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February 5, 2018

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
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**RE: Proposed Accounting Standards Update, *Leases (Topic 842): Targeted Improvements*
(File Reference No. 2018-200)**

Dear Technical Director:

We appreciate the opportunity to comment on the proposed ASU, *Leases (Topic 842): Targeted Improvements*.

Transition – comparative reporting at adoption

We support the Board’s proposal to permit an entity to adopt Topic 842 through a cumulative effect adjustment as of the date of adoption (i.e. the effective date), rather than requiring a modified retrospective transition approach. We believe this option will ease the transition to the new guidance for many entities and is a reasonable cost-benefit accommodation.

Separating components of a contract

We also support the Board’s proposed practical expedient not to require a lessor to separate lease and related non-lease components. However, we suggest specific modifications to the proposed expedient in the final ASU. If the Board pursues one or more of our proposed alternatives, we note that conforming edits should be made to the Basis for Conclusions (e.g. to paragraphs BC18, BC19 and BC23).

Applicability to ‘net’ leases

Based on our observation of the Board’s deliberations of the practical expedient, and our subsequent discussions with the FASB staff, we understood the Board’s intent to be consistent with paragraph BC116 of ASU 2014-09. That paragraph refers to “concurrently delivered distinct goods or services that have the same pattern of *transfer*,” rather than same “pattern of *revenue recognition*” as is used in proposed paragraph 842-10-15-42A(a) [emphasis added]. Pattern of transfer (or measure of progress) and pattern of revenue recognition are not synonymous. Consider a ‘stand-ready’ non-lease component for which the customer is charged ongoing, variable payments (frequently, in addition to a fixed fee). Under Topic 606, the lessor may reasonably conclude that a time-based measure of progress is appropriate, reflecting a straight-line pattern of transfer for the non-lease component to the customer. However, the entity may also conclude that the stand-ready non-lease component is a ‘series’ (under paragraph 606-10-25-14(b)), to which it must apply the variable consideration allocation guidance in paragraph 606-10-32-40, thereby recognizing the variable payments as revenue in the distinct period to which those payments relate.¹ If those

¹ The guidance in paragraph 606-10-32-40 is not optional when its requirements are met.

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payments vary each period, the pattern of revenue recognition for the non-lease component will not be straight line. And because the pattern of revenue recognition for the operating lease component *will* generally be straight line, it would appear that the criterion in paragraph 842-10-15-42A(a) would not be met to combine the lease component and the stand-ready non-lease component.

We believe this fact pattern may frequently arise in ‘net’ real estate lease scenarios, i.e. scenarios in which the lessee makes fixed rental payments, but is also responsible for making variable payments to the lessor for the lessee’s proportionate share of common area maintenance (CAM) costs. We believe lessors would frequently conclude for these leases that the CAM component of the lease contract constitutes a series of distinct CAM service periods and that the variable CAM reimbursement payments should be allocated to (and recognized in) the distinct service period to which the costs relate, even though there is a straight-line pattern of transfer of the non-lease component to the customer. In the absence of being able to apply the practical expedient to net leases, the lessor would typically still need to allocate a portion of the fixed payments in the contract for those leases to the CAM because the variable CAM payments reflect only the reimbursement of CAM costs (i.e. at zero margin), and therefore allocation of *only* those variable amounts to the CAM component would not meet the Topic 606 allocation objective.

We do not believe it was the Board’s intent to exclude net real estate leases or other similar arrangements from the proposed practical expedient. Therefore, we suggest two possible drafting alternatives that we believe would resolve the issue identified above with respect to net leases.

Alternative 1 – Align to BC116 of ASU 2014-09

The Board could revise the language in the proposed ASU from ‘pattern of revenue recognition’ to ‘pattern of transfer’ as used in BC116 of ASU 2014-09:

842-10-15-42A As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and those the associated nonlease components that meet both of the following criteria ~~associated with that lease component~~ as a single lease component ~~if both of the following are met:~~

- a. The timing and pattern of ~~revenue recognition transfer to the lessee for the lease component and~~ associated nonlease component(s) ~~associated with that lease component~~ are the same.
- b. The combined single lease component is classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3.

We believe this revision, along with corresponding revisions to the Basis for Conclusions, would resolve the ‘net’ real estate lease issue (which we do not believe would be isolated to those leases) because a lessor would frequently be able to conclude that the lease and the CAM (or similar Topic 606 performance obligation) have a straight-line (i.e. time-based) pattern of transfer to the customer, even if the CAM would not have a straight-line pattern of revenue recognition if accounted for separately.

We also believe that combining the lease and related non-lease component(s) after this revision would be consistent with the Board’s intent for the practical expedient (as we understand it) because the timing and pattern of revenue recognition for the combined lease component would still be the same as the timing and

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pattern of revenue recognition for the lease and related non-lease component(s), when considered in the aggregate, if they were accounted for separately from each other. In other words, the only difference between applying the practical expedient and not applying it would be income statement presentation and disclosure.

Using the net real estate lease example, this presentation and disclosure only effect would be the outcome because, whether accounted for separately or combined:

- The fixed payments in the contract would be recognized on a straight-line basis. If combined, all of the fixed payments would be recognized on a straight-line basis under paragraph 842-30-25-11(a). If the lease and the CAM were separated, the portion of the fixed payments allocated to the lease would be recognized on a straight-line basis, while the portion of the fixed payments allocated to the CAM would also be recognized on a straight-line basis if a time-based measure of progress is assigned to that performance obligation.
- The variable payments for CAM would be recognized in the period to which those payments relate. If combined, the variable CAM payments would be variable *lease* payments based on the Board's proposal and, therefore, would be recognized in the period to which those payments relate under paragraph 842-30-25-11(b). If the lease and the CAM were separated, those variable payments that specifically relate to the CAM (paragraph 842-10-15-39) would frequently be recognized in the period to which they relate, as described earlier, on the basis of the variable consideration allocation guidance in paragraph 606-10-32-40.

Alternative 2 – Revise 842-10-15-42A(a) in line with the principle for the practical expedient

Alternatively, and with the same effect on net leases as Alternative 1, the Board could revise 842-10-15-42A as follows

842-10-15-42A As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and those associated nonlease components that meet both of the following criteria associated with that lease component as a single lease component ~~if both of the following are met:~~

- a. The timing and pattern of revenue recognition for the single lease component is the same as the timing and pattern of revenue recognition would be in aggregate for the lease and associated nonlease component(s) associated with that lease component are the same if they were accounted for separately.
- b. The combined single lease component is classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3.

Additionally, we believe Alternative 2 would preserve – consistent with the proposal – a lessor's ability to combine lease and non-lease components when the non-lease component is a supply of goods (e.g. consumables the lessee will use with a piece of leased equipment) and all of the payments under the contract are contingent on the lessee's consumable orders. We do not believe Alternative 1 would preserve that ability.

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For example, assume a lessor leases a piece of equipment under an operating lease and sells consumables to the lessee for use with the equipment at \$1 each. Under Alternative 2, this arrangement would be eligible for the practical expedient because, whether separately accounted for or not, the timing and pattern of revenue recognition would not differ. If accounted for separately, the portion of each consumable order allocated to the lease and the portion allocable to the transferred consumables would both be recognized at the point in time the consumables are transferred to the lessee. And if the lease and the consumables are not separately accounted for, the consumable payments would still be recognized at the point in time when the consumables are transferred to the lessee (i.e. the point in time when the changes in facts and circumstances on which those variable payments are based occur). The only difference is that the \$1 payment per consumable would be classified as a variable lease payment in its entirety.

Under Alternative 1, we do not believe this arrangement would qualify for the practical expedient because the equipment lease, transferred to the customer on a straight-line basis over time, would not have the same pattern of transfer to the lessee as the consumables, which are transferred to the customer at a point in time.

Contracts with ‘minor’ lease components

As proposed, we believe many lessors with lease components that are relatively minor as compared to the related non-lease components of the contract would likely not be able to avail themselves of this practical expedient. This is because the single, combined component will frequently fail the criterion in paragraph 842-10-15-42A(b) as a result of applying the present value classification test in paragraph 842-10-25-2(d) or paragraph 842-10-25-3(b)(1) to the combined lease and non-lease payments. It seems counter-intuitive that the costs to apply Topic 842 may be more significant for ‘minor’ lessors than for lessors for whom the lease is the predominant element of the arrangement (and the addition of the payments for the non-lease component to the ‘lease payments’ is unlikely to affect lease classification). This result also seems contrary to the discussion in paragraph BC25 of the proposed ASU, which appears to suggest the Board did not intend to preclude the use of the practical expedient when the non-lease component is significant.

We believe the simplest solution to this issue is to specify that a lessor should not apply the present value classification test, either in determining whether it qualifies for the practical expedient or in classifying a combined single lease component to which the practical expedient is applied, when the lease component would clearly be a minor element of the combined component. We believe clarifying language such as that used to explain predominance in paragraph 606-10-55-65A could explain what the Board means by ‘minor’. We believe this concept of a minor ‘screen’ can be applied reasonably and without undue difficulty in practice.

842-10-15-42B The criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1) shall not be considered by a lessor for purposes of lease classification in accordance with paragraph 842-10-15-42A(b) or for purposes of classifying a single lease component combined in accordance with paragraph 842-10-15-42A if the lease is only a minor element of the combined lease component (for example, the lease may be only a minor element when the lessor reasonably expects that significantly more of the value of the arrangement is attributable to the nonlease component(s) with which the lease is combined).

In suggesting this possible approach, we considered that the Board has previously decided, under the current and the new leases guidance (Topic 840 and Topic 842, respectively), to exclude consideration of certain lease classification criteria when the outcome from applying those criteria would not reflect the economic

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substance of the transaction.² We believe basing eligibility for the practical expedient or classification of the combined lease component in ‘minor’ lease scenarios on passing the present value classification test using the combined payments for the lease and non-lease components may produce such a result. Therefore, we believe it would be consistent with historical and recent precedent for the Board to consider this approach, and that doing so also would be consistent with the cost relief that this proposed practical expedient is intended to provide.

An alternative approach would be to specify that when the lease would be only a minor element of the combined component, the lessor should apply the revenue recognition guidance in Topic 606 to the combined component, and not consider lease classification for the combined component. If revenue recognition under Topic 606 for the combined component with only a minor lease element would not differ from the revenue recognition that would result from separately accounting for the lease and non-lease components in accordance with Topics 842 and 606, the practical expedient would apply *and* the lessor would account for the combined component in accordance with Topic 606.

Applicability of the practical expedient

We understand that for a lessor to be able to apply the practical expedient to a lease contract, it would not only have to elect (or have elected) the practical expedient for the applicable class of underlying asset, but the lease would also have to qualify for the practical expedient by meeting both criteria in paragraph 842-10-15-42A, which is a lease-by-lease evaluation. It is possible that a lessor may elect the practical expedient, but for certain leases, it would not be available because either (1) the criteria in paragraph 842-10-15-42A are not met or (2) the lessor did not elect the practical expedient for the relevant class of underlying asset. We recommend revisions to paragraphs 842-10-55-134 and 842-30-50-3 to clarify.

842-10-55-134 In accordance with paragraph 842-10-15-31, Lessee and Lessor will account for the nonlease maintenance services component separate from the three separate lease components (unless Lessee elects the practical expedient or Lessor elects the practical expedient and the lease meets the criteria in paragraph 842-10-15-42A—see Case B . . .

842-30-50-3 A lessor shall disclose both of the following:

. . .

- b. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:
 1. The determination of whether a **contract** contains a lease (as described in paragraphs 842-10-15-2 through 15-27)
 2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32) to leases for which the lessor does not apply the practical expedient in paragraph 842-10-15-42A

² See paragraph BC71 of ASU 2016-02 and paragraph 75 of FASB Statement No. 13.

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3. The determination of the amount the lessor expects to derive from the underlying asset following the end of the **lease term**.

Transition guidance for early adopters

For the additional transition approach and the lessor practical expedient, it would be helpful for the Board to clarify how entities that have already adopted Topic 842 prior to the issuance of a final ASU should apply the proposal. As an example, a lessor that adopted Topic 842 on January 1, 2017 would have already applied the separation and allocation guidance in paragraphs 842-10-15-31 and 842-10-15-38. It is unclear whether the lessor would adopt the practical expedient on issuance of a final ASU prospectively for new leases entered into after that date or if the practical expedient should (or can) be retrospectively applied in that situation.

* * * * *

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

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,

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Appendix – Responses to Selected Questions for Respondents

Transition – Comparative reporting at adoption

Question 1:

Would the proposed optional transition method to apply the new lease requirements through a cumulative-effect adjustment in the period of adoption reduce the costs and complexity associated with implementing Topic 842? If not, please explain why.

Yes. We believe the proposed optional transition method would reduce the costs and complexity associated with implementing Topic 842.

Question 2:

Is the proposed transition method, as written in this proposed Update, operable? If not, please explain why.

Yes. We believe entities would be able to apply the proposed transition method as proposed.

Separating components of a contract

Question 3:

Would the practical expedient in this proposed Update for lessors to not separate nonlease components from the related lease components and, instead, to account for those as a single lease component reduce the costs and complexity associated with applying Topic 842 for lessors? If not, please explain why.

Yes, we believe the proposed practical expedient would reduce the costs and complexity associated with applying Topic 842 for those lessors that are able to apply it. Please refer to our detailed comments and suggestions in our cover letter as to the practical expedient's applicability.

Question 4:

Is the proposed practical expedient, as written in this proposed Update, operable? If not, please explain why.

Please refer to our comments and suggested revisions in our cover letter.

Question 5:

Would the information in the financial statements, including disclosures, provided by lessors electing the practical expedient in this proposed Update be decision useful? If not, please explain why.

We believe this question is best addressed by financial statement users.