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Comment Letter No. 26

FASB Leases - Topic 842

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Respondent information

Type of entity or individual:

Lessor - VP Finance & Accounting

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Questions and responses

1. This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration." An entity would determine whether a contract contains a lease by assessing whether: 1. Fulfillment of the contract depends on the use of an identified asset.2. The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.Do you agree with the definition of a lease and the proposed requirements in paragraphs 842-10-15-2 through15-16 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any,to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

Agree. Most contracts I work with will fall into this test without confusion. Other lessees/lessors may work with more complex products and could lend more insight into the pros & cons of this treatment. I would add that I would encourage any steps that can be taken to minimize the complexities of asset level analysis and/or bifurcation of the contract. Those items will add greatly to the cost of implementation and future compliance.

2. This revised Exposure Draft would require an entity to recognize assets and liabilities arising from a lease.When assessing how to account for a lease, a lessee and a lessor would classify a lease on the basis of whether a lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.This revised Exposure Draft would require an entity to apply that consumption principle by presuming that leases of property are Type B leases and leases of assets other than property are Type A leases, unless specified classification criteria are met. Those classification criteria are different for leases of property and leases of assets other than property to reflect the different natures of property (which often embeds a land element) and assets other than property.The Boards acknowledge that, for some leases, the application of the classification criteria might result indifferent outcomes than if the consumption principle were to be applied without additional requirements. Nonetheless,this revised Exposure Draft would require an entity to classify leases by applying the classification criteria in paragraphs 842-10-25-5 through 25-8 to simplify the proposals.Lessee AccountingA lessee would do the following: 1. For all leases, recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments(except if a lessee elects to apply the recognition exemption for short-term leases). 2. For Type A leases, subsequently measure the lease liability on an amortized cost basis and amortize the right-of-use asset on a systematic basis that reflects the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. The lessee would present the unwinding of the discount on the lease liability as interest separately from the amortization of the right-of-use asset. 3. For Type B leases, subsequently measure the lease liability on an amortized cost basis and amortize the right-of-use asset in each period so that the lessee would recognize the total lease cost on a straight-line basis over the lease term. In each period, the lessee would present a single lease cost combining the unwinding of the discount on the lease liability with the amortization of the right of use asset.Lessor AccountingA lessor would do the following: 1. For Type A leases, derecognize the underlying asset and recognize a lease receivable and a residual asset. The lessor would recognize both of the following: a. The unwinding of the discount on both the lease receivable and the residual asset as interest income over the lease term b. Any profit relating to the lease (as described in paragraph 842-30-30-7) at the commencement date.2. For Type B leases (and any short-term leases if the lessor elects to apply the exemption for short-term leases), continue to recognize the underlying asset and recognize lease income over the lease term, typically on a straight-line basis.Question 2: Lessee AccountingDo you agree that the recognition, measurement, and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Given that it seems to be a forgone conclusion that virtually all leases MUST be brought onto the balance sheet, in general, for a lessee I would favor more of a concentration on the lease CONTRACT and measurement of the rights and obligations of that contract, rather than the type of asset (ex: Type "A" vs. Type "B") or the level of "consumption" of the economic benefits of the underlying asset. In my view, if the assets & liabilities are to go on the balance sheet, there's little reason to have two types of leases. (In addition, the definition of "insignificant" can be arbitrary and require a great deal of judgement and knowledge, especially as it is being applied to the underlying asset. (ex:What is significant vs. insignificant for a rail car is quite different than that for a laptop or PC)). This will create controversy and uncertainty between lessees, preparers, internal & external auditors, and statement users, and much more disclosure needs.
I would propose that it would be clearer, simpler and better for all involved parties if a simplified version of "Type B" treatment was used for most leases. The accounting could be simplified by allowing the monthly lease payments to be coded directly to rental expense (adjusting for straight line recognition if necessary if they are step payments), and then a journal entry reducing the ROU asset and the liability by the reduction in the PV, as an "offset" entry (preferably). Assets and Liabilities would reflect the appropriate amounts as of the balance sheet date, and Rental Expense would be shown on the income statement concisely on one line. Expense would generally equal cash flow, which simplifies one's understanding of the transactions. Leases could be this one type (other than perhaps short term or other excluded

immaterial contracts). This treatment would GREATLY reduce the cost and overhead for lessees, while ending up with the same net treatment "Type B" has in the exposure draft. Users/Investors would have a very clear picture of the lease transactions, preparers would have an efficient, reliable treatment, and all this would be with a minimum of ambiguity. There would be less confusion and impact on certain key measurements (EBITDA, etc). I strongly encourage the boards to consider exploring this possibility.

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3. Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

As a Lessor, I agree with the idea of maintaining "Operating" lease treatment (Lessor "Type B") for certain assets. For instance a clear example might be a business doing daily/weekly rentals of automobiles. Clearly, the automobile itself should not be "de-recognized" and substituted for the rental stream; each rental is insignificant to the automobile,and each rental is a current payment for current use. On the other hand, a single long term rental agreement (ex: 5-6 years) on an automobile (same asset), where the lessor expects to receive a relatively minor residual value (ex: 5-10%) is more of a financial investment transaction by the lessor. Unlike a Lessee, as a Lessor, our core business is to lease assets, and try to make a return on them. I can see the logic of having the two classifications (unlike the Lessee, who is generally acquiring the use of an asset to obtain the benefits it might provide in order to further their business goals/revenue).

However, the idea of what is & what isn't "insignificant" is unsettled, and will lead to ambiguity, especially since the focus in parts of this exposure draft seems to be on the asset type. I would suggest that at a minimum the boards give us more clarification/guidance as to what is considered insignificant. If that is not done, each entity, accountant, auditor, etc. may have their own reading of "insignificant", which will lead to additional confusion, expense and uncertainty to preparers and users of statements.

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4. Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 842-10-25-5 through 25-8, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

For LESSORS, all leases are shown on the balance sheet now, which will not change under the new exposure draft. I believe they should be "Operating (Type B)" or "Capital (Type A)" (for the most part) as proposed since that reflects the business model(s) of the Lessor.
However, for the LESSEE, (given that it appears that the boards have decided that virtually all leases MUST be reflected on balance sheet), I believe a modified "Type B" treatment (as explained in my answer to Question 2 above) would more simply, clearly and accurately reflect the lease CONTRACT ROU asset, Liability, Income, Cash Flow, etc., achieve the balance sheet recognition goal, as well as provide financial statement users an improved product - which (I believe) is the reported ultimate goal of this project. (Please see my answer to Question 2 above.)

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5. This revised Exposure Draft would require that a lessee and a lessor measure assets and liabilities arising from a lease on a basis that:1. Reflects a lease term determined as the noncancellable period, together with both of the following: a. Periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option b. Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.2. Includes fixed lease payments and variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate) but excludes other variable lease payments unless those payments are in-substance fixed payments. The lessee and lessor would measure variable lease payments that depend on an index or a rate using the index or rate at the commencement date.A lessee would reassess the measurement of the lease liability, and a lessor would reassess the measurement of the lease receivable, if either of the following occurs: 1. There is a change in relevant factors that would result in a change in the lease term (as described in paragraph 842-10-55-5).
2. There is a change in an index or a rate used to determine lease payments.Question 5: Lease TermDo you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease and why?

In general, the reassessment process could add a great deal of cost and complexity to the practical application of the standard. Therefore, reassessment provisions should be minimized. I agree with a reassessment of the lease term if there is a highly MATERIAL change in relevant factors. I do NOT agree if the change is less material. I also do NOT agree reassessment should be done based on a change in an index or rate used to determine the lease payments. For instance, if the lease payment has an escalation clause based on CPI, I believe it would greatly lessen the cost of implementation and maintain statement quality if this change was expensed as incurred. I therefore believe (at a minimum), the entity should be ALLOWED to choose to expense the change as incurred (with a statement in disclosures if necessary). As a compromise, perhaps there could be some type of threshold for reassessment (especially related to an index or rate used to determine lease payments) based on remaining term of the lease agreement (ex: less than 3 years remaining term would not be reassessed). I encourage the boards to seriously consider changes to minimize the burdensome reassessment process.

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6. Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

As stated above, the reassessment process could add a great deal of cost and complexity to the practical application of the standard. Therefore, reassessment provisions should be minimized. I do NOT agree reassessment should be done based on a change in an index or rate used to determine the lease payments. For instance, if the lease payment has an escalation clause based on CPI, I believe it would greatly lessen the cost of implementation and maintain statement quality if this change was expensed as incurred (either per the standard, or as an election by the entity). As a compromise, perhaps there could be some type of threshold for reassessment (especially related to an index or rate used to determine lease payments) based on remaining term of the lease agreement (ex: less than 3 years remaining term would not be reassessed). Even then, if the result is not highly material, it should not lead to reassessment. I encourage the boards to seriously consider changes to minimize the burdensome reassessment process, especially the index or rate factor.

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7. Subparagraphs 842-10-65-1(b) through (h) and (k) through (y) state that a lessee and a lessor would recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?Are there any additional transition issues the Boards should consider? If yes, what are they and why?

Although it is better to have the modified retrospective approach as an option rather than not, I would encourage the boards to be even more flexible regarding transition. In general, leases are multi-year, sometimes complex instruments, and can contain thousands of assets in hundreds of locations all over the world. The cost of transition may be huge, and may be a great burden on many entities, both large and small. At a minimum, I would suggest that the boards strongly consider allowing existing leases with less than a certain remaining term (ex: preferably 3 years remaining-- or at least 12 months if more is not acceptable) to be grandfathered with their existing treatment. This could be fully disclosed in the footnotes. This would be a huge step in mitigating the costly burden of this change, and I believe would not result in a significant burden to users of the financial statements. This would allow entities time to get new systems in place for booking and recording their new contracts, and would eliminate the "re-booking" of all the existing lease agreements and/or the dual systems/bookings that would be necessary during the transition period, as the exposure draft now stands. I feel strongly about this being a key point in mitigating the pain to the entities, while not burdening the financial information users unduly. At a minimum, even if grandfathering were not allowed for Lessees, I believe it could be allowed for Lessors with little negative impact. All leases are already capitalized and reflected on Lessors' balance sheets, and the cost to switch (formerly) Operating leases over to "Type A" leases is not justified.

If grandfathering treatment on lease agreements would be unacceptable, I would suggest (as a secondary alternative) capitalization of only the REMAINING term of the leases as of adoption date. For instance, if on adoption date a 60 month lease has 48 months left to go, I would propose capitalizing only the remaining 48 months, without restating the prior periods. This would be more burdensome than grandfathering the entire agreement for its remaining life, but it would eliminate the "two-sets-of-books" issue that will be an incredible burden to entities, and will not provide the commensurate benefit to statement users compared to the costs.

In addition,I would encourage the boards to provide a SUBSTANTIAL period before implementation. This change in lease accounting will necessitate development and changes in software programs, data gathering, and operations worldwide. A substantial amount of time is needed to implement these changes. A long lead time would also allow entities to re-visit their lease agreements as they mature (or before) with the new pronouncement in mind. There will be much less upheaval, confusion & opposition to the new pronouncement if enough time is given.

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8. Paragraphs 842-10-50-1, 842-20-50-1 through 50-10, and 842-30-50-1 through 50-13 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments, reconciliations of amounts recognized in the statement of financial position, and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

In my opinion, the "rollforward" of the balance sheet items for the Lessee and some other items might be more costly than the benefit received.
I would also consider my answer to Question 2 re: modified "Type B" treatment for Lessees, which might have a beneficial impact on disclosure needs.

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9. To strive for a reasonable balance between the costs and benefits of information, the FASB decided to provide the following specified reliefs for nonpublic entities: 1. To permit a nonpublic entity to make an accounting policy election to use a risk-free discount rate to measure the lease liability. If an entity elects to use a risk-free discount rate, that fact should be disclosed. 2. To exempt a nonpublic entity from the requirement to provide a reconciliation of the opening and closing balance of the lease liability. Will these specified reliefs for nonpublic entities help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements? If not, what changes do you propose and why?

Both of these proposals will be a help to preparers - not a huge benefit, but certainly worthwhile given that with disclosure I believe the statement user is not harmed.

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10. The FASB decided that the recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties based on the legally enforceable terms and conditions of the lease, acknowledging that some related party transactions are not documented and/or the terms and conditions are not at arm's length. In addition, lessees and lessors would be required to apply the disclosure requirements for related party transactions in Topic 850, Related Party Disclosures. Under existing U.S. GAAP, entities are required to account for leases with related parties on the basis of their economic substance, which may be difficult when there are no legally enforceable terms and conditions of the agreement. Question 10: (FASB Only)Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases (for example, to require the lease to be accounted for based on the economic substance of the lease rather than the legally enforceable terms and conditions)? If not, what different recognition and measurement requirements do you propose and why?

I agree. Between the proposed recognition and measurement requirements and the Related Party Disclosures, I believe the user of the financial statement is served adequately.

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11. Do you agree that it is not necessary to provide additional disclosures (beyond those required by Topic 850) for related party leases? If not, what additional disclosure requirements would you propose and why?

I agree.

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12. The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40, Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

Additional comments - updt. Please provide any additional comments on the Invitation to Comment:

I have several points, as follows: 1) "Month-to-month" Rentals After Lease Maturity - As a Lessor, most of our leases require a notification period from the lessee at or after maturity of their intent to terminate the lease and return the equipment. If no notice is received, the lease may continue for 30, 60, or 90 day periods until notice is given. Logistically and operationally, it is common for a lessee to need several months to gather all the lease assets, transition to whatever replacements might be needed, pack, ship, etc. So, it is very common for all or a portion of the assets on a lease to continue month-to-month for some unknown period of time. As written, it is not 100% clear to me how those rentals would be treated (by the lessee or lessor), and I would encourage the boards to clarify that in those limited cases the rental would be directly expensed by the lessee and taken to rental income by the lessor, as in the Short-term lease treatment.

2) I would again encourage the boards to consider a modified "Type B" approach for Lessees (no "Type A") per my comments in Question 2 & 3. In my opinion, this would solve many of the ancillary problems that will exist with the ED as proposed.

3) In addition, I would strongly encourage the boards to consider my comments in Question 7 regarding transition. These include: a) grandfathering leases (most helpful), b) only capitalizing the remaining term of leases active at adoption, and c) allowing a very substantial transition period.

4) My comments in Questions 5 & 6 iterate my view that reassessment should be very limited in scope, and definitely not include changes in indexes or rates unless they are overwhelmingly material. The complexity and added burden of having to "re-book" leases dealing with these changes (ex: CPI, etc) would not seem to warrant the questionable degree of benefit to the statement user.

5) I would also encourage a long, extensive period of field testing of the proposal before adoption. Obviously, this subject impacts a huge number of businesses over all industries throughout the globe, and we need to be sure that we "get it right the first time". It would be far better to continue with the standards as they exist now (statement users are familiar with them), than cause the confusion and disruption that would result from faulty, problematic new pronouncements. I suspect that many entities have not focused on this subject, and it's important that we reach the goal of disclosing and improving financial information, not making it more complex, obtuse, subjective, and less useful.

6) Finally, I continue to hope the board will always consider the cost vs. benefits of this and any proposal. An impact study should be done to try to ascertain the costs this proposal will produce for virtually every entity, and view all requirements through that lens.

Thank you for your consideration.

Additional comments - process. Please provide any comments on the electronic feedback process:

The electronic process helps expedite the feedback. I appreciate it being avaliable.