Financial Reporting Advisors, LLC
100 North LaSalle Street, Suite 2215
Chicago, Illinois 60602
312.345.9101
www.FinRA.com

September 10, 2013

VIA EMAIL TO: director@FASB.org

Technical Director
File Reference No. 2013-270
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update (Revised), *Leases (Topic 842)*

To Whom It May Concern:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions. We appreciate the opportunity to provide comments on the FASB's Proposed Accounting Standards Update (Revised), *Leases (Topic 842)* (the ED).

We continue to support the fundamental objective of the ED—recognizing lease liabilities and related right-of-use assets for leases in the statement of financial position of lessees. We understand that leases are very flexible contractual arrangements with some transferring much more of the typical risks and rewards of ownership of the underlying asset to the lessee than others. We also understand that not all leases are treated the same in certain situations such as a bankruptcy of the lessee. As a result, understandably, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (collectively, the Boards) have received and will continue to receive widely different responses to their proposal on accounting for leases. We do not believe it is possible for the Boards to fashion a standard on leasing that will be satisfying to all interested parties. However, it should be possible for the Boards to develop a standard that is understandable and useful for *general purpose* financial reporting. We urge the Boards to complete this project.

We commend the Board and its staff for considering the input received on the first exposure draft and for publishing a second exposure draft for comment. Some of our concerns with the first exposure draft have been addressed, but we have two fundamental concerns about the guidance in the ED—the creation of two types of leases for lessees and partial sale accounting for lessors.

We set forth our concerns about the creation of two types of leases in our response to Question 2 in Appendix A, and we set forth our concerns about partial sale accounting for lessors in our response to Question 3 in Appendix A. One theme that you will see throughout this letter is that we believe more can be done and should be done to make the guidance for lessors as comparable as possible to the guidance to be issued shortly by the Boards on accounting for revenue contracts. In summary, our letter points out the following inconsistencies between the guidance in the ED and the Boards' proposed revenue recognition standard:

- Requiring partial sale accounting for some lease transactions (see our response to Question 3 in Appendix A)
- Treating certain residual value guarantees obtained from counterparties other than the lessee as if those guarantees were lease payments to be received from the lessee (see Item 1 of Appendix B)
- Determining gross versus net revenue presentation for a lessor (see Item 3 of Appendix B)
- Recognizing stepped rents by a lessor for Type B leases (see Item 4 of Appendix B)

Attachment A responds to the questions in the ED and Attachment B lists a number of other issues for the Boards' consideration.

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Once again we appreciate the opportunity to comment on the Proposed Accounting Standards Update (Revised), *Leases*. If there are any questions, please contact Richard R. Petersen at 312-345-9102.

Sincerely,

Financial Reporting Advisors, LLC

Financial Reporting Advisors, LLC

Appendix A

File Reference 2013-270
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Response to Questions

Question 1: Identifying a Lease

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 through 15-16 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.

Inventory

In the Basis for Conclusions, the Boards state:

> BC89. The 2010 Exposure Draft did not specifically exclude leases of inventory from its scope. Some respondents questioned whether what is sometimes referred to as "leased inventory" would be within the scope of the lease proposals. "Leased inventory" is sometimes used to describe purchases of nondepreciating spare parts, operating materials, and supplies that are associated with leasing another underlying asset. The Boards decided not to specifically exclude leases of inventory from the scope of this Exposure Draft. The Boards note that few of these transactions, if any, would meet the definition of a lease and, therefore, a scope exception would not be necessary. In addition, in the Boards' view, it is unlikely that an asset will simultaneously meet the definition of an underlying asset and inventory from a lessee's perspective. That is because a lessee is unlikely to be able to hold an asset that it leases (and that is owned by another party) for sale in the ordinary course of business or for consumption in the process of production for sale in the ordinary course of business.

We do not understand the rationale behind the Boards' belief that "few of these transactions, if any, would meet the definition of a lease." We are similarly puzzled by the statement "it is unlikely that an asset will simultaneously meet the definition of an underlying asset and inventory from the lessee's perspective." It appears to us that contracts to lease inventory would meet the definition of a lease and that the underlying asset would also meet the definition of inventory. It would be helpful if the Boards included their rationale for the above two assertions in the Basis for Conclusions or through an implementation example.

Regardless, given the changes the Boards have made to the ED to treat both (1) all purchase options for which the lessee has a significant economic incentive to exercise and (2) a combination of a fixed price purchase option and a residual value guarantee as lease payments, we believe the ability to move inventory risk off balance sheet using the provisions of the ED has been substantially reduced.

We would point out that including inventory within the scope of the ED appears to create some conflicts with existing guidance on accounting for inventory.

- Section 842-20-35 of the ED requires all right-of-use assets be amortized while Topic 330, *Inventory*, precludes amortization of inventory.

- Section 842-20-35 of the ED requires all right-of-use assets be assessed for impairment in accordance with the guidance in Topic 360, *Property, Plant, and Equipment,* while Topic 330 has its own, quite different, guidance for assessing impairment of inventory.

- Some contracts for leases of inventory within the scope of the ED would appear also to be within the scope of Subtopic 470-40, *Product Financing Arrangements*, and it is not clear to us what guidance should be followed in that situation.

We certainly understand (and agree with) the Boards desire to limit scope exceptions on any project. However, we believe that if the Boards continue to include inventory within the scope of the ED, more work needs to be done to identify and resolve conflicts between the provisions of the ED and existing U.S. GAAP on accounting for inventory.

Internal-Use Software

We agree with the Boards' conclusion in BC81 that a separate and comprehensive review of accounting for intangible assets should be performed before requiring all leases of intangible assets to be accounted for under the ED. However, we do not agree with the FASB's conclusion to eliminate the existing guidance on a lessee's accounting for leases of internal-use software. In our opinion, that guidance is operational and provides useful financial reporting for leases of internal-use software. We do not see the harm in leaving that guidance in place until the Boards have completed a comprehensive review of accounting for intangible assets. In fact, we believe it would be harmful to eliminate the existing guidance. As there is no guidance to replace the current guidance on a lessee's accounting for leases of internal-use software, this seems to be a step backwards that will inevitably create diversity in practice in accounting for leases of internal-use software. We believe the elimination of this guidance will also create differences in accounting between leasing and owning internal-use software in situations in which there is little economic difference between leasing and owning internal-use software.

Undivided Interests

It is common in the United States for utilities to own undivided interests in large electric generating facilities. SEC SAB Topic 10.C, *Jointly Owned Electric Utility Plants*, describes these arrangements and requires certain disclosures related to such arrangements. In brief, there is no legal entity and each participating utility has an undivided interest in the electric generating facility and is responsible for its proportionate share of the costs of construction and operations and is entitled to its proportionate share of the energy produced. Participating utilities must jointly agree on construction and operating decisions, but all other decisions, such as how to finance the investment in the facility and how to market the energy produced, are made separately by each participating utility. Assume Utility A owns a 25 percent undivided interest in Electric Station X and leases its 25 percent interest to Utility B. Today, that transaction would be accounted for as a lease. However, that transaction is not within the scope of the ED as the underlying asset is not a physically distinct portion of the electric generating facility. How should that transaction be accounted for once the guidance in the ED becomes effective?

Distinguishing between a Lease and a Sale

We agree with the Boards' conclusion in BC118 that "They [the proposals in the ED] do not apply to transactions for which control of the underlying asset is transferred to the lessee—such transactions are sales within the scope of other IFRSs or U.S. GAAP." However, we note that the ED gives guidance on accounting for a transaction in which it appears control is transferred to the lessee (in other words, a transaction we thought would be outside the scope of the ED). The guidance in paragraphs 842-30-55-1 and 55-2 appears to encompass a lease in which the lessee (1) agrees to sell the underlying asset on the lessor's behalf at the end of the lease term, (2) agrees to make the lessor whole for any deficiency in the sales price as compared to a specified amount, and (3) is entitled to retain any proceeds from the sale in excess of the same specified amount. In that situation, we believe control, as defined in the revenue recognition project, has been transferred to the lessee at lease commencement.

We believe what distinguishes a lease from a sale is the fact that a lessee obtains control of an underlying asset, compensates the lessor for its use of the underlying asset, and has the ability (and/or obligation) to then return the underlying asset to the lessor at a future date. That is, in a lease, control of the underlying asset passes from lessor to lessee at the beginning of the lease and control may transfer back to the lessor at the end of the lease. In transactions such as the one described above, control of the underlying asset will not transfer back to the lessor at the end of the lease and therefore we believe that transaction should not be within the scope of the ED.

We recommend that the principle stated in BC118 be specifically stated in the scope section of Topic 842 and that the guidance in paragraphs 842-30-55-1 and 55-2 be revised to be consistent with the principle stated in BC118.

Question 2: Lessee Accounting

Do 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?

We do not agree with the conclusion in the ED that there are two types of leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefit embedded in the underlying asset. Our reasons for disagreeing are both conceptual and pragmatic.

On a conceptual basis, we believe a lessee is obtaining the same benefit from a lease each period regardless of the length of the lease. Consider a simple example. Assume Lessee leases locomotives to be used in its business and assume that the locomotives have an estimated economic life of 20 years. Lessee has two leases for identical locomotives—Lease A has a five year lease term and Lease B has an 18 month lease term. Further assume that Lease A consumes more than an insignificant amount of the economic benefit and Lease B consumes an insignificant amount of the economic benefit of the underlying asset of the underlying asset. In this example, Lessee received exactly the same benefit from both leases in every period during the leases—the right to use the underlying asset (the locomotive) to move railcars around its network of tracks. However, the amount recognized as expense each period for the two leases could be quite different under the guidance in the ED.

We understand that leases are very flexible contractual arrangements with some transferring much more of the typical risks and rewards of ownership of the underlying asset to the lessee than others. We also understand that not all leases are treated the same in certain situations such as a bankruptcy of the lessee. However, fundamentally all leases give the lessee the right to use the underlying asset for a period of time. We believe that "right to use" provides the same benefit to the lessee whether the lease is for an insignificant amount of time or more than an insignificant amount of time. As a result, we do not agree with the "Type A" and "Type B" distinction made in the ED. To the extent a reporting entity concludes it would be useful to the user of its financial statements to understand the degree to which the risks of ownership are transferred in a lease or the treatment that a lease would receive in bankruptcy, that information should be disclosed in the notes to the financial statements or through the use of separate line items in the statement of financial position.

On a pragmatic basis, we believe a standard with two types of leases will significantly increase the complexity of applying the ED. A large part of the complexity with current accounting for leases is the distinction between operating and capital leases. We expect the same or more complexity if the final document includes two types of leases. In addition to differences in judgment about whether a lease does or does not consume more than an insignificant amount of the economic benefits embedded in the underlying asset and all the confusion and non-comparability that such differences in judgment will bring to accounting for leases, consider the following complexities caused by two types of leases:

- Distinguishing between property and non-property

- Determining whether the property or the non-property asset in single unit of account is the primary asset

- The need to change from one model to another in certain situations after an impairment is recognized

Further, anytime there are two accounting models for similar transactions, there will be structuring opportunities that will become problematic. For example, the structuring opportunity cited by dissenting Board members in BC401 that plays off the difference between reassessing a lease and modifying a lease will become problematic in practice.

We recommend that the Boards settle on a single lease model for lessees (see Question 3 for our thoughts on lessor accounting). For the following reasons, we favor using the Type A lease model in the ED for lessee accounting for all leases, other than short term leases.

The Boards are proposing that it is acceptable to present right-of-use assets within the same line item as the corresponding underlying asset and are proposing that right-of-use assets be assessed for impairment using the guidance in Topic 360, *Property, Plant, and Equipment*. These conclusions imply to us that the Boards view the right to use property, plant, and equipment as very similar to owning property, plant, and equipment. Current U.S. GAAP precludes the use of the amortization method used for Type B leases when depreciating property, plant, and equipment.[1] Further, depreciation is a method of allocating cost among periods benefited in a systematic and rational manner.[2] Depreciation is not a method of valuing the asset. The logic behind the amortization method for Type B leases appears to be based on allocating changes in value of the asset rather than allocating cost among period benefited.[3]

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[1] Codification paragraph 360-10-35-10.

[2] FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 149, and Codification paragraph 360-10-35-4.

[3] Paragraph BC56 of the ED.

The amortization pattern for Type B leases is driven by the degree to which the right-to-use asset is financed under the lease contract (in other words, the magnitude of any frontend payments made by the lessee). If the lessee prepays the entire lease at lease commencement, the right-of-use asset would be amortized on a straight-line basis. If the lessee makes level lease payments over the term of the lease, the amortization of the right-to-use asset will increase each accounting period. We do not believe the degree to which a right-of-use asset is financed should change the amortization pattern of a right-to-use asset.

The FASB proposed in 2006 to use an increasing rate amortization method for intangible assets in FASB Staff Position No. 142-d, *Amortization and Impairment of Acquired Renewable Intangible Assets*. The FASB did not include that guidance in its final standard. Our memory is that most respondents did not support using an increasing rate amortization method for intangible assets (although our memory may be biased by our own response to that proposal).

A lessee's treatment of a Type B lease in its statement of financial position is inconsistent with its treatment in its statement of comprehensive income and statement of cash flow (to use the Boards' language, the statements do not articulate). The statement of financial position reflects a long-lived asset and a liability. However, the statement of comprehensive income has neither amortization expense related to the long-lived asset or interest expense related to the liability. Similarly, principal payments on the lease liability are not classified as financing cash outflows, but are instead classified as operating cash outflows. In our view, this inconsistency is a sign of a flawed model.

Finally, the Type B lease amortization methodology has some of the same weaknesses that led to the elimination of APB Opinion No. 11, *Accounting for Income Taxes*—the methodology is an income statement based with-and-without calculation which results in amounts recognized on the balance sheet that can only be explained in terms of the computation used to create them.[4]

Question 3: Lessor Accounting

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?

We do not agree with the conclusion in the ED that lessors should account differently depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. To improve financial reporting for lessors and to decrease the likelihood of gamesmanship, we believe it is critical that lessor accounting be as consistent with the proposed standard on revenue recognition as possible. In our view, a lease in which the lessor may regain control of the underlying asset and retains significant risks or benefits is simply a contract in which the lessor satisfied its performance obligation (allowing the lessee the use of the leased item) over time rather than at a point in time and should receive accounting treatment comparable to a service contract under the proposed revenue recognition standard.

We believe the appropriate "unit of account" for the lessor is the asset being leased. We think of the lease transactions within the scope of the ED as being of two types—leases that are substantially the same as selling the underlying asset and those that are not. In our view, a lease (which by definition

[4] See paragraphs 181 to 187 in the Basis for Conclusion to FASB Statement No. 96, *Income Taxes*, for a summary of the criticisms of Opinion 11. See paragraph 241 of Concepts Statement 6 for an explanation of why deferred tax charges and credits under Opinion 11 do not meet the concepts statements definitions of assets and liabilities.

transfers control of the underlying asset from the lessor to the lessee for a period of time) in which (1) the lessor does not retain significant risks or benefits with respect to the underlying asset and (2) the lessor may only regain control of the asset after substantially all of the economic benefit of controlling the underlying asset has been realized is economically similar to the sale of the asset and therefore believe that a derecognition approach is the appropriate accounting model. We believe a lease in which the lessor may regain control of the underlying asset and retains significant risks or benefits related to the underlying asset should be viewed as a "failed sale" and not as a partial sale. In our view, distinguishing leases in this manner is consistent with the Boards' conclusions in the proposed revenue recognition standard (for example, the guidance addressing accounting for a revenue transaction in which the seller has an option to repurchase the asset sold) and U.S. GAAP on transfers of financial assets.

The proposed revenue recognition standard bases revenue recognition on the satisfaction of performance obligations, noting that a performance obligation is satisfied when control of a good or service is obtained by the customer, and that control of a good or service rests with the customer when the customer has the ability to direct the use of an asset and obtain substantially all of the remaining benefits from the asset. If the lessor may regain control of the underlying asset and has retained significant risks or benefits related to the leased asset, by definition, the lessee does not obtain substantially all of the remaining benefits from the leased asset and therefore, the performance obligation related to the asset can only be settled over time.

The FASB addressed the same issue with respect to transfers of financial assets and concluded that the whole asset (or a pro rata participating interest in the whole asset[5]) must be transferred in order to achieve sales treatment. The FASB concluded that, for example, the transfer of the cash flows for the first five years from a debt instrument with a 15-year term could not be a partial sale for financial reporting purposes. We believe that following the same logic would preclude the use of a partial derecognition approach for lease contracts.

Because we believe the leased asset is either substantially sold or not substantially sold for financial reporting purposes, we prefer a full derecognition method for leases in which the leased asset is substantially sold. We believe the retained residual in a lease that qualifies for the derecognition approach is quite different than the asset transferred to the lessee and should be viewed as proceeds rather than a retained interest in the leased asset. We would also point out that a full derecognition approach would be consistent with the Boards' conclusion on the deconsolidation of a subsidiary with a retained noncontrolling interest and U.S. GAAP for the sale of a financial asset with a retained beneficial interest.

In summary, all of the above leads us to conclude that the best financial reporting for a lessor that retains significant risks or benefits related to the underlying asset is to continue to apply operating lease accounting to such arrangements.

We do not believe our suggested approach for lessor accounting is inconsistent with the lessee accounting we propose. Accounting by the lessee does not, in our view, raise unit of account issues. The lessee is acquiring a valuable contractual right (the right of use of the underlying asset) by incurring a liability (the obligation to make lease payments). That is a true statement regardless of whether the lessee has the right of use of the asset for a small or large portion of the asset's economic useful life.

Question 4: Classification of Leases

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[5] An undivided interest as described in our response to Question 1 would be analogous to a participating interest in the whole asset.

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?

As explained in our response to questions 2 and 3, we do not agree with the ED's lease classification criteria.

Question 5: Lease Term

Do 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 term and why?

We agree with the proposals on lease term.

Question 6: Variable Lease Payments

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?

For the reasons stated in paragraphs BC151 and BC152, we agree with the ED's proposals for measuring variable lease payments at lease commencement. However, we are unsure whether continuously remeasuring lease liabilities for changes in an index or rate provides a sufficient benefit to justify the costs involved. Paragraph BC175 accurately states that the costs to reassess the lease liability each period under the ED will be lower than the costs expected to be incurred under the 2010 ED. However, that fact, by itself, does not persuade us that the proposal for remeasuring the lease liability every period for changes in an index or rate meets a realistic cost-benefit test. Accordingly, we recommend that changes in lease payments due to changes in an index or rate that occur subsequent to lease commencement be included in income as they become payable consistent with current practice.

We are also concerned that the guidance in the ED regarding in substance fixed payments (paragraph 842-20-55-46 to 55-52) will allow some in substance fixed payments that are treated as minimum lease payments under current accounting to be treated as variable payments under the ED. All of the examples in the ED illustrate situations in which it is a mathematical certainty that a minimum amount of lease payments will be made. In practice under current accounting, we believe most accountants also include as a minimum lease payment contingent rent payments that are not based on the use or performance of the lease asset when it is remote that the lease payment will not be made. For example, assume that a lease provides that lease payments will increase by the lesser of (a) two percent annually or (b) five times the change in the Consumer Price Index. In that situation, it is mathematically possible the lease payment will not increase (if there is no increase in the Consumer Price Index, there will be no increase in the lease payment), but it is virtually certain the lease payments will increase each year by two percent. We believe in practice today most accountants view such a provision as a disguised minimum lease payment and therefore treat it as a minimum lease payment. We recommend that Example 4B be revised so that the lease payments increase by the lesser of a fixed percent or a multiple of the increase in the Consumer Price Index.

Question 7: Transition

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?

In general, we are supportive of the transition requirements of the ED. We do, however, question one aspect of a lessor's transition for leases previously classified as direct finance or sales-type leases. Paragraph 842-10-65-1(t) requires that lessors classify their net investment, including any unguaranteed residual value, in direct finance and sales-type leases as a lease receivable upon adoption of the new lease guidance. We believe unguaranteed residual values should not be treated as lease receivables upon adoption of the new lease guidance. We foresee various issues with that treatment in the subsequent accounting for those leases, including uncertainty about how to assess such "lease receivables" for impairment.

Question 8: Disclosure

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?

We agree with the overall objectives. However, we will defer to preparers and users of financial statements with respect to whether all of the disclosure requirements provide sufficient benefit to users to outweigh their costs to preparers. That said, we do question the need for two specific disclosure requirements.

- The requirement for a lessee to disclose a maturity analysis of commitments for nonlease components related to a lease. Assume that as part of the lease contract, the lessee is also contracting for maintenance of the leased asset. If the lessee had contracted with a third party other than the lessor, the lessee would not be required to disclose a maturity analysis of its commitment. Similarly, entities are not required to disclose a maturity analysis of their commitment for maintenance agreements related to owned assets. Given the lack of disclosure for similar commitments, we question the need for this disclosure.

- The requirement for a lessor to disclose how it manages its risks associated with residual assets. In our view, this type of disclosure is better addressed by public entities in their disclosures required by Item 303 of Regulation S-K (Management's Discussion and Analysis of Financial Condition and Results of Operations). We also question whether this disclosure is needed for nonpublic entities.

Question 9: Nonpublic Entities (FASB Only)

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?

In general, we do not see any conceptual support for different recognition and measurement principles for private companies. That being said, we agree with allowing a nonpublic entity an accounting policy election to use a simplified computation in situations in which the nonpublic entity would otherwise have no reason to develop the data to make the computation (for example, volatility estimates used in valuing stock awards). We are surprised by the assertion that nonpublic entities would not know their incremental borrowing rate.

As indicated in our response to the prior question, we do not believe nonpublic lessors should be required to disclose information about how they manage risks related to residual assets.

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?

We agree with the ED guidance regarding leases between related parties.

Question 11: (FASB Only)

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?

We agree that it is not necessary to provide additional disclosures for related party leases.

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Other Issues

The following are other issues we noted in the course of our review of the ED.

1. *Definition of lease payments*. We have two concerns regarding the definition of lease payments.

    - The definition of lease payments for a lessor includes residual value guarantees in which the lessee guarantees a specific value of the leased asset at the end of the lease term and the lessee is also entitled to any value in the leased asset above the specified guaranteed value. BC220 explains that the Boards concluded in such an arrangement the specified amount is economically the same as a fixed balloon payment. As a result the Boards concluded the specified amount should be treated as a lease payment by the lessor. As we explained in our response to Question 1 in Appendix A in the section addressing distinguishing a lease from a sale, we believe such transactions often are sale transactions rather than lease transactions as the "lessor" relinquishes control of the underlying asset at the commencement of the lease term and does not regain control at the end of the lease term. However, if the final standard continues to include these transactions within the scope of the lease guidance, we agree with the Boards' treatment of these arrangements and believe that same logic should result in that same specified amount being treated as a lease payment by the lessee. As drafted, the ED does not include the specified guaranteed amount as a lease payment for a lessee.

    - The definition of lease payments begins with the phrase "Payments made by a *lessee* to a lessor…." However, once the guidance in paragraphs 842-30-55-1 and 55-2 is considered, lease payments for a lessor also include amounts due from third parties under residual value guarantees structured such that the third party is also entitled to any proceeds from the sale of the leased asset in excess of the guaranteed amount. We believe the definition of lease payments should be limited to payments made by a lessee to a lessor and disagree with the guidance in paragraphs 842-30-55-1 and 55-2 with respect to arrangements with third parties. In our view, the guidance in paragraphs 842-30-55-1 and 55-2 inappropriately combines two separate contracts—the lease contract between the lessee and the lessor and the residual value guarantee contract between a third party and lessor—into one unit of account. We find nothing in BC217 to BC222 which discusses the Boards' rationale for its treatment of residual value guarantees as to why the Boards chose to combine two separate contracts with different counterparties into one unit of account. We believe that a residual value guarantee in which a third party guarantees the lessor a specified value for the residual asset and the third party is entitled to any value in excess of the specified amount could be considered (1) a derivative, (2) an insurance contract, or (3) the equivalent of the third party having agreed to purchase the residual value at a future date for a specified price. We could understand considering a third party residual value guarantee when assessing the realizability of a residual interest. However, we do not believe a residual value guarantee provided by a third party should be considered a lease payment. Considering a third party residual value guarantee as a lease payment will result, in some situations, with a lessor recognizing a sale of the underlying asset at lease commencement when the reality is the lessor has leased the asset to one counterparty for a period of time and then agreed to sell the underlying asset to another counterparty at the end of the lease.

2. *Definition of variable lease payments*. The definition of variable lease payments is sufficiently broad as to encompass features that would meet the definition of an embedded derivative that should be bifurcated and accounted for separately under the guidance in Topic 815, *Derivatives and Hedging*. The Boards note in BC97 that derivatives embedded in leases should be subject to

the requirements in Topic 815 for bifurcating embedded derivatives. We agree with that conclusion. We suggest that a reference to the requirement to bifurcate derivatives from leases be included in Topic 842 and that the definition of variable lease payments be revised to explicitly state that embedded derivatives required to be bifurcated under Topic 815 are not variable lease payments.

3. *Gross versus net lessor revenue recognition*. The ED requires that lessors recognize revenue gross or net, depending on the lessor's business model. Because of user focus on an entity's revenue line, gross versus net reporting of revenue has been a hotly debated issue at various times in the past (for example, EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*). The Boards' proposed revenue recognition standard substantially carries forward the guidance in Issue 99-19. We believe this is another area in which the Boards should conform the guidance in the ED to the guidance in the proposed revenue recognition standard. We are unaware of any reason why the analysis of gross versus net revenue recognition should be different for a lessor than for entities applying the proposed revenue recognition standard.

4. *Lessor revenue recognition of stepped rents for a Type B lease*. BC277 and BC278 explain the ED provides that lessors are allowed to recognize stepped rents (defined as fixed increases in rents over the lease term) as those rents become payable rather than be recognized on a straight line basis if recognizing rents in this manner better reflects the pattern in which income is earned from the leased asset. As explained in our response to Question 2, we believe a straight line expense recognition pattern for the amortization of the right-of-use asset is appropriate and, for the same reason, we believe straight line revenue recognition is appropriate for the lessor. In particular, we are concerned that this guidance for lessors in the ED is not consistent with the guidance in the Boards' proposed revenue recognition standard. The proposed revenue recognition standard provides that when performance obligations are completed over time, revenue should be recognized based on a reasonable measure of progress toward completing the performance obligation. For a Type B lease, we believe a lessor achieves the same amount of its performance obligation each day of the lease. We do not believe the proposed revenue recognition standard requires or allows an entity to place different values on identical performance obligations that are satisfied over time. We also believe the Boards' guidance on stepped rents is not operational. For example, should a lessor receiving level lease payments but who expects the value of its leased asset to increase during the lease term recognize lower rental income in the earlier years of the lease than the later years of the lease? Should a lessor receiving level lease payments but who expects the value of its leased asset to decline during the lease term recognize higher rental income in the earlier years of the lease than the later years of the lease? If non straight line recognition is acceptable for the lessor, why isn't non straight line amortization acceptable to a lessee under a Type A lease?

5. *Lessor presentation of cash flows from certain Type A leases*. Paragraph 842-30-45-5 requires lessors with Type A leases to classify cash receipts from lease payments as operating cash flows. A subset of Type A leases are what we currently classify as direct finance leases. These are leasing arrangements that are economically no different than lending activities. The ED provides that such leases will be presented no differently than originated loans in the statement of financial position and statement of comprehensive income (in other words, the asset recognized is a lease receivable, no revenue is recognized at lease inception, and interest income is then recognized over the term of the lease). Paragraph 230-10-45-12 provides that cash flows from collections of the carrying amounts of loans should be classified as investing cash inflow. We recommend that cash receipts from lease payments from such leases be classified in the statement of cash flows consistent with the manner in which debt service payments are classified by lenders—collection of the carrying amount of a loan is classified as an investing cash inflow and collection of interest is classified as an operating cash inflow.

6. *Buyer-lessor accounting for a failed sale and leaseback transaction*. The ED provides that a transferee (the buyer-lessor) in a sale and leaseback transaction in which the transferee does not obtain control (a failed sale and leaseback transaction) should not recognize the transferred asset and should instead account for the amount paid as a receivable. We understand the combination of the ED guidance and the Boards' proposed revenue recognition standard to cause sale and leaseback transactions in which the transferor (the seller-lessee) has a purchase option (even a non-bargain purchase option) to result in a failed sale and leaseback. In such a transaction, the buyer-lessor's asset may have much more of the attributes of an investment in a long-lived asset than a receivable. For example, assume the asset transferred is an oil tanker with a two-year leaseback and the seller-lessee has a non-bargain purchase option at the end of the two-year lease term. In that fact pattern, the buyer-lessor's asset has much more of the attributes of an investment in an oil tanker than a receivable from the seller-lessee. How should the buyer-lessor recognize income and assess impairment of its receivable during the lease term? Should the buyer-lessor apply, by analogy, the guidance on acquisition, development, and construction arrangements in Topic 310, *Receivables*?

7. *Seller-lessee accounting for a failed sale and leaseback transaction*. The ED provides that a transferor (the seller-lessee) in a sale and leaseback transaction in which the transferee does not obtain control (a failed sale and leaseback transaction) should not derecognize the transferred asset and should instead account for the amount received "as a financial liability in accordance with other Topics." Under current U.S. GAAP, a seller-lessee in a failed sale and leaseback transaction follows the guidance in Subtopic 360-20, *Real Estate Sales,* when accounting for the financial liability recognized in a failed sale and leaseback transaction. We expect that Subtopic 360-20 will be eliminated by the Boards' proposed revenue recognition standard. We recommend that the FASB retain the guidance on accounting by a seller-lessee for failed sale and leaseback transactions currently contained in Subtopic 360-20 is some section of the Codification.

8. *Build-to-suit leases*. Paragraph 842-40-55-2 states, "If the lessee controls the underlying asset before the commencement date, the transaction is a sale and leaseback transaction." The concept of "control" is somewhat different in a leasing context than in the Boards' proposed revenue recognition standard (in a leasing context, control is focused on control during the lease term whereas in a revenue recognition context, control is focused on the life of the asset). We are unsure whether entities should use the leasing definition or the proposed revenue recognition standard definition when applying the guidance in paragraph 842-40-55-2. On one hand, the ED is all about leasing. On the other hand, the other party to the build-to-suit transaction will be applying the proposed revenue recognition standard's definition of control in its financial reporting of the transaction. On balance, we recommend that the Boards indicate that control in the context of paragraph 842-40-55-2 should be evaluated using the notion of control in the proposed revenue recognition standard.

9. *Treatment of the increase in lease liability due to a change in estimate about the amount of a lessee's residual value guarantee payment*. The ED proposes that such an increase in lease liability should increase the carrying amount of the related right-of-way asset. Acknowledging that the value of the asset is declining, BC177 explains the Boards' rationale and includes the following statement, "The Boards noted that the proposed requirement for lessees to review right-of-use assets for impairment would ensure that assets arising from leases are not overstated." We disagree. The impairment guidance in Topic 360 only results in the recognition of an impairment loss for long-lived assets that are intended to be held and used if net undiscounted cash flows from the use and eventual disposition of the asset group are insufficient to recover the carrying amount of the asset grouping (the lowest level of asset grouping for which there are identifiable cash flows that are largely independent of the cash flows of other assets). We believe it is a real stretch to conclude the impairment guidance in Topic 360 will ensure assets arising from leases are not overstated. We agree that all amounts paid by a lessee are part of the cost of the right-of-use asset. However, we are concerned with the financial reporting that could result

from a significant increase in the amount expected to be paid under a residual value guarantee in the latter part of a lease term. Under the ED, that increase in carrying amount of the right-of-use asset will be amortized prospectively over the remaining term of the lease. We recommend the Boards consider a cumulative catch-up adjustment to the amortization of the right-of-way asset in that situation.

10. *Executory costs*. Under current accounting, there is guidance for accounting for executory costs (real estate taxes, insurance, and so forth). The ED does not explicitly address accounting for executory costs. The ED does address accounting for nonlease components of a contract and it may be that executory costs should be considered nonlease components of a contract under the ED. However, we are uncertain if that is the correct interpretation as it is difficult to see how real estate taxes paid by a lessor meet the criteria in paragraph 842-10-15-17 for a separate component. We also note that the ED contains a number of examples of identifying nonlease components and none of those examples include executory costs. We recommend that the final standard explicitly address the accounting for executory costs.

11. *Assessing residual assets for impairment*. The ED requires lessors to assess residual assets for impairment in accordance with Topic 360. We recommend that the guidance indicate that the lessor should evaluate the undiscounted residual value for impairment under Topic 360. We are concerned that the guidance in the ED as currently drafted will lead entities to assess the current carrying amount (the present value of the residual asset) for impairment under Topic 360 and that such an approach will backend the recognition of an impairment problem related to a residual asset even though the impairment problem was known in earlier periods. Under our recommendation, the undiscounted amount after impairment would then be present valued to determine the appropriate adjustment to the carrying amount of the residual asset.

12. *Amendment to paragraph 360-10-55-43(b).* Prior to the proposed amendment, this paragraph provided guidance regarding assets that are expected to be sold in a transaction that meets the criteria for sale and leaseback accounting and required that such assets continue to be classified as assets held for use (in other words, do not classify the asset as held for sale and do not stop depreciating the asset). After the proposed amendment, this paragraph only addresses assets subject to failed sale and leaseback transactions. Does this mean the Boards intend to change the accounting for assets expected to be sold and leased back in transactions that qualify for sale and leaseback accounting? If so, we disagree. We recommend that this paragraph be revised to continue to address assets that are expected to be sold in a transaction that meets the criteria for sale and leaseback accounting and that the guidance continue to require such assets be classified as assets held for use.

13. *Recognition of leases in a business combination*. We have two concerns about the recognition of leases in a business combination:

    - New paragraph 805-20-25-30 precludes recognition in a business combination of an asset or a liability for leases with a remaining term of 12 months or less. We agree that the value of such leases often will be immaterial given their short remaining lease term, but we do not understand why this provision is included in the Codification. If the value of the acquired lease is immaterial, entities will not need to recognize the value of the lease. If the value of the acquired lease is material, we believe it should be recognized in the accounting for the business combination. We recommend this paragraph be deleted.

    - New paragraph 805-20-30-23C prohibits the acquirer of a lessor of a Type B lease in a business combination from recognizing a separate asset or liability for the value of the acquired lease and instead requires that the lease and related underlying asset be treated as a single unit of account. We disagree with this guidance. This guidance is contrary to the principles that underlie Topic 805 and is inconsistent with the guidance for a lessee acquired in a business combination (paragraph 805-20-55-2(a)).

14. *Leases and variable interests*. Paragraph BC352 states that the FASB does not intend to change current U.S. GAAP on variable interests. However, we believe the proposed amendment to paragraph 810-10-55-39 does change current U.S. GAAP on evaluating whether a lease is a variable interest. Prior to the proposed change in language, the guidance in that paragraph (1) is limited to VIEs that are lessors and (2) explicitly states that most "plain vanilla" leases do not absorb variability in the fair value of a lessor VIE's net assets. With the proposed change in language, that paragraph (1) applies to VIEs that are lessees as well as lessors and (2) no longer explicitly states that most "plain vanilla" leases do not absorb variability in the fair value of a lessor VIE's net assets.