



KPMG LLP
345 Park Avenue
New York, N.Y. 10154-0102

Telephone +1 212 758 9700
Fax +1 212 758 9819
Internet www.us.kpmg.com

October 25, 2017

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: *Part II. Accounting Standards Update No. 2016-02, Leases (Topic 842) of the Proposed Accounting Standards Update, Technical Corrections and Improvements to Recently Issued Standards (File Reference No. 2017-310)*

Dear Technical Director:

We appreciate the opportunity to comment on *Part II. Accounting Standards Update No. 2016-02, Leases (Topic 842)* of the proposed ASU, *Technical Corrections and Improvements to Recently Issued Standards*. We will provide comments on *Part I. Accounting Standards Update No. 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, separately.

We support the Board's efforts to make technical corrections and improvements to the Accounting Standards Codification on a regular basis. We think it is important for the Board to continue to make corrections to major new standards such as Topic 842 separate from the overall annual technical corrections and Codification improvements project. We believe that approach permits more timely and transparent changes to major new standards than if those changes were part of the overall annual initiative. We encourage the Board to continue making stand-alone technical corrections and Codification improvements in the future for major new standards if there is a sufficient volume of amendments, even if that process takes place after the effective date of a new standard.

We support all of the technical corrections and Codification improvements in the proposed ASU. However, we have highlighted one potential consideration related to Issue 2 in the proposed ASU in our response to Question 1 of the Questions for Respondents. In addition, there are two other amendments that we believe the Board should consider. Our suggestions for those amendments are included in our response to Question 3 of the Questions for Respondents.

Our responses to the Questions for Respondents are included in the Appendix to this letter.

Technical Director
Financial Accounting Standards Board
October 25, 2017
Page 2

* * * * *

If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at (212) 909-5664 or kbascom@kpmg.com, or Scott Muir at (212) 909-5073 or smuir@kpmg.com.

Sincerely,

KPMG LLP

KPMG LLP

Appendix – Responses to Selected Questions for Respondents

Question 1:

Would the amendments in this proposed Update clarify the guidance in Topic 842 or provide a better link between paragraphs within Topic 842 or between the guidance in Topic 842 and other Topics? If not, please explain which proposed amendment(s) you disagree with and why.

Yes. We believe that the amendments in the proposed ASU represent improvements to Topic 842 and support each proposed amendment.

Additional comment re: 'Issue 2: Rate Implicit in the Lease'

We support the proposal to clarify that the rate implicit in the lease cannot be less than zero. That proposal is consistent with our understanding of the Board's intent related to the accounting by lessors in sales-type lease arrangements where all or a significant portion of the payments for the lease are variable. However, it appears that this proposal may also result in the use of a zero discount rate by the lessee in those scenarios because, under the proposal, the rate implicit in the lease (zero) would likely be 'readily determinable' by the lessee. If this result for the lessee in these arrangements is acceptable to the Board, no further action is necessary. However, if this is not the Board's intent, we suggest clarifying that if the implicit rate determined using the existing Topic 842 definition of 'rate implicit in the lease' would be less than zero, the lessor shall use an implicit rate of zero, while the lessee shall use its incremental borrowing rate (which a lessee will use for nearly all other leases).

Question 2:

Will any of the proposed amendments result in substantive changes to the application of Topic 842 that would require transition provisions or an effective date for the final amendments other than those noted in the Summary section "When Would the Amendments Be Effective?" If so, please describe.

No. We believe that the proposed amendments either clarify important aspects of the guidance (e.g. what cash flows to consider when assessing impairment of the net investment in a sales-type or direct financing lease) in a manner that is *helpful* to an entity's ongoing implementation efforts or are minor in nature. Therefore, we do not believe the proposed amendments impose an additional transition burden on preparers that would require different or extended transition provisions.

Question 3:

Should other changes that are directly or indirectly related to the proposed amendments be made? Please note that the Board will conduct Codification improvements projects on a periodic basis and additional changes may be postponed to a subsequent Codification improvements project.

Yes. We suggest that the Board consider including two other technical corrections in the final ASU.

Suggested additional technical correction 1 – sales-type leases resulting from seller repurchase options

We believe the lease classification guidance in Topic 842 created a circumstance in which the repurchase agreements guidance in paragraph 606-10-55-68(a) may have no practical accounting effect. We believe that the Board intended for paragraph 606-10-55-68(a) to result in accounting for the lease in the sale of a good subject to a seller call option as an operating lease. However, we believe that in most sale scenarios

subject to a seller call option, the seller would classify the lease as a sales-type lease. We believe that, when considering the lease term and the lease payments criteria in paragraphs 842-10-25-2(c) and 25-2(d), together with the lease term guidance in paragraph 842-10-30-1, the seller would conclude that:

- the lease term is the remaining economic life of the sold item. This is because the lease term includes all lessor-controlled renewal options, and in the case of a seller call option, the seller alone controls whether the ‘lease’ *ever* terminates; and
- the lease payments, in this case the sales price paid by the customer for the good, are at least substantially all the fair value of the underlying asset unless the sales price is significantly below fair value. The analysis ignores the exercise price of the call option because the seller (lessor) controls the option.

The repurchase agreements guidance states that control of the sold item does not transfer to the customer and, therefore, revenue (and profit) should not be recognized on the contractual sale. Notwithstanding that guidance, classifying the lease in the sale of a good subject to a seller call option as a sales-type lease would result in derecognition of the underlying asset and recognition of product revenue and selling profit. This will, in effect, obviate the effect of the guidance in Topic 606 that applies to seller call options. This outcome may also occur less frequently in seller forward and customer put option scenarios, e.g. if the forward date or put option exercise date is sufficiently far into the future that the period from sale until the forward date or put option exercise date (the ‘lease term’) is for a major part of the remaining economic life of the sold item.

Based on previous discussions, we believe the Board and staff may have had the impression that sales-type lease classification would occur infrequently. However, after further consideration, we do not believe that would be the case. Rather, we expect that in *most* seller call option scenarios, the lease will be a sales-type lease. We believe that replacing the words ‘A lease’ at the beginning of paragraph 606-10-55-68(a) with ‘An operating lease’ would produce an accounting result consistent with the intent of that paragraph, as we understand it.

This amendment would not only preserve the objective of the guidance in Topic 606, but would also enhance convergence with IFRS. Under IFRS, we believe entities in this scenario would frequently conclude, based on IFRS 16.65, that the lease “does not transfer substantially all the risks and rewards incidental to ownership” when the seller has a call option. If the Board does not wish to amend Topic 606 to effect this technical correction, we believe it could specify in section 842-10-25 or section 842-10-55 that leases resulting from applying the repurchase agreements guidance in section 606-10-55 shall be classified as operating leases.

Suggested additional technical correction 2 – lessor recognition of variable payments for non-lease components

Paragraph 842-10-15-40 states that a lessor “shall **recognize** those payments as income in profit or loss **in the period when the changes in facts and circumstances on which the variable payment is based occur** (for example, when the lessee’s sales on which the amount of the variable payment depends occur)” [emphasis added]. We believe that paragraph can be read to permit recognition of revenue from variable payments related to a non-lease good or service in an earlier period than the revenue would be recognized if the good or service were not included in the lease contract.

The period in which changes in facts and circumstances on which the variable payment is based may be different from the period in which the non-lease good or service is transferred to the customer. Consider a

contract in which the lessor leases retail space to a lessee and agrees to provide consulting services to the lessee that will result in the delivery of a detailed report. Payments for the lease and the services are entirely variable, based on a percentage of the monthly store sales. Assume that the consulting services either (1) are not a performance obligation satisfied over time under Topic 606 or (2) will be substantially performed during later periods of the lease. In this example, we believe that paragraph 842-10-15-40 can be read to require recognition of the portion of the variable payments allocable to the non-lease consulting services each month as they become fixed or determinable. We do not believe this was the Board's intent. Instead, we believe that the Board intended for the portion of the variable payments allocated to the non-lease consulting services to be recognized as revenue on satisfaction of the performance obligation at a point in time or over time, in accordance with the general Topic 606 guidance.

To better reflect what we believe to be the Board's intent, and not create an inconsistency with Topic 606, we suggest this technical correction to paragraph 842-10-15-40:

842-10-15-40 If the terms of a variable payment amount other than those in paragraph 842-10-15-35 relate to a lease component, even partially, the lessor shall ~~recognize~~ allocate those payments to the lease and nonlease components of the contract (on the same basis as ~~income~~ the initial allocation of the consideration in profit or loss in the period the contract) when the changes in facts and circumstances on which the variable payment is based occur (for example, when the lessee's sales on which the amount of the variable payment depends occur). Variable lease payments shall be recognized as income in profit or loss in accordance with Subtopic 842-30, while variable payments attributable to nonlease components shall be recognized in accordance with other Topics (for example, Topic 606).

If the Board decides not to make this technical correction, we suggest that the Board explain its intent with respect to the application of paragraph 842-10-15-40 in the Basis for Conclusions to the final technical corrections ASU. For example, this explanation could occur in the context of explaining the Board's decision on why this technical correction is not necessary.