset and those that are not. We agree with the FASB’s dividing line between the two types of leases—whether or not the lessor retains significant risks

or benefits with respect to the underlying asset.⁶ In our view, a lease (which by definition transfers control of the underlying asset from the lessor to the lessee for a period of time) in which the lessor does not retain significant risks or benefits with respect to the underlying asset is economically similar to the sale of the asset and therefore believe that a derecognition approach is the appropriate accounting. We prefer a full derecognition method for such leases as we believe the appropriate “unit of account” for a lease is the entire asset (or an undivided interest in the entire asset⁷). We believe the leased asset (or undivided interest) is either substantially sold or not substantially sold for financial reporting purposes. We believe the retained residual in a lease that qualifies for the derecognition approach is quite different than the asset transferred to the lessee and should be viewed as proceeds rather than a retained interest in the leased asset. We would also point out that a full derecognition approach would be consistent with the FASB’s conclusion on the deconsolidation of a subsidiary with a retained noncontrolling interest and its conclusion on the sale of a financial asset with a retained beneficial interest.

However, our most significant concern relates to the accounting for leases in which the lessor retains significant risks or benefits related to the underlying asset. Consistent with our view on the unit of account for leasing, we view a lease in which the lessor retains significant risks or benefits related to the underlying asset to be a failed sale and not a partial sale of the underlying asset. Accordingly, we do not believe it would be appropriate to use a partial derecognition approach for such leases. We believe that the accounting for these leases should follow the principles outlined under the proposed standard for revenue recognition. That proposal bases revenue recognition on the satisfaction of performance obligations, noting that a performance obligation is satisfied when control of a good or service is obtained by the customer, and that control of a good or service rests with the customer when the customer has the right to direct the use of an asset “for its remaining economic life” (paragraph 27 of the proposed standard on revenue recognition). As the lessee does not obtain the right to use the asset for its remaining economic life, the performance obligation related to the asset can only be settled over time. While this is consistent with the result of applying the model in the ED, the performance obligation method diverges from the revenue recognition proposal at this point. We believe the performance obligation method to be inappropriate for such leases for the following reasons:

- Receivables should not be recognized by a seller in a failed sale transaction. Instead, a contract asset should be recorded as it would under the revenue recognition proposal, if the lessor performs by allowing the lessee to use the asset before the lessee performs by making lease payments. Similarly, a contract liability should be recorded if payment precedes use of the asset by the lessee.
- The performance obligation recognized under this approach is difficult to explain and is inconsistent with the notion of a performance obligation under the proposed revenue recognition standard.
- The pattern of revenue recognition under the performance obligation method is inconsistent with the pattern of revenue recognition for a service arrangement under the proposed revenue recognition standard.

⁶ However, as explained in our response to Question 2 in Appendix A, we do have concerns about the operability of the guidance used to distinguish the two types of leases.

⁷ Undivided interest in tangible assets can be bought and sold and therefore should be eligible to be leased. For example, this form of ownership is common for electric generating stations. Further, Topic 860, *Transfers and Servicing*, allows for sale accounting for transfers of participating interests (a pro rata ownership interest in an entire financial asset). Accordingly, we believe that a lease that transfers substantially all of the risk and benefits of a pro rata undivided interest in an asset should be accounted for using the derecognition approach.

To truly improve financial reporting for lessors and to decrease the likelihood of gamesmanship, we believe it is critical that lessor accounting be as consistent with the proposed standard on revenue recognition as possible. In our view, a lease in which the lessor retains significant risks or benefits is simply a contract in which control of the underlying asset (the use of the leased item) transfers throughout the contract term rather than at a point in time and should receive accounting treatment comparable to a service contract under the proposed revenue recognition standard.

All of the above leads us to conclude that the best financial reporting for a lessor that retains significant risks or benefits related to the underlying asset is to continue to apply operating lease accounting to such arrangements.

We do not believe our suggested approach is inconsistent with lessee accounting as proposed in the ED. Accounting by the lessee does not, in our view, raise unit of account issues. The lessee is acquiring a valuable contractual right (the right of use of the underlying asset) by incurring a liability (the obligation to make lease payments).

Statement of Cash Flows

The ED proposes that a lessee classify its entire lease payment as a financing cash outflow. Although we understand the conceptual argument for this treatment, we are baffled at why the interest component related to a lease obligation should be classified differently than the interest component related to a debt obligation. We would be supportive of classifying all interest expense as a financing cash outflow but cannot support different treatment for the interest related to a lease obligation than the interest related to a debt obligation. Classifying interest payments differently for leases than other debt obligations needlessly creates complexity and also impairs the comparability in financial reporting between lease obligations and debt obligations.

Similarly, we do not agree with the requirement for a lessor under the derecognition approach to classify the entire lease payment received as operating cash inflows. In effect, lessors under the derecognition approach will be classifying receipt of principal payments as operating cash inflows. Lenders classify collections of principal as investing cash inflows and we cannot understand why lessors' cash inflows under the derecognition approach should be treated any differently than the cash inflows to a lender under a debt arrangement.

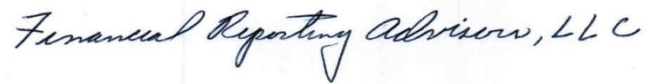
Need to Expose Changes to Codification

Consistent with our comments on the proposed standard on revenue recognition, we strongly encourage the FASB to expose for comment the proposed changes to the Codification that will result from the ED. The FASB's decision to codify GAAP has resulted in a significant change to the way in which financial reporting standards are organized, presented and written. While constituents have been largely supportive of the codification project, we believe that support was premised on an expectation that the Board would continue its long standing due process of exposing changes in the literature. Failure to provide constituents with the intended changes to the Codification is, in our view, inconsistent with the objective of due process.

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Once again we appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Leases*. If there are any questions, please contact Richard R. Petersen at 312-345-9102.

Sincerely,

A handwritten signature in cursive script that reads "Financial Reporting Advisors, LLC". The signature is written in black ink and is positioned above the typed name of the company.

Financial Reporting Advisors, LLC

Response To Questions

The exposure draft proposes a new accounting model for leases in which:

- (a) a lessee would recognize an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortize the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.*
- (b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23–BC27).*

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?*
- (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 a right-of-use asset and a liability to make lease payments. We believe such gross accounting for a lease contract allows for more informative financial reporting for the lease contract. The lessee's obligation to make lease payments will be recognized in a manner similar to other obligations of the lessee. For example, if the right-of-use asset becomes impaired, that impairment can be measured and recognized without affecting the accounting for the lessee's obligation to make lease payments.

We also agree that a lessee should recognize amortization of the right-to-use asset and interest on the liability to make lease payments. We agree that the amortization pattern for the right-to-use asset should follow the guidance in Topic 350, *Intangibles—Goodwill and Other*, for finite lived intangible assets. We do recommend that the phrase "on a systematic basis" be deleted from paragraph 20 as that phrase is not used in Topic 350.

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?*
- (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?*

- (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?*

As stated in the body of our letter, we agree that a derecognition approach should be used if the lessor does not retain exposure to significant risks or benefits. We believe such lease arrangements are similar to a purchase and sale of the underlying asset and believe a derecognition approach appropriately portrays the economics of the lease arrangement. As noted in the body of our letter, we support a full derecognition approach. In our view, the underlying asset has been sold and the lessor received as proceeds the lessee's obligation to make lease payments and a residual interest in the underlying asset. By definition, the lessor has not retained any significant risk or benefit related to the underlying asset in a lease accounted for by the derecognition approach. Consequently, consistent with current lessor accounting, we do not view the lessor's residual interest in the underlying asset as a "retained" interest.

We do not agree that the performance obligation approach should be applied if a lessor retains exposure to significant risks and benefits associated with the underlying asset. In our view, such leases should be treated akin to failed sales of the underlying asset. The FASB recently addressed the same issue with respect to transfers of financial assets and concluded that the whole asset (or a participating interest in the whole asset) must be transferred in order to achieve sales treatment. The FASB concluded that, for example, the transfer of the cash flows for the first five years from a debt instrument with a 15-year term could never be a partial sale for financial reporting purposes. We believe that following the same logic would preclude the use of a partial derecognition approach for lease contracts. Further, we do not believe the performance obligation method should be used for such "failed sale" lease arrangements. Instead, as noted in the body of our letter, we believe that such arrangements should be accounted for consistent with transactions discussed in the proposed standard on revenue recognition in which control of the asset transfers to the customer continuously over the contract term rather than at a point in time.

All of the above leads us to conclude that the best financial reporting for a lessor that retains significant risks or benefits related to the underlying asset is to (1) not recognize a receivable from the failed sale, (2) treat the lease contract similar to a service contract, and (3) recognize revenue on a straight-line basis over the term of the lease contract. In effect, the appropriate financial reporting in this fact pattern would be an accounting model that is very similar to a lessor's accounting for an operating lease.

Whether or not the FASB agrees with our suggestions or continues with the performance obligation approach, we believe that the proposed guidance for determining whether a lease does or does not qualify for the derecognition approach needs to be revised to be operational. We understand the FASB's desire to state a principle and to not prescribe detailed rules for distinguishing leases that qualify for the derecognition approach from other leases. However, the guidance given, in particular paragraph B24, is confusing to us. Subparagraph B24(a) seems backwards to us. Given that we are trying to determine whether or not the lessor remains exposed to significant risk or benefits, we believe it is important to understand whether the estimated remaining useful life of the asset at the end of the lease term is significant when compared to the asset's estimated remaining useful life at the commencement of the lease term. We do not understand subparagraph B24(b)—a significant change in value compared to its value at the inception of the lease or its expected value at the end of the lease? Is the FASB's intent to consider the possible volatility in asset value at the end of the lease? We are concerned that, as written, the application of this guidance will create diversity in practice with respect to which leases do and do not qualify for the derecognition approach.

We do agree that there should be no separate approach for lessors with leveraged leases. In our view, the differences between a regular lease and a leveraged lease (primarily the existence of nonrecourse financing) are not sufficient to justify a different accounting model.

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 believe that lessees with short-term leases should have the option to recognize their right-of-use assets and their lease obligations at the undiscounted amount of the lease payments (plus initial direct costs for the right-to-use asset). In other words, lessees would comply with all of the requirements of the ED except for the consideration of the time value of money. Such an approach would simplify the accounting for short-term leases without materially affecting the quality or relevance of information provided to the users of the financial statements. We recommend that the last sentence in paragraph 64 be deleted as it is causing more confusion than enlightenment. For example, it is unclear after reading that sentence how the lease expense should be characterized in the income statement. Is it amortization expense or something else? Is the lease payment an expense or a payment on a liability?

Additionally, we are confused about the last sentence in paragraph BC45—“[h]owever, preparers would not necessarily be required to comply with all of the estimations and calculations proposed for other leases because the short lease period may make their impact on the financial statements insignificant.” We read paragraph 64 as only allowing lessees to ignore the time value of money. However, paragraph BC45 implies that there are more “estimations and calculations” that do not need to be considered for short-term leases than just the time value of money. Consequently, we are confused as to the exact differences between the general requirements of the ED and the requirements for short-term leases.

As stated in the body of our letter, we recommend that lessors not recognize assets and liabilities arising from any leases that do not meet the conditions for use of the derecognition approach.

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?*
- (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?*
- (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?*

We agree with the definition of a lease.

We do not agree with the guidance in paragraphs 8, B9, and B10 for distinguishing a lease from a contract that is a purchase and sale. Please see our comments on this topic in the body of our letter.

We believe the guidance in paragraphs B1 to B4 is appropriate for distinguishing leases from service contracts.

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 believe that non-depreciable tangible assets (other than land) should be excluded from the scope of the ED. Non-depreciable tangible assets (other than land) are excluded from the scope of Topic 840, *Leases*, today and we believe that exclusion to be appropriate. For example, we do not believe that the ED should be applied to “leases” of inventory.

We are unclear whether time-share arrangements are within the scope of the proposed standard on revenue recognition or within the scope of the ED. Currently time-share arrangements that meet the conditions in Subtopic 978-605, *Real Estate—Time-Sharing Activities*, are accounted for as sale transactions. However, time-share arrangements appear to meet the definition of a lease in the ED.

We encourage the FASB to leave in place the guidance in Section 350-40-25, *Intangibles—Internal Use Software*, that requires licensees of internal use software to analogize to the leasing guidance.

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 agree with the proposed accounting when there is a distinct service component. The difficult issue relates to lease contracts that contain service components that are not distinct. If the service component is not distinct, we believe there is a single unit of account—the lease contract inclusive of the service component. Concluding that the lease contract with the service component that is not distinct is a single unit of account drives us to conclude the lessee and lessor should apply the lease accounting requirements to the combined contract.

That being said, we believe a lessor should not qualify to use the derecognition approach for a lease contract that includes a substantive service component that is not distinct. Paragraph BC13 states, “the boards think that it is important that accounting for leases by lessors should, as much as possible, be consistent with the proposals in their project on revenue recognition.” We agree. Revenue is recognized under the proposed standard for revenue recognition when the related performance obligation is satisfied. In order for the ED to be consistent with the proposed standard for revenue recognition, the final leasing standard should provide that substantive service components that are not distinct preclude the lessor from applying the derecognition approach.

We believe the FASB needs to examine the treatment of executory costs (as that term is used in Section 840-10-25) under the ED. The ED does not explicitly address the accounting for executory costs. We are concerned that some executory costs, specifically real estate taxes, will not meet the conditions to be considered distinct services and, absent specific guidance on the treatment of executory costs, therefore would be treated as lease payments. In some leases, the lessor is responsible for real estate taxes (the lease contract may or may not adjust the lease payments for changes in real estate taxes on the leased asset) and in other leases the lessee pays the real estate taxes directly to the taxing authority. Under current guidance, the real estate taxes are accounted for consistently regardless of whether the lessee pays the real estate taxes to the lessor or to the taxing authority. Under the ED the lessee's payment to the lessor for real estate taxes does not appear to meet the conditions to be considered a distinct service. Absent explicit guidance on executory costs, it appears that the following could occur:

- Lessees' right-to-use assets and lease obligations will be overstated for lease contracts of real estate in which the lessor is responsible for payment of real estate taxes to the taxing authority.
- Lessors' receivables for lease payments will be overstated for lease contracts of real estate in which the lessor is responsible for payment of real estate taxes to the taxing authority.

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?

As stated in the body of our letter, we agree that non-bargain purchase options should not be part of the accounting for the lease contract and should be accounted for when exercised. However, we believe that bargain purchase options (any purchase option that is reasonably assured of being exercised) should be included in the accounting for the lease with the exercise price treated as a lease payment.

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?

As stated in the body of our letter, we do not believe that the lease term should be based on whether renewal is more-likely-than-not. We believe that the lease term should include only renewal period options that are reasonably assured of being exercised.

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?

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 conceptually with the proposed treatment of contingent rental payments and payments from residual value guarantees for lessees. However, we believe it is likely lessees will encounter significant operationality issues in making some of the required estimates. For example, we believe lessees will struggle to estimate contingent rents that are based on future sales related to assets under long-term leases as the lease term will in all likelihood extend well beyond the normal budgeting and planning periods. We believe this to be an area in which the FASB should carefully weigh the costs to comply with the standard with the benefits received by users of the financial statements.

We provided the following comments with respect to recognition of contingent revenue amounts in connection with the proposed standard on revenue recognition and believe the same comments to be appropriate for lessor accounting under the ED.

In general, we believe that any recognition of revenue based, in substance, on predictions of the outcome of future events, should be limited to situations in which a large pool of homogeneous transactions exists. In that situation, we believe that the probability-weighted estimates generally would have a sufficient degree of reliability on which to base revenue recognition. In addition, when considering the large pool as a whole, the recorded revenue amounts based on probability-weighted estimates would generally represent the most likely outcome as well.

When a large pool of homogeneous transactions does not exist, we prefer to limit the estimate of the transaction price to the amounts that are not subject to change based on future events. While we acknowledge that this will have the effect, on the whole, of underestimating the economic value of revenue at the time that performance obligations are completed, we believe that the importance of reporting reliable, understandable amounts of revenue justifies this restriction.

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?

We agree.

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?

Please see the body of our letter for our concerns and suggested changes to the criteria for classification of a transaction as a sale and leaseback transaction or as a financing.

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 believe lessees should have the option of presenting this information either on the face of the financial statement or in the notes to the financial statements. For many lessees the magnitude of the lease related assets and liabilities simply would not warrant a requirement to present those amounts separately on the face of the financial statements.

- (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?*

As stated in the body of the letter, we do not believe lessors should apply the performance obligation approach. If the final leasing statement does require the use of the performance obligation approach, we do agree that lease related assets and liabilities should be presented net.

- (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?*

We believe lessors should have the option of presenting this information either on the face of the financial statement or in the notes to the financial statements. For many lessors the magnitude of the lease related assets and liabilities simply would not warrant a requirement to present those amounts separately on the face of the financial statements.

- (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?*

If the lessor presents its lease related assets and liabilities separate from other assets and liabilities on the face of its financial statements, we believe it should also distinguish assets and liabilities that arise under a sublease on the face of its financial statements.

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?

Consistent with our response to question 12, we believe lessees and lessors should have the flexibility to present this information in a manner that they believe is most meaningful in their circumstances. Accordingly, we believe they should have the option to present the information either on the face of their financial statement or in the notes to the financial statements.

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?

Please see the body of our letter for our concerns about the classification of the cash flows arising from lease contracts in the statement of cash flows.

Consistent with our response to questions 12 and 13, we believe lessees and lessors should have the flexibility to present this information in a manner that they believe is most meaningful in their circumstances. Accordingly, we believe they should have the option to present the information either on the face of their financial statement or in the notes to the financial statements.

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?

We agree with the overall objectives. However, we will defer to preparers and users of financial statements with respect to whether all of the disclosure requirements provide sufficient benefit to users to outweigh their costs to preparers.

We do observe that the ED proposes to require balance sheet account reconciliations. Perhaps those proposals would be better considered as part of the FASB's projects on financial statement presentation or disclosure framework.

Further, we believe the stated disclosure objective is so broad and generic as to be unhelpful. As written, it could be applied to any standard. There is nothing in paragraph 70 that is tailored to disclosures about leases, and therefore we do not believe the objective will be helpful to preparers in evaluating what should be disclosed. For that reason, we are not encouraged by inclusion of paragraph 72 which suggests that the Board believes that despite the 13 paragraphs of specific disclosure requirements, there will be situations where even more disclosure is required to meet the

disclosure objective. Given that it is always possible to identify additional potential disclosures, how could a company ever defend its conclusion that it had complied with the vague disclosure objectives?

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?*

Transition provisions need to be pragmatic in how best to move entities from one method of accounting to another. We believe that for some entities the difference in amounts reported for lease income and lease expense between the simplified retrospective and full retrospective will be quite significant. We also believe it is not practical to require all entities to adopt the new standard on a full retrospective basis. Consequently, we believe that entities should have the option of adopting the new standard for all of their leases on either the simplified or full retrospective basis.

As written, the ED would require some lease contracts that are currently accounted for as leases to be accounted for as in-substance purchase and sale transactions. We believe the final standard should specify the transition requirements for those lease arrangements.

Benefits and costs

Question 17

Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

Preparers and users of financial statements are in a better position than we to comment on the overall cost vs. benefits of the ED. We will say that we believe our suggested changes to the treatment of renewal period options and the lessor accounting model would reduce the costs of complying with the ED.

Other comments

Question 18

Do you have any other comments on the proposals?

Please see Appendix B for other comments on the ED.

Non-public 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?

We do not see any conceptual support for different recognition and measurement principles for private companies. We do not have expertise in accounting for not-for-profit entities.

Other Issues

The following are other issues we noted in the course of our review of the ED.

1. Accounting for lease incentives. Lease incentives are a common element of leases for some types of assets (for example, office space) but the ED does not address this issue. Because lease incentives are so common, we believe it would be useful for the FASB to explain the principle that should be applied to lease incentives. We note that FASB Statement No. 13, *Accounting for Leases*, did not address this issue, but the FASB found it necessary to address the issue in a later FASB Technical Bulletin.
2. Accounting by the original lessee for the substitution of a new lessee when the original lessee continues to be obligated under the lease agreement. This fairly common situation is not addressed by the ED. Should the original lessee account for this situation as a sublease or as a guarantee? We recommend this situation be addressed in the final standard.
3. Interest capitalization. In several standards, the FASB has explicitly stated that the expense recognized due to the accretion of a liability is not eligible to be capitalized under Subtopic 835-20, *Interest—Capitalization of Interest*, (for example, accretion expense related to exit costs and asset retirement obligations) although current GAAP does include interest costs from a capital lease as eligible interest costs. Is the interest expense recognized by a lessee under the ED eligible for capitalization under Subtopic 835-20? Given that all leases with a maximum lease term in excess of 12 months will cause the recognition of interest expense, this will be a common issue for lessees.
4. Changes in estimates between inception of the lease and the lease commencement. The ED does not address the accounting for changes in estimate that occur between the inception of the lease and the lease commencement date. For some leases, there can be a long period between inception of the lease and the commencement of the lease. Accordingly, we believe that entities will need to determine how to account for such changes in estimates and suggest the final statement address that situation.
5. Changes in estimates related to term option penalties and residual value guarantee payments. Based on the guidance in paragraph 18, it is unclear to us whether such payments should be ascribed to future periods or should be ascribed to all periods of the lease (and therefore a portion would be related to prior periods and a portion would be related to future periods).
6. Allocating the cost of the asset under the derecognition approach. Paragraph 50 requires that the allocation be done on a relative fair value basis. However, the example in paragraph B30 uses the present value of the lease payments rather than the fair value of the lease payments. What is the FASB's intent?
7. Impairment of residual assets. In our view, the residual asset is a tangible asset. We are unclear why paragraph 59 refers to both Topic 350, *Intangibles—Goodwill and Other*, and Topic 360, *Property, Plant, and Equipment*, in the guidance for impairment of residual assets.

8. Disclosures related to lease receivables and payables. Do the disclosure requirements for other financial instruments apply to lease receivables and payables? For example, do the disclosures of fair value, credit risk of receivables, troubled debt restructurings, and modifications apply to lease receivables? Paragraphs 84, BC75, BC93, BC123, BC168(b), and BC181 send mixed signals.
9. Accounting for changes in lease term under the derecognition approach. We believe the adjustments to the carrying amount of the residual asset at the end of year 1 in the examples in paragraph B30 are incorrect. There are likely a number of supportable ways to compute the adjustment to the carrying amount of the residual asset, one of which follows.

Based on the guidance in paragraphs 56 and 50 of the ED, we believe the adjustment of the carrying amount of the residual asset should be computed as follows: the cost of the asset (\$5,000) less the resultant of the present value of 7 years of lease payments (\$5,206) divided by the fair value of the leased asset (\$6,250) times the cost of the asset (\$5,000) gives us the adjusted residual asset carrying amount after the change in estimate ($\$5,000 - (\$5,206/\$6,250 \times \$5,000) = \$835$). The revised amount of the residual asset (\$835) less the original carrying amount of the residual asset (\$207) determines the adjustment to the residual asset—an increase of \$628 in this example.

10. Accounting by a sublessor. The only guidance for sublessors in the ED is in the section of the ED dealing with the performance obligation approach (paragraphs 43 and B29) which thereby implies that sublessors should account for subleases using the performance obligation approach. However, paragraph BC140 implies that a sublessor should determine which lessor model to apply just like any other lessor. The final standard should be clear on whether or not sublessors are required to use the performance obligation approach. If the sublessor needs to determine which lessor model to apply, the final standard should discuss how it determines retention or transfer of risks and benefits. Is the focus on the whole asset or only the lessee/sublessor's "share" of the asset?
11. Lessee's incremental borrowing rate. The definition of the lessee's incremental borrowing rate in Appendix A makes sense to us—the rate of interest the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar underlying asset. However, paragraph B13 states that the determination of the lessee's incremental borrowing rate would consider all of the terms of the lease including expected contingent rents, expected payments under term option penalties, and expected payments under residual value guarantees. We believe that the guidance in paragraph B13 is incorrect as we believe that variability in future cash flows would be incorporated in the probability-weighted average of the cash flows rather than being incorporated in the determination of the discount rate.
12. Discount rate. We are concerned that the guidance in paragraphs 12, B11, and B12 will create significant, unwarranted diversity in the determination of discount rates. We understand using the lessee's incremental borrowing rate or the rate implicit in the lease as the discount rate. However, we find the notion of a "rate the lessor charges the lessee" to be so general that we are concerned that rate could be determined in a variety of (very different) ways. We recommend limiting the discount rate to either the incremental borrowing rate or the rate implicit in the lease. If the notion of a rate the lessor charges the lessee remains in the final standard, we recommend that the final standard contain a principle to allow for evaluating the acceptability the rate determined.

Appendix B

File Reference No. 1850-100
November 30, 2010

13. Initial direct costs. Initial direct costs related to leases and to loans have the same definition today and, by analogy, that definition is sometimes used with respect to revenue contracts. However, we note that the definitions of initial direct costs are not the same in the ED and the proposed standard on financial instruments. Further, such costs are immediately expensed under the proposed standard on revenue recognition. We are skeptical that there are underlying fundamental differences driving this diversity in accounting for initial direct costs in these areas. We recommend that the FASB develop a definition of initial direct costs that can be applied consistently to the ED, the proposed standard on financial instruments, and the proposed standard on revenue recognition (and, if a new standard is developed for insurance activities, for that standard as well).
14. Accounting for leases in a business combination. The FASB reached some tentative decisions about accounting for leases acquired in a business combination prior to the issuance of the ED. That proposed guidance is not included in the ED. How will this proposed guidance on accounting for leases acquired in a business combination be exposed for public comment?