Ernst & Young LLP
5 Times Square
New York, NY 10036

Tel: +1 212 773 3000
ey.com

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Ms. Hillary H. Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

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**Proposed Accounting Standards Update, *Leases (Topic 842): Targeted Improvements* (File Reference No. 2020-700)**

Dear Ms. Salo:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Leases (Topic 842): Targeted Improvements,* issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's post-implementation review efforts related to Accounting Standards Codification (ASC) 842, *Leases,* to address issues that have arisen since the adoption of ASC 842 by public business entities, which also will help entities that have not yet adopted it. Specifically, we believe the proposal would simplify the accounting for some lease modifications that reduce the scope of a lease contract with multiple lease components and address stakeholders' concerns about sales-type leases with variable lease payments and remeasurements of future lease payments based on a reference index or rate. However, as noted in our responses to questions in the proposal, we believe further clarification could reduce potential diversity in practice in applying the proposed guidance.

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Our responses to the questions in the proposal are included in Appendix A. We have included other suggestions in Appendix B.

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

Very truly yours,

Ernst + Young LLP

**Appendix A — Responses to questions raised in the proposal**

**Issue 1: Sales-type leases with variable lease payments — lessor only**

**Question 1:** Are the amendments in this proposed Update operable? Why or why not?

We believe that the proposed guidance for sales-type leases with variable lease payments is operable. We acknowledge that judgment may be required to determine which payments in the contract would be allocated to the lease (in accordance with ASC 842-10-15-38) and whether such allocated variable lease payments that do not depend on an index or rate are predominant (relative to the allocated fixed lease payments). However, consistent with the Board's view expressed in paragraph BC13 of the Background Information and Basis for Conclusions, we believe that in many cases a lessor should be able to qualitatively make that determination. If it cannot, the lessor could leverage its estimates of expected variable lease payments used to price the lease contract in a quantitative calculation.

**Question 2:** Should a lessor be required to classify and account for a sales-type lease with predominantly variable lease payments that do not depend on a reference index or a rate as an operating lease? Why or why not?

Yes. We agree that a lessor should classify and account for a lease with predominantly variable lease payments that do not depend on a reference index or a rate, and that would otherwise be classified as a sales-type lease, as an operating lease because doing so would better reflect the economics of these types of transactions.

Proposed paragraph 842-10-25-3A states that the guidance would apply at lease commencement. We recommend that the Board clarify that this guidance would also apply when an entity reassesses lease classification at the effective date of a lease modification (when the lease modification is not accounted for as a separate contract).

**Question 3:** Should "predominant" be the threshold for determining when a lessor should classify a lease with variable payments that do not depend on a reference index or a rate as an operating lease? Alternatively, would another threshold be more appropriate and operable (for example, "substantially all")? Please provide your rationale.

We agree that a "predominant" threshold should be used to classify a lease with variable lease payments that do not depend on an index or rate as an operating lease. We acknowledge that, if this threshold is used, a lessor may still recognize a loss at lease commencement for certain sales-type leases that are otherwise profitable and may account for certain leases that would not have resulted in a loss at lease commencement as operating leases. However, we believe the "predominant" threshold provides an appropriate balance between those two outcomes while meeting the objective of the proposal.

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| **Question 4:** Would the proposed amendments provide improved decision-useful information for users of financial statements? Why or why not? |

We believe that the proposal would improve the decision usefulness of the information provided to users of financial statements because it would reduce the number of situations in which an immediate loss would be recognized for a lease that would otherwise be profitable.

We recommend that the Board clarify that if significant judgment is required to determine whether allocated variable lease payments that do not depend on an index or rate are predominant (relative to the allocated fixed lease payments) an entity should disclose this judgment in accordance with ASC 842-30-50-3(b). This disclosure would provide additional information to financial statement users that would help them evaluate the amount, timing and uncertainty of the cash flows for that lease.

**Issue 2: Option to remeasure lease liability — lessee only**

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| **Question 5:** Are the proposed amendments operable? Why or why not? |

We believe that the guidance could be clarified in certain areas to improve its operability.

While one of the Board's stated objectives for the option to remeasure lease liabilities is to reduce the ongoing costs and complexity of maintaining separate lease payment analyses and schedules for entities that issue financial statements under both US GAAP and IFRS (i.e., dual reporting entities), we believe there may be inconsistencies between the conclusions in the proposed amendments and IFRS 16, *Leases,* that might make it difficult for some entities to benefit from this change.

Specifically, we believe that the conclusion on determining the date at which a change in lease payments takes effect, and therefore, the point in time that lease payments should be measured in proposed paragraph 842-10-55-231A of Example 25, Case A, may be inconsistent with Example 14 of the Illustrative Examples for IFRS 16 and, importantly, diverse practices under IFRS.

In Example 14, the lessee remeasures the lease liability to reflect the change in the Consumer Price Index (CPI) at the beginning of the third year because that is when the example says the change in CPI is known. In Example 25, Case A, the change in CPI is known at the end of the first year, but proposed paragraph 842-10-55-231A indicates that the lessee remeasures the lease liability at the beginning of year two of the lease, when the payment reflecting the change in CPI is made.

We understand that if the change in CPI is known at the end of the year, some entities that apply IFRS 16 remeasure variable lease payments based on changes in CPI at the end of the year and do not wait until the first payment reflecting the change in CPI is due. That is, some entities that apply IFRS 16 interpret the date at which the change in lease payments takes effect to be the date that the change in the lease payments is known (which, in the fact pattern in Example 25, would be at the end of year 1).

Any inconsistency between specific guidance in ASC 842 and existing practice under IFRS 16 in this area would not meet the objective of the proposed guidance and would potentially eliminate its benefits. We recommend that the Board remove potential inconsistencies by doing one of the following:

- Align the facts in Example 25, Case A of ASC 842 with the facts of Example 14 of the Illustrative Examples for IFRS 16
- Use Example 14 of the Illustrative Examples for IFRS 16 rather than amending Example 25 in ASC 842
- Exclude an example on this proposed guidance from ASC 842

Similarly, we recommend that the Board use the language from IFRS 16 in ASC 842 to describe when an entity should remeasure the lease liability because we believe this will help avoid questions about whether the requirements in ASC 842 and IFRS 16 are the same. Paragraph 42(b) of IFRS 16 states, "The lessee shall remeasure the lease liability to reflect those revised lease payments *only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect)*" [emphasis added], whereas proposed paragraph 842-10-35-4A states, "A lessee that makes the election in paragraph 842-20-35-4A to remeasure the lease liability to reflect changes to variable lease payments resulting from a change in an index or a rate shall remeasure the lease liability *only when the adjustment to the lease payments from the change in the index or rate takes effect*" [emphasis added].

Further, to make the guidance more operable, we suggest that the Board clarify how the guidance on remeasuring lease liabilities for changes in an index or a rate interacts with the guidance in ASC 270, *Interim Reporting*, that requires estimates to be made in interim periods in certain cases. Our understanding is that an entity would not estimate in interim periods future changes in an index or rate. Instead, an entity would wait until the adjustment to the lease payments takes effect. If our understanding is correct, we recommend that the Board clarify this point in amendments to ASC 842.

**Question 6:** Should a lessee be provided with an option to remeasure lease liabilities solely for a change in a reference index or a rate on which payments are based? Why or why not?

Yes. While we agree with the Board's decision during the development of ASC 842 that requiring a lessee to remeasure those liabilities would not justify the costs associated with requiring that remeasurement, we believe that a lessee should be given an option to remeasure lease liabilities solely for a change in an index or a rate because this option would likely reduce the ongoing costs and complexity for dual reporting entities. Lessees that elect to remeasure these liabilities would also be providing the most up-to-date information about their future cash obligations.

**Question 7:** Should a lessee be required to make an entity-wide accounting policy election to remeasure lease liabilities solely for a change in a reference index or a rate on which payments are based? Why or why not? If not, at what level should that accounting policy election be required to be applied?

Yes. We believe the election to remeasure lease liabilities solely for a change in an index or a rate should be made on an entity-wide basis. We believe that doing so would be consistent with the objective of this aspect of the proposal, which is to reduce the ongoing costs and complexity of maintaining separate schedules and analyses for dual reporting entities, as the entity's system would remeasure all of the entity's lease liabilities in the same way.

However, the FASB should also consider feedback from users and preparers impacted by the proposed guidance. We understand that some dual reporting entities may have different lease systems to track and account for leases of different underlying classes of assets (e.g., real estate, transportation assets), and remeasuring lease liabilities for changes in an index or rate for one or more underlying class of asset is immaterial for IFRS reporting purposes. In this case, allowing entities to make an election by underlying class of asset could further reduce the ongoing costs of remeasuring lease liabilities for changes in an index or rate.

**Question 8:** Would the proposed amendments provide improved decision-useful information for users of financial statements? Why or why not?

We agree with the Board's assertion in paragraph BC16 of the Basis for Conclusions that remeasuring the lease liability provides the most up-to-date information about a lessee's future cash obligations and would result in more decision-useful information for financial statement users. However, we acknowledge that an option to remeasure the lease liability would reduce the comparability of the information between entities that make the election and those that don't make the election and, therefore, may reduce the decision usefulness of that information. See our response to Question 9.

**Question 9:** Would the comparability of information be significantly affected by the option to remeasure lease liabilities solely for a change in a reference index or a rate on which payments are based?

We defer to financial statement users on whether comparability would be significantly affected by the option to remeasure lease liabilities solely for a change in a reference index or a rate. We believe that the disclosures in proposed paragraph 842-20-50-10 would highlight the lack of comparability for them.

**Issue 3: Modifications reducing the scope of a lease contract**

**Question 10:** Are the proposed amendments operable? Why or why not?

We believe the proposed amendments are operable, but we note that they would address a specific type of lease modification (i.e., a reduction in scope of a lease with no (or an insignificant) termination payment), so the impact of the proposed guidance may be limited. We suggest that the Board consider whether it would be more effective to consider the proposed amendments in a broader project on lease modifications.

Further, we recommend that the Board clarify the following to improve the operability of the guidance.

**How to account for a termination penalty payment:** We believe the proposal is clear on how an entity would consider a termination penalty payment when evaluating whether a modification affects the remaining lease component(s), as described in proposed paragraph 842-10-25-8B(c). However, it is unclear to us how an entity would account for a termination penalty payment when it determines that the remaining lease components are not affected.

For example, one entity may believe that it should adjust the accounting for the remaining lease components for the termination penalty payment because the penalty is included in the evaluation of whether the remaining lease component or components are affected by the modification. However, another entity may believe that it should account for the termination penalty as part of the modified component(s) because proposed paragraph 842-10-25-8B states that an entity should not "adjust its accounting for the remaining lease component(s)" if the criteria in that paragraph are met.

We recommend that the Board clarify its intent. Further, we recommend that the Board require an entity to account for the termination penalty as part of the modified components when the criteria in paragraph 842-10-25-8B are met because that is most consistent with the conclusion that the remaining lease components are not affected by the modification.

**How to consider reassessment events:** We recommend that the Board clarify how an entity should consider lessee reassessment events that change the lease term before the date of a modification when evaluating whether the remaining lease components are affected by the modification. We believe that the same events or conditions that lead to a lessee modification that reduces the scope of the lease (e.g., store closure, restructuring) may result in the reassessment of the lease term before the modification. We recommend that the Board clarify whether and how a lessee's reassessment of the lease term shortly before a lease modification would result in an entity concluding that the remaining lease components are or are not affected by the modification in accordance with proposed paragraph 842-10-25-8B.

**Add an example:** Due to the complexity of the guidance in proposed paragraphs 842-10-25-8A through 25-8C, we recommend that the Board add an example to ASC 842 to illustrate the accounting for a lease contract that is modified to reduce the term of a lease component and the remaining lease components are unaffected. This would help illustrate the clarifications recommended above as well as the payments that should be included in the evaluation of whether the remaining lease components are unaffected by the modification (e.g., total payments for the entire lease term and not the remaining lease term, as indicated in paragraph BC26 of the Basis for Conclusions).

**Question 11:** Would the proposed amendments provide improved decision-useful information for users of financial statements? Why or why not?

We agree with the Board's assertion in paragraph BC23 of the Basis for Conclusions that the proposed guidance would increase the decision usefulness of information provided to financial statement users because it would result in an entity not reassessing lease classification (and other aspects of the lease, such as discount rates and payment allocation) of economically unaffected remaining lease components. Reassessment in those cases could have resulted in changes to lease classification solely because of the passage of time, which would not represent the economics of the arrangement.

**Question 12:** Are there other aspects of the modification accounting model in Topic 842 that could be improved without compromising the decision usefulness of the information provided?

As indicated in Question 10, we note that the proposal addresses limited circumstances in which the scope of a lease contract with multiple lease components is reduced and the remaining lease components remain unchanged. We encourage the Board to perform further outreach with stakeholders to understand what other aspects of the modification accounting model in ASC 842 could be improved without compromising the decision usefulness of information provided.

For example, it may be helpful to address the accounting for the following changes to leases:

- An increase in the term of a lease component in a lease contract with multiple lease components and the remaining lease components remain unchanged

- A reduction in the term of a lease that does not meet the conditions in proposed paragraph 842-10-25-8B

- A reduction in the scope of a lease to reduce the amount of square feet leased when the reduced space may not have met the criteria to be a separate lease component at lease commencement (e.g., a reduction in the amount of square feet leased in an undivided warehouse)

**Transition**

**Question 13:** For entities that have not adopted Topic 842 by the effective date of a final Update of these proposed amendments, should the proposed amendments be applied at the date that an entity first applies Topic 842 using the same transition methodology in accordance with paragraph 842-10-65-1(c)? Why or why not?

We agree that an entity that has not adopted ASC 842 by the effective date of a final Update should apply these proposed amendments when it first applies ASC 842 using the same transition methodology in accordance with paragraph 842-10-65-1(c). This would result in a single adoption of changes to lease accounting for these entities rather than one change for the guidance in ASC 842 and another for the guidance that would be included in a final Update. However, we encourage the Board to finalize the proposal as soon as possible to give these entities sufficient time to include the proposed amendments in their implementation process.

**Question 14:** For entities that have adopted Topic 842 by the effective date of a final Update of these proposed amendments, should the proposed amendments be applied either retrospectively or prospectively as described in this proposed Update? Why or why not?

We agree that entities that have adopted ASC 842 by the effective date of a final Update should have the option to apply the proposed guidance either on a retrospective or a prospective basis. This would provide entities with the flexibility to select the transition method that is most appropriate (e.g., most cost effective, most meaningful to financial statement users) for them, based on their circumstances.

We recommend that the Board clarify how an entity should adopt the amendments on remeasuring lease liabilities for a change in an index or a rate prospectively. To address this, we recommend that the Board simplify the prospective approach. Our understanding is that an entity applying the prospective approach would remeasure lease liabilities when the next adjustment to the lease payments from the change in the index or rate takes effect, which could be several years after the entity first adopts the proposed guidance. This approach could be operationally challenging because it could require an entity to monitor its leases (with related updates to its systems) on a contract-by-contract basis. An approach that requires an entity to remeasure all existing leases using the index or rate in effect at the date of adoption could reduce the cost and complexity of implementing the proposed guidance and result in a more immediate convergence with the entity's IFRS 16 reporting.

We also recommend that the Board provide further clarification on how to account for impairments of right-of-use assets for lessees that elect to adopt the amendments on remeasuring lease liabilities for a change in an index or a rate retrospectively. Without clarification, some of the proposed amendments could result in an increase to the right-of-use asset in prior periods (remeasuring lease payments based on an index or rate), which may result in an impairment in prior periods or increase the size of a previously recognized impairment. Reassessing impairments in prior periods could make implementing the proposed guidance retrospectively significantly more complex.

We note that the Board stated at its 30 November 2016 meeting that a right-of-use asset related to an operating lease need not be evaluated for impairment under ASC 360 until the effective date of ASC 842, which addressed similar concerns to those described above for entities initially adopting ASC 842. We recommend that the Board provide similar clarification in the Basis for Conclusions.

For entities that adopt the proposed guidance prospectively, we suggest requiring specific transition disclosures instead of referencing the transition disclosures in ASC 250 because certain disclosures in ASC 250 (e.g., ASC 250-10-50-1(b)(1), ASC 250-10-50-1(b)(3)) require disclosure of prior-period information that has been adjusted and the cumulative effect of the change on retained earnings, which would not apply if an entity adopts the proposal prospectively. We observe that other updates that allow prospective adoption require disclosures similar to the following (without referencing ASC 250):

- The nature of and reason for the change in accounting principle
- The transition method
- A qualitative description of the financial statement line items affected by the change

**Appendix B — Other comments**

We recommend the following clarifications to the proposal:

We recommend stating in ASC 842-10-55-231 and proposed paragraph 842-10-55-231A that the amount to be included in the maturity analysis is a per-year amount, as follows:

> "842-10-55-231 … In its maturity analysis of its operating lease liability, Lessee will include $100,000 per year as the undiscounted cash flows from the lease (see paragraph 842-20-50-6)."
>
> "842-10-55-231A … In its maturity analysis of its operating lease liability, Lessee will include $102,400 per year as the undiscounted cash flows from the lease (see paragraph 842-20-50-6)."

We note the amendments to ASC 842-10-25-13 would require different accounting for a partial termination of a lease contract that contains a single lease component and a lease contract that contains more than one lease component. That is, an entity that partially terminates a lease contract that contains a single lease component would be able to reduce the right-of-use asset in one of two ways (as illustrated in Example 18, Case A and Case B, of ASC 842), but an entity that partially terminates a lease contract that contains more than one lease component must reduce the right-of-use asset based on the remeasurement of the lease liability (i.e., using the approach in Case A of Example 18). We suggest that the Board consider whether the option to remeasure the right-of-use asset based on the remaining right of use (i.e., Example 18, Case B) should be eliminated to align the accounting for all partial terminations.