

December 15, 2010

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

By e-mail: [director@fasb.org](mailto:director@fasb.org)

**Re: Proposed Accounting Standards Update—Leases (Topic 840)**

**(File Reference No. 1850-100)**

The New York State Society of Certified Public Accountants, representing more than 27,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned exposure draft.

The NYSSCPA's Financial Accounting Standards and International Accounting and Auditing Committees deliberated the exposure draft and prepared the attached comments. If you would like additional discussion with us, please contact Mark Mycio, Chair of the Financial Accounting Standards Committee at (212) 838-5100, William M. Stocker, Chair of the International Accounting and Auditing Committee at (212) 503-8800 or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,



Margaret A. Wood  
President

Attachment

**NEW YORK STATE SOCIETY OF  
CERTIFIED PUBLIC ACCOUNTANTS**

**COMMENTS ON  
PROPOSED ACCOUNTING STANDARDS UPDATE—LEASES (TOPIC 840)  
(FILE REFERENCE NO. 1850-100)**

**December 15, 2010**

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# New York State Society of Certified Public Accountants

## Financial Accounting Standards Committee International Accounting and Auditing Committee

### Comments on

### **Proposed Accounting Standards Update—Leases (*Topic 840*) (File Reference No. 1850-100)**

We have reviewed the joint proposed standard from the Financial Accounting Standards Board and the International Accounting Standards Board, Proposed Accounting Standards Update—*Leases (Topic 840)*, and we appreciate the opportunity to provide our thoughts and responses to the questions for respondents.

#### **General Comments**

We wish to bring to your attention Question 18 in which we have identified problematic issues that broker-dealers in securities would encounter in implementing lease accounting as proposed in the exposure draft, and Question 19 in which we have noted how the guidance might need to differ for smaller non-public companies and not-for-profit organizations.

#### **Responses to Questions**

##### **Question 1: Lessees**

**(a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?**

**(b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose?**

**Response 1(a):** We agree with the application of the model to reflect the assets and liabilities arising in all leases in the statement of financial position. This would result in: the consistency of accounting for the majority of leases, improved comparability of the statement of financial position and the income statement, and feasibility for a wide range of leasing arrangements. This also aligns with the Boards' conceptual frameworks.

We do not agree with using the lessee's incremental borrowing rate to determine the lease liability. We believe this could cause fluctuations for various lessees in the amounts of the lease liability, and affect the amount of the rate-of-use. Using this model, two lessees could lease the same equipment and have substantially different amounts for the right-to-

use asset and lease liability. Given the same lease payments, the financial statements could reflect very different interest and lease expense, though it is the same equipment, leased over the same period of time, and the lease payments are the same.

We recommend a more standard rate be used such as a risk-free rate from one of several financial instruments to reflect the time-value of money. We believe that applying a risk factor based on the lessee's credit standing fails to take into account the fact that the lease liability is effectively collateralized by the right-of-use asset that ultimately is under the control of the lessor if the lease payments are not made.

**Response 1(b):** We agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments. The approach is consistent with the classification of the asset and liability. The asset "as if" it were a tangible asset would reflect amortization over the lease term or useful life of the underlying asset, if shorter, and the liability would reflect repayment as would be the case for a loan.

## **Question 2: Lessors**

**(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?**

**(b) Do you agree with the Boards' proposal for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?**

**(c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC 15)? If not? What approach should be applied to those leases and why?**

**Response 2 (a):** We agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise. The performance obligation reflects continued involvement and value to the lessor. The right-to-use asset and the liability do not have the criteria to be offset; however, following the presentation requirements, they are, effectively, netted out in the statement of financial position. Derecognition is appropriate for leases that are not performance obligations because that approach records the leases as though they were a sale of the underlying assets.

**Response 2 (b):** We agree with the performance obligation approach which presents the underlying asset as the lessor's economic resource. The lease creates a new asset—the right to receive lease payments and a new lease liability—representing the obligation to

permit the lessee to continue to use the underlying asset during the lease term. These are separate from the underlying asset. Further, we agree with the provisions of the exposure draft that require the lease receivable, lease liability and the underlying asset be presented together in the statement of financial position and the recognition of lease income and interest income in the income statement. This presentation in the income statement is consistent with the asset classification that gives rise to the income.

**Response 2 (c):** We agree with including leveraged leases under this proposed ASU, and this is consistent with IFRS which does not have such an exception. This approach is plausible because the cash inflows from the tax attributes of a leased asset are the same to the lessor whether it is financed with recourse or nonrecourse debt. The pattern of income recognition should not be affected by a difference in the method of financing.

### **Question 3: Short-term leases**

**This exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:**

**(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).**

**(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65).**

**(See also paragraphs BC41–BC46.)**

**Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?**

**Response:** We agree that a lessee or a lessor should account for short-term leases in this way. This is practical for short-term leases, without having to delve into all the various calculations for other leases, and for which the amounts would not be significant. The information to ascertain the scope of short-term leases is covered in the disclosure requirements. If there are significant issues with respect to the short term leases, they would be disclosed in the financial statements.

## Definition of a lease

### Question 4: Definition of a lease

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1-B4 and BC29-BC-32). This exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, (B!) and BC59-BC-62) and on distinguishing a lease from a service contract (paragraphs B1-B4 and BC29-BC32).

- (a) Do you agree that a lease is defined appropriately?
- (b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or Why Not? If not, what alternative criteria would you propose and why?
- (c) Do you think that the guidance in paragraphs B1 and B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance is necessary and why?

**Response 4 (a):** Yes, we agree that a lease is defined appropriately.

**Response 4 (b):** Yes, we agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale. The differentiation between leasing and a purchase or sale of underlying asset is clear. Emphasis on transferring control and bargain purchase terms are the appropriate criteria to identify the nature of the transaction.

**Response 4 (c):** Yes, we think that the guidance in paragraphs B1 and B4 for distinguishing leases from service contracts is sufficient. The exposure draft provides details for distinguishing service components, and guidance for being able to allocate the payments between the contract and service components, and indicates that if payments cannot be allocated, lessee and lessor apply guidance for distinct service components to the whole of the contract as a lease. Further, determining whether servicing components are distinct or not allows for subjective decisions and does not try to burden the lessee or lessor with rules that might be unduly burdensome.

## Scope

### Question 5: Scope exclusions

This exposure draft proposes that a lessee or lessor should apply the proposed guidance to all leases, including leases of right-of-use assets in a sublease, except leases of biological assets and leases to explore or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33-BC46).



**Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?**

**Response 5:** We agree with paragraphs BC33-BC46 which identify the various problems with the items that are included in the scope exclusions and identify IFRS accounting issues.

**Question 6: Contracts that contain service components and lease components**

**This exposure draft proposes that lessees and lessors should apply the guidance proposed in Accounting Standards Update, *Revenue Recognition* (Topic 605): *Revenue Recognition from Contracts with Customers*, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5- B8 and BC47-BC54). If the service component in a contract that contains service components is not distinct:**

- (a) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.**
- (b) The IASB proposes that:**
  - (i) a lessee should apply the lease accounting requirements to the combined contract.**
  - (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.**
  - (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.**

**Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?**

**Response 6:** We agree with the IASB because this all-inclusive approach should improve standardization of lease payments for comparability. It takes away carving out various expenses. Everyone is on the same level.

**Question 7: Purchase options**

**This exposure draft proposes that a lease contract should be considered terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).**

**Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?**

**Response 7:** We agree because waiting until the option is exercised eliminates having to assess factors used in estimating whether the option will be exercised. As indicated in BC64, bargain purchase options are considered when determining if a transaction is a lease or purchase or sale.

## **Measurement**

**This exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:**

**(a) assumes the longest possible term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease (paragraphs 13, 34, 51, B16-20 and BC114-BC120).**

**(b) includes in the lease payments contingent rentals and expected payments under term options penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121-131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual guarantees that can be reliably measured.**

**(c) is updated when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments, including expected payments under term option penalties and residual value guarantees, since the previous reporting period (paragraphs 17, 39, 56 and BC 132-BC 135).**

## **Question 8: Lease Term**

**Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?**

**Response 8:** Assuming that the options are all those of the lessee, then in the case of the lessor, we agree that using the longest possible term that is more likely than not to occur will provide the best approximation of present value, which is a reasonable measure of the fair value, and because it will be less complex for lessees to determine present value than fair value. If circumstances change which are significant, guidance is provided for remeasurement.

We do not believe that, except possibly in certain limited circumstances, the lease term should include renewal options because we agree with the respondents to the discussion paper mentioned in BC116 that this would result in the recording of liabilities by the lessee that do not meet the definition of a liability.

To reiterate the definitions of a liability consider the following definitions from FASB Concepts Statement No. 6, *Elements of Financial Statements* paragraph 35 and from the IFRS Conceptual Framework paragraph 4.15:

“35. Liabilities are probable<sup>21</sup> future sacrifices of economic benefits arising from present obligations<sup>22</sup> of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

“<sup>21</sup> *Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary*, p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).

“<sup>22</sup> *Obligations* in the definition is broader than legal obligations. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth (*Webster's New World Dictionary*, p. 981). It includes equitable and constructive obligations as well as legal obligations (pars. 37-40).”

“4.15 An essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an entity decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.”

In both definitions a liability only arises from a present obligation. Payments under an extension option, or that are avoidable under a cancellation privilege, would not meet those definitions. Of course, any nonrenewal or cancellation penalty would be a present obligation to the extent not in excess of the rentals that would occur under the longer term.

The Boards, at the very least, should provide greater explanation as to their basis for concluding that a liability should be recorded for amounts which do not meet the definition of a liability. The explanation as set forth in paragraph BC117 simply asserts that “if optional periods are not included in the lease term (*i.e.*, using only obligations that meet the definition of a liability) the right-of-use asset or the lease liability might be misstated.” This seems like a circular argument. In the case of claiming that the liability could be misstated if there were a failure to record amounts that are not liabilities, it seems illogical.

It also does not appear that the right-of-use asset would be misstated, as only the present value of unavoidable payments constituting the initial term (plus nonrenewal penalties if applicable) represents the cost of the asset (including the renewal option.)

In the case of the lessor, there is a performance obligation to provide use of the property if called for by the lessee.

In any cases in which the lessor has the option to force renewal or to force cancellation (which in our experience we believe to be rare, although that may not be true in some countries), the lessee would appropriately have a liability for which the proposed measurement model would be appropriate.

As a compromise alternative to not recording the optional terms as part of the lease term, we suggest consideration of adopting the model as proposed by the Boards, except that in the case of the depiction on the balance sheet, the right-of-use asset be directly offset by the present value of the payments under as yet unexercised options or under the initial term but subject to cancellation (*i.e.*, the payments not meeting the definition of a liability). This would be in lieu of depicting the present value of the payments as liabilities. This would result in the same effect on net income and equity while not showing the entity to be more leveraged than is actually the case. Disclosure of the gross amounts would be required. A further basis for this alternative is that, should the expected payments under the option be considered to be a liability, there is a right of offset in that the lessee could cancel the liability by surrendering the related portion of the asset (*i.e.*, not exercise the renewal option).

### **Question 9: Lease payments**

**Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?**

**Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the**

**measurement of the right to receive lease payments if they can be reliably measured? Why or why not?**

**Response 9:** We do not agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique. We believe the expected outcome method is too subjective in many instances because of the averaging of outcomes of various probabilities. Payments should be recognized in the financial statements by lessees and lessors when it is probable that those events will occur and they can be reliably measured. In this case, our use of the word “probable” is in the manner it is understood in US GAAP. For IFRS purposes, the word “probable” means “more likely than not.”

This difference in the US GAAP and IFRS definitions of “probable” permeates the respective standards and threatens to seriously reduce the effectiveness of many convergence efforts. It seems that the Boards are trying to deal with this problem in this case by using the “more likely than not” phrase thereby making the converged standard the same as the IFRS definition of “probable.”

We would prefer that the difference in the US GAAP and IFRS definition of “probable,” to the extent it cannot yet be dealt with in the conceptual framework, be attended to in this instance by adopting language that, while avoiding the term “probable,” essentially provides a threshold that is similar to the US GAAP definition of “probable.” A possible suggestion is “highly likely.”

**Question 10: Reassessment**

**Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make these payments or in the right to receive lease payments arising from changes in the lease term or contingent payments including expected payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?**

**Response 10:** We agree with the stipulation that remeasurement should occur only when it is probable that events will occur that warrant remeasurement.

**Sale and leaseback**

**This exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions of a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales or leases. If a contract represents a sale of the underlying asset the leaseback would also meet the definition of a lease, rather**

than a repurchase of the underlying asset by the lessee (paragraphs 66-67, B31 and BC160-BC167).

#### **Question 11: Sale and Leaseback**

**Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?**

**Response 11:** We agree with the criteria for classification as a sale and leaseback transaction. This provides consistency for the classification of the transaction and provides guidance with respect to adjustments to be made if sale consideration and leaseback are not at market rates, and the accounting for a combined transaction that is a sale and leaseback (if transferee/lessor remains exposed to significant risks and benefits during or after the lease term and lessor has to apply lease performance approach). This results in assets, liabilities, gains and losses recognized by both the lessee and lessor are neither understated or overstated.

#### **Presentation**

**This exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25-27,42-45, +60-63 and BC 142-BC 159).**

#### **Question 12: Statement of financial position**

**(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease (paragraphs 25 and BC143-145)? Why or why not? If not, do you think that a lessee should disclose this information in the Notes instead? What alternative presentation do you propose and why?**

**(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totaling to a net lease asset or lease liability (paragraphs 42, BC 148 and BC 149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?**

**(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC 154 and BC 155)? Why or why not? Do you think that a lessor should disclose this**

**information in the notes instead? What alternative presentation do you propose and why?**

**(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC 156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?**

**Response 12(a):** We agree with the presentation requisites to separately identify these items, but do believe there should be an option to reflect this information in the notes to financial statements. This allows subjective discretion as to the best presentation for the users of the financial statements.

**Response 12(b):** We agree that for performance obligations, the lease receivable and payable should be shown gross, and with the underlying asset should be presented together. We feel an option for including this in the notes to financial statements would provide discretion in presentation. This would avoid having overload in the statement of financial position.

**Response 12(c):** We agree. The objective is to provide additional disclosures for the lease transactions, and separately present the information to facilitate the users of the financial statements identify this information.. In addition, inclusion with property, plant and equipment is preferable, because the right-of-use asset, although an intangible asset, is considered as if it were a tangible asset.

**Response 12(d):** We disagree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC 156). We believe that the notes to financial statements should be used to disclose the relevant information, with a net number in the statement of financial position. Full disclosure in the statement of financial position may make the statement look overloaded and not easily readable by the average user of the financial statements. However, the financial statement issuer should have the option of displaying this information on the statement of financial position in the manner described in the ED.

### **Question 13: Income Statement**

**Do you think that lessees and lessors should present lease income and lease expense differently from other income and expense in the income statement (paragraphs 26,44,61,62, BC146, BC 151, BC 152, BC 157 and BC 158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?**

**Response 13:** For real estate rental properties, the lease income would presumably be presented separately. For a lessee, the materiality to the other components in the income statement would be a factor in the manner of presentation.

#### **Question 14: Statement of Cash Flows**

**Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraph 27, 45, 63, BC 147, BC 153 and BC 159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead?**

**Response 14:** No, we do not think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows. Inclusion with the other cash flow items would achieve the same purpose of displaying the cash flow information. Separate presentation would probably exasperate the problem users of financial statements have now in understanding cash flow statements. Users of financial statements such as banks and other credit grantors will get the information they want directly from the client, and analyze the information for their purposes.

#### **Disclosure**

#### **Question 15**

**Do you agree that lessees and lessors should disclose quantitative and qualitative information that:**

- (a) identifies and explains the amounts recognized in the financial statements arising from leases; and**
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows?**

**(paragraphs 70-86 and BC 168-BC183)? Why or why not? If not, how would you amend the objectives and why?**

**Response 15:** We agree with the Boards' approach to disclosure as discussed in (a) and (b), above. The FASB's disclosure guidelines present a comprehensive list of the items to be covered to satisfy the disclosure objectives. To achieve this objective, we agree that existing requirements had to be considered and considerations for certain IFRS disclosures, as discussed in paragraph BC 168 (b). We also agree the guidelines for disclosures will provide the necessary information for ascertaining cash flows arising from leases.

#### **Transition**

#### **Question 16**

**(a) This exposure draft proposes that lessees and lessors should recognize and measure outstanding leases as of the date of initial obligation using a simplified retrospective approach (paragraphs 88-96 and BC186-BC199). Are these proposals**



**appropriate? Why or why not? If not' what transitional requirements do you propose and why?**

**(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?**

**(c) Are there any other transitional issues that the boards need to consider? If yes, which ones and why?**

**Response 16(a):** We agree this gives a unified starting point and reduces excessive calculations that would otherwise be necessary if the full retrospective approach were used.

**Response 16(b):** We do not think there should be a choice between the simplified method and full retrospective method. Applying the new accounting for leases should be across the board. The objective of this project is to achieve consistency in the application of models used for recording, displaying and disclosing lease information. Accordingly, it would seem as a practical matter to use the simplified method for all leases at the date of initial application.

**Response 16(c):** No, there are not any other transitional issues that the Boards need to consider.

## **Benefits and costs**

### **Question 17**

**Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?**

**Response 17:** We agree that the benefits of the proposals would outweigh the costs. The costs of initial implementation would for the most part be a single charge. Subsequently, developing the information would be routine. Although there would be additional costs, overall, they would probably be minimal.

## **Other Comments**

### **Question 18**

**Do you have any other comments on the proposals?**

**Response 18:** Yes.

Broker-dealers in securities would have to record a lease as liability; however, for United States regulatory purposes, the right-to- use asset would be recorded as an unallowable

asset in the determination of capital as reported in the FOCUS report (Financial and Operational Combined Uniform Single Report), and would have a significant negative impact on net capital.

We believe that this potential problem would be alleviated by a delayed effective date under US GAAP for broker-dealers in securities. Alternatively, the delay in the effective date could apply only to broker-dealers that are not public companies. This delay would provide time for the United States Securities and Exchange Commission (SEC) to determine that the lease liability is either partially or wholly a non-allowable liability or to allow the new standard to negatively impact net capital.

This issue regarding broker-dealers' net capital for SEC purposes would not affect implementation of the proposed standards for IFRS purposes. We believe, however, that there may be industries in other countries subject to prudential capital regulation for which IFRS is the starting point and would have a similar problem.

With regard to the maturity analyses required in paragraphs 85 and 86, we believe that the provision of individual year maturities, or at least maturities in five year bands, beyond the initial five years, should be required. The financial statement amounts will be significantly affected by key assumptions as to term, discount rate and contingent rentals. These would be better understood by giving more detail on the amounts after five years. This would be particularly useful to analysts who we understand prefer to recalculate present value under varied assumptions. In the case of the lessor maturity analysis required in paragraph 86, we believe that for each year or other period for which maturities are listed, there should be disclosure to provide context regarding what portion of the lessor's property is obligated under the disclosed cash flows for which there is a right to receive.

For example, a real estate lessor might disclose that the cash flows required for the first subsequent year are for 86% rentable square feet and the cash flows for the second subsequent year are for 80%.

Under current general standards for the amortization of intangible assets, it is appropriate to amortize the right-of-use asset as called for in paragraph 20. Likewise, the permitted methods for amortization of the performance obligation liability under paragraph 38 are the only ones appropriate based on general standards. We believe, however, that these methods may result in a distortion because of a potential problem that should be considered in the future in a project with a much broader scope than lease accounting. This is discussed in **Appendix A** in the context of the amortization of the right-of-use asset but would apply to long-term assets and obligations generally.

### **Question 19**

**Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?**

**Response 19:** Yes, some of the proposed guidance should be different for non-public entities. For the smaller non-public companies, we believe that the lease accounting as proposed in the exposure draft introduces a level of complexity and opaqueness rather than transparency and simplicity. Most smaller private entities issue financial statements to relatively few users, chief among them—lenders. Smaller private companies usually have to provide their lenders, *et al.* with additional information not included in the traditional financial statements, such as, cash flow forecasts, rent rolls, aged accounts receivable schedules, debt covenant calculations, *etc.* on an interim basis.

For a number of not-for-profit organizations, including charities, implementing the proposed lease accounting might cause them to be in default under loan covenants. Charities receive a large number of contributions based upon evaluations from charity rating organizations. These evaluations are based on certain ratios involving percentages of revenue spent on programs, administrative costs, and other ratios, which would be negatively impacted under the proposed lease accounting.

In the case of not-for-profit organizations, the FASB could consider additional provisions to ameliorate the concerns of not-for-profit organizations without considering convergence as IFRS does not inherently apply to not-for-profit organizations.

~ Appendix A follows ~

## APPENDIX A

We believe that, in its conception, the accounting model set forth in the exposure draft is representationally faithful to the balance sheet but, because what could be seen as a flaw in the existing treatment in long-term assets, possibly not to the income statement. The general concept, in the case of the lessee, that a liability has been incurred for the present value of the future contractually required payments with the corresponding acquisition of the right-of-use asset is representationally faithful. It is consequently representationally faithful to record interest expense on that liability on the interest rate method.

The cause of what could be seen as a distortion in the income statement is the fact that, under current standards, there is a loss of representational faithfulness in the treatment of long-term prepaid assets and by extension, other long-term assets, both tangible and intangible, in that no interest income is imputed to the investment in fixed assets. This loss in representational faithfulness under current standards is carried into the proposal and its resulting ubiquity will result in a substantial increase in the incidence of the distortion. The distortion can be attributed to the use of the present value concept in some assets and liabilities but not in others.

To illustrate the alternative model of viewing the leasing transaction, consider the following example. If an entity were able to enter into a lease for a property at the rate of CU100 per year payable in advance, that same lessor would presumably be willing to lease the property for a three year period with a payment in advance of some amount less than the CU300 total because of the time value. Suppose the implicit interest rate were 6% per year. The lessor would then be willing to accept CU283.34 which would include CU100 for the first year, CU94.34 for the second year (which at 6% would grow to CU100 in one year) and CU89 (which at 6% would grow to CU100 in two years.)

All of this, like most financial accounting standards, ignores any expectation of inflation. The example assumes one year periods.

In this scenario, current standards would require a straight-lining of the CU283.34, or CU94.45 per year. The reality of this prepayment would best be depicted, instead, by imputing interest income in the first year of CU11.00 (CU183.34 at 6%, only CU183.34 because CU100 is immediately applied as payment of year 1 with no time value.) CU100 is applied to rent expense for the first year.

The year 1 journal entries would be:

Dr – Right-of-use asset	CU11.00
Cr – Imputed interest income	CU11.00
To record imputation of interest on Right-of-use asset balance	

Dr – Rent expense	CU100.00
Cr – Right-of-use asset	CU100.00
To record rent expense	

This results in reducing pre-tax income by CU89.00, the rent expense of CU100.00 less the imputed interest income of CU11.00. This net expense is manifested on the balance sheet by the reduction of right-of-use asset from the CU283.34 initial balance to CU194.34. This represents the present value of two years future use. What was consumed in operations was the CU89.00 present value of the most distant (third) year's future use.

Alternatively, the imputed interest income could be included as a reduction in rent expense, leaving the CU89.00 as the first year's amortization of the right-of-use asset. This provides the basis for the increasing amortization similar to that proposed at paragraph BC8 but rejected by the Boards. Unlike that alternative mentioned and rejected, this would apply to all cases and would apply to the purchase of assets while treating any obligation like a loan. This suggestion bases the increasing amortization of the asset on the economic reality of the time value embodied in the advance payment for the use of the asset. We realize that by implication this would justify, and perhaps require similar increasing depreciation on fixed assets and thus has pervasive implications well beyond the scope of this exposure draft.

The year 2 journal entries would be:

Dr – Right-of-use asset           CU 5.66  
Cr – Imputed interest income           CU 5.66  
To record imputation of interest on right-of-use asset balance

Dr – Rent expense    CU100.00  
Cr – Right-of-use asset           CU100.00  
To record rent expense

This results in reducing pre-tax income by CU94.34, the rent expense of CU100.00 less the imputed interest income of CU5.66. This net expense is manifested on the balance sheet by the reduction of the right-of-use asset from the CU194.34 beginning of year balance to CU100.00. This represents the present value of one year's future use. What was consumed in operations was the CU94.34 present value of the most distant (second) year's future use.

The year 3 journal entry would be:

Dr – Rent expense    CU100.00  
Cr – Right-of-use asset           CU100.00  
To record rent expense

For additional illustration of the concept, consider the financial statement user comparing the financial statements of the entity in the example with an entity that rented a similar property under a one year lease for CU100 in advance; put CU183.34 in an investment account yielding 6% and then rented the property for each of two more years at CU100 under negotiated renewals of the lease. At every point, the total assets, total equity, net

income and return on equity of the two entities would be the same. We think that this identity is representationally faithful and the comparability appropriate. Conversely, the amortization of the asset at CU94.45 per year on a straight-line basis as called for under both the current standards and under the model proposed in the exposure draft would show lower income for the long-term lessee in the early period and higher income in later periods when such a difference does not represent a difference in economic performance.

Instead of the above example, the example of a lease that was not an actual cash prepayment, but a standard fixed rate lease of CU100 per year payable in advance. In that case, if a 6% rate were used on both the obligation and the asset, the accounting for the right of use asset would be the same as above but there would also be a liability recorded in exactly the manner as called for in the exposure draft. The result would be that the balance sheet would appropriately depict a right of use asset at roughly the present value of the future benefit and a liability at the present value of the future payments. The income statement on the other hand would reflect CU100.00 net expense each period including the interest expense on the liability. We believe that to be the appropriate result because of the time value embodied in the payment for the asset which, if the same discount rate is assumed, offsets the time value of the loan payments.

The last example happens to result in the same annual expense as would occur under current standards. This is, however, only because of the simplicity of the example. Had a lease been entered into for three years with the “free rent” (“rent holiday”) for the first year and CU150 rent payable in advance for years two and three, under current standards rent expense would be CU100 per year over the three year period.

Under our both the method called for in the exposure draft and under our alternative model, assuming a 6% discount rate, the right-of-use asset and liability recorded initially would be CU275.01. Under both methods, the subsequent recording of the liability and interest expense would be identical.

Under our proposal, the asset (a prepayment of CU275.01) would be treated the same as a prepayment of a three year lease with a value of CU97.06 per year payable in advance. That is the equal annual payment amount with a present value of CU275.01 at 6%. This asset would be depicted as imputing interest income in the first year of CU10.68 (CU177.95 at 6%, only CU177.95 because CU97.06 is immediately applied against the initial CU275.01 as payment of year 1 with no time value.) CU97.06 is applied to rent expense for the first year.

The year 1 journal entries would be:

Dr – Right-of-use asset	CU10.68	
Cr – Imputed interest income		CU10.68
To record imputation of interest on right-of-use asset balance		

Dr – Rent expense      CU97.06  
Cr – Right-of-use asset      CU97.06  
To record rent expense

This results in reducing pre-tax income by CU86.38, the rent expense of CU97.06 less the imputed interest income of CU10.68. This net expense is manifested on the balance sheet by the reduction of the right-of-use asset from the CU275.01 initial balance to CU188.63. This represents the present value of two years future use. What was consumed in operations was the CU86.38 present value of the most distant (third) year's future use.

The year 2 journal entries would be:

Dr – Right-of-use asset      CU5.49  
Cr – Imputed interest income      CU5.49  
To record imputation of interest on right-of-use asset balance

Dr – Rent expense      CU97.06  
Cr – Right-of-use asset      CU97.06  
To record rent expense

This results in reducing pre-tax income by CU91.57, the rent expense of CU97.06 less the imputed interest income of CU5.49. This net expense is manifested on the balance sheet by the reduction of the right-of-use asset from the CU188.63 beginning of year balance to CU97.06. This represents the present value of one year's future use. What was consumed in operations was the CU86.38 present value of the most distant (second) year's prepayment.

The year 3 journal entry would be:

Dr – Rent expense      CU97.06  
Cr – Right-of-use asset      CU97.06  
To record rent expense

Virtually the same analysis would apply to the performance obligation liability and the imputation of interest expense.