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

Dear Ms. Cospers:

We appreciate the opportunity to comment on the proposed Accounting Standards Update (ASU) issued by the Financial Accounting Standards Board (FASB or Board). We support the effort by the Board to improve the Accounting Standards Codification (ASC or Codification) and address stakeholder feedback about how to apply certain aspects of ASC 842.

We agree that the proposed changes clarify the Codification and correct guidance that could be misinterpreted or does not represent the intention of the Board. Our responses to the questions in the proposed ASU and additional suggestions to improve it are included in Appendix A. We have included other editorial suggestions in Appendix B.

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We would be pleased to discuss our comments with the FASB or its staff at your convenience.

Very truly yours,

Appendix A – Responses to questions in the proposed ASU

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?

We believe that the proposed amendments would clarify how to apply the guidance in ASC 842. However, we recommend that the Board further clarify the transition guidance for leases acquired as part of a business combination as discussed below.

Issue 8, Transition guidance for amounts previously recognized in business combinations, and Issue 9, Certain transition adjustments

It is not clear in the proposed amendments to paragraph 842-10-65-1(h)(3) whether the Board intended for entities to record adjustments to amounts recorded for leases acquired in a business combination that occurs after the earliest period presented but before the effective date (e.g., a business combination that occurs on 30 June 2017) in equity or as part of purchase accounting when they apply the transition guidance. If the Board does not believe there would be a net difference as a result of applying the transition guidance for amounts previously recognized in business combinations when the classification changes (e.g., an intangible asset or liability recognized related to an operating lease would impact the fair value of the net investment in lease in a sales-type lease), we recommend that the Board specifically address that in the final ASU.

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.

Yes. We note that the “When Would the Amendments Be Effective?” section makes it clear that for entities that have early adopted ASC 842, the proposed amendments would be effective upon the issuance of the final ASU and these entities would follow the transition guidance in ASC 842. However, the proposed ASU does not include amendments to the transition guidance in paragraph 842-10-65-1 to indicate how an entity that has already adopted ASC 842 would record any adjustments resulting from applying the proposed amendments.

For example, consider a lessor that adopted ASC 842 on 1 January 2017 and used a negative rate implicit in the lease to account for a direct financing lease with significant variable lease payments that do not depend on an index or a rate. It is not clear in the proposed amendments to ASC 842 whether the lessor would need to adjust its net investment in the lease to use a rate of zero upon the issuance of the final ASU or whether it would apply the amended definition of the rate implicit in the lease prospectively to leases entered into or modified following the issuance of the final ASU.

If the Board’s intent is for the lessor to adjust its existing net investment in the lease upon the issuance of the final ASU, the proposed ASU does not indicate how the lessor would record the corresponding adjustment (e.g., as a cumulative effect adjustment in the period of adoption of the ASU or as an adjustment to earnings in the current period).

We recommend that the Board provide transition guidance in ASC 842 to clarify how entities that have early adopted ASC 842 would record any adjustment resulting from the proposed amendments. For example, the transition guidance could state that an entity that has adopted ASC 842 before adopting the final ASU should apply the amendments prospectively.

Question 3: Should other changes that are directly or indirectly related to proposed amendments be made?

Our additional observations and recommendations for the Board to consider in the current or subsequent Codification improvements project are below.

Timing of the recognition of variable lease payments by lessors

ASC 842 provides recognition guidance for variable lease payments by a lessor. Specifically, paragraph 842-10-15-40 states that [**emphasis added**]:

“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** 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**).”

Based on this guidance, the recognition of variable payments not included in the consideration in the contract is dependent upon changes in facts and circumstances on which the variable payment is based. This is a known difference compared to variable payments that solely relate to non-lease components (i.e., variable payments that would be included in the transaction price in accordance with the guidance on variable consideration in ASC 606).

For variable payments not included in the consideration in the contract, paragraph 842-10-55-152 in Example 14 – *Determining the Consideration in the Contract – Variable Payments* states that [**emphasis added**]:

“Lessor, in the same manner as Lessee, also will recognize the income related to the variable payments and allocate that income between the lease and nonlease maintenance services (on the same basis as the initial allocation of the consideration in the contract), **when and if earned.**”

This paragraph illustrates that a lessor considers whether the variable payment allocated to the non-lease component has been earned based on the guidance in ASC 606 in order to recognize the non-lease income.

Therefore, it appears that the timing of revenue recognition for variable payments not included in consideration in the contract in paragraph 842-10-15-40 may be inconsistent with the guidance in Example 14. We are concerned that an entity could interpret paragraph 842-10-15-40 to mean that variable payments allocated to the non-lease component could be recognized as income at the same time as the payment allocated to the lease component, even when the performance obligation related to the payments has not been satisfied in accordance with ASC 606 (i.e., the income has not been earned).

We recommend that the Board make conforming amendments to align the language in paragraph 842-10-15-40 with that in paragraph 842-10-55-152 in Example 14 (i.e., to indicate that variable payments are recognized when the changes in facts and circumstances on which the variable lease payments are based occur and when and if the income is earned).

Subsequent accounting by a lessor for operating leases when classification does not change in transition

We recommend that the Board provide subsequent measurement guidance for periods beginning on the effective date to indicate how a lessor would account for leases previously classified as operating leases under ASC 840 that remain operating leases under ASC 842.

Paragraph 842-10-65-1(v) does not provide subsequent measurement guidance for periods beginning on the effective date for leases that a lessor previously classified as operating leases under ASC 840 that continue to be classified as operating leases under ASC 842. However, the transition guidance addresses subsequent measurement by a lessor beginning on the effective date for leases previously classified as direct financing leases or sales-type leases under ASC 840 (paragraphs 842-10-65-1(x)(4) and 65-1(y)(4)) and leases previously classified as operating leases under ASC 840 that are classified as sales-type or direct financing leases under ASC 842 (paragraph ASC 842-10-65-1(w)(4)). Therefore, it is unclear whether an entity should continue to apply ASC 840 or begin to apply ASC 842 to account for those leases that a lessor previously classified as operating leases under ASC 840 that continue to be classified as operating leases under ASC 842 beginning on the effective date.

In addition, at its 10 May 2017 meeting, the FASB clarified that "The transition provisions also generally enable entities to 'run off' their existing leases for the remainder of the lease term (including in periods after the effective date), unless, on or after the effective date, either: (a) The lease is modified and that modification is not accounted for as a separate contract in accordance with the guidance in paragraph 842-10-25-8; (b) For lessees only, the lease liability is remeasured in accordance with the subsequent measurement guidance in Subtopic 842-20."

However, BC390 states "Entities will, in effect, 'run off' existing leases, as described, unless the lease is either modified (and that modification is not accounted for as a separate contract) or, for lessees only, the lease liability is remeasured in accordance with the subsequent measurement guidance in Subtopic 842-30 on or after the effective date. To ensure that the financial statements provide relevant and reliable financial information, lessees and lessors should apply the subsequent measurement guidance in ASC 842 beginning on the effective date."

We recommend that the Board add subsequent measurement guidance to paragraph ASC 842-10-65-1(v) to clarify the accounting for leases that a lessor previously classified as operating leases under ASC 840 that continue to be classified as operating leases under ASC 842.

Appendix B – Editorial comments

Issue 5: Variable lease payments that depend on an index or a rate

The language used to refer to a reference rate in the proposed amendments to paragraphs 842-10-35-4 through 35-5 is not consistent with the language in BC14. The proposed amendments state that a change “in” a reference index or a rate would not constitute the resolution of a contingency as described in paragraph 842-10-35-4. However, BC14 states that a change “to” a reference index or a rate does not constitute the resolution of a contingency as described in paragraph 842-10-35-4.

We believe the language in BC14 (i.e., a change “to” a reference index or rate) could suggest that the index or rate is changing (e.g., a change from the Consumer Price Index to the London Interbank Offered Rate). We recommend that the Board amend the language in BC14 to match the language in the proposed amendments (i.e., a change “in” a reference index or rate).

Issue 13: Impairment of net investment in the lease

The use of “collateral” in paragraph 842-30-35-3 is not consistent with the FASB’s Master Glossary definition of collateral, which is “personal or real property in which a security interest is given.” We recommend the following revision to the proposed amendments (deleted text is struck out):

“A lessor shall determine impairment related to the net investment in the lease and shall recognize any impairment in accordance with Topic 310 on receivables (as described in paragraphs 310-10-35-16 through 35-30). When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration ~~the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents~~ the cash flows that the lessor would expect to receive (or derive) from the lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term.”

To better align the language in the proposed guidance with ASC 326-20, we recommend that the Board amend the pending content and the related heading for paragraph 842-30-35-3 as follows (proposed text is underlined, and deleted text is struck out):

“>> Loss Allowance for credit losses on the Net Investment in the Lease

A lessor shall determine the ~~loss allowance~~ loss allowance for credit losses related to the net investment in the lease and shall record any ~~loss allowance~~ loss allowance for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. When determining the ~~loss allowance~~ loss allowance for credit losses for a net investment in the lease, a lessor shall take into consideration ~~the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents~~ the cash flows that the lessor would expect to receive (or derive) from lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term.”