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Technical Director FASB 401 Merritt 7 Norwalk, CT via: Email

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The members of the Accounting and Reporting Standards Committee of the Connecticut Society of Certified Public Accountants are pleased to submit their comments on the Proposed Accounting Standards Update; *Leases (Topic 840)*.

The views expressed in this letter are those expressed by members of the Accounting and Reporting Standards Committee. These views are not necessarily the view of the membership of the Connecticut Society of Certified Public Accountants.

We appreciate the opportunity to present our comments. Should there be any questions, please feel free to contact Hal Manoian at 860-285-6336 or hxmanoia@valassis.com.

Very truly yours,

Hal Manoian, CPA Connecticut Society of Certified Public Accountants Chair, Accounting and Reporting Standards Committee

## **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?

We believe the accounting makes sense but believe that implementation of the standard as written is overbroad in its application. When we thought through the application of the proposed standard update to an entity with many leases of a relatively short duration, we believe the costs of calculating these leases under the proposed accounting standards update outweigh the benefit of the information offered.

We then sought to develop relevant parameters to the application. Because the interest component becomes more material the longer the lease term, we believe that leases with a term more than 12 months and less than 5 years be accounted for under a simplified reporting or safe harbor model. The computation would use the lease term and a readily available interest rate, published on the date of the commencement of the lease. This approach would allow for streamlined record keeping with a readily available and auditable discount rate.

(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 and why?

Yes. Amortization of the right-of-use assets matches the cost to the benefits received. Recognition of interest on the liability recognizes that a lease is a financing decision and is consistent with the way other long-term obligations are recognized.

## **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?

The derecognition approach as outlined is quite complex and very subjective. Should the board go ahead with it we would like to see more detailed guidance. We do not believe that derecognition can be applied to a partial asset.

- (b) Do you agree with the boards' proposals 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 BC15)?

## **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 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?

We agree with the proposal for leases with a term of 12 months or less. We don't see the purpose to allowing the lessor's election on lease by lease basis. This would allow the reporting entity to manipulate the amount of debt on the financial statements and would impede transparency.

#### Definition of a lease

This 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–BC32). This exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

## **Question 4**

- (a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?
- (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?

We generally agree with the criteria, but would like to see clarification of what constitutes a bargain purchase option. Certainly, a \$1 purchase option is a bargain purchase option. But what about a purchase option for 10% of FMV at inception of

the lease? Example: A computer, copier or car with a FMV of \$20,000 is leased for three years with a 10% of FMV purchase option (\$2,000) at the end of the three years. Is the computer, copier or car worth significantly more than \$2,000 after the three years? It may depend on factors beyond the lessee's or lessor's control or knowledge such as technological innovation, obsolescence, etc.

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

No. Preparers need more guidance on distinguishing leases from service contracts. We see ambiguity that could lead to manipulation and a lack of transparency.

### Scope

## **Question 5: Scope exclusions**

This exposure draft proposes that a lessee or a lessor should apply the proposed guidance to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for 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?

We don't see why the definitions of an asset under the proposed guidance would not apply to leases of intangible assets. What makes them any different from tangible assets? Examples: 1) Computer software that may be leased concurrently with the acquisition of new computer hardware, whether the software component is broken out separately on the invoice or not, 2) computer software that is acquired using the SaaS model (cloud computing), and 3) a franchisee paying a monthly/quarterly amount to a franchisor for the right to use the franchisor's trademarks, servicemarks, logos, methods, etc.

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

This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, *Revenue Recognition* (Topic 605): *Revenue 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 and lease 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?

We believe under either proposal there needs to be an exception for de minimis, or incidental amounts. Say, for example, there is a service component that is distinct and identifiable, but the value of that service represents less than 10% of the entire value of the transaction. In those cases, the lease should be accounted for as a combined contract regardless of whether the service component is "distinct" or not.

# 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?

We agree with accounting for the purchase options only when exercised. The lease portion represents the right to use the asset during the term of the lease and the purchase option represents the termination of the lease and a completely new transaction for the purchase of an asset that represents the right to use the asset with no definite time period.

#### 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–B20 and BC114–BC120).

For lessees with numerous leases over many years, such as an airline company, it may be a reasonable approach to assume the longest possible term that is more likely than not (a 51% threshold) to occur. With that type of a lessee, there should be sufficient data to determine how long a lease is likely to last. Adopting this standard would eliminate the possibility of abuse caused, for example, by unrealistically short lease terms intended to reduce the amount of the asset and liability.

On the other hand, most companies do not have objective and precise evidence to corroborate what is more likely than not to occur. For most of our clients, the largest leases by far are their real property leases. There also may be incidental

office equipment, factory or warehouse equipment leases. These lessee's don't have enough data to support an evaluation of what is more likely than not to occur, and we believe that to allow management's judgment to influence this determination in any significant way will lead to unintentional volatility and the lack of comparability in reporting, as well as intentional manipulation. In these cases, this standard implies a level of precision that simply does not exist. In further support of this position, there is no obligation to make lease payments for the option period and, accordingly, there is no liability to recognize until an option is actually exercised. Furthermore, even if you might argue that a liability "more likely than not" exists, the asset and liability should be netted since the legal right of set-off exists. We do not believe including options to extend the lease or termination payment provides a true economic picture.

(d) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121-BC131).

We think both lessees and lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be reliably measured. Any difference between the estimated amounts and actual amounts should flow through income/loss in the period the actual amounts are known.

#### **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?

We believe the lease should be recorded as a right to use the asset for its initial period and each additional option should be recorded as a new right to use the asset and obligation to make lease payments at the time the option is exercised. We believe that more likely than not would more likely than not be a very subjective assessment and will not meet the definition of a liability under concept statement 6.

# **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?

No, we do not agree that contingent rentals, expected payments under term option penalties and residual value guarantees should be included in the measurement because they can't be reliably determined at the inception of the lease, and do not meet the definition of a liability.

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?

To reduce the subjectivity of the measurement such provisions should be charged to expense in the period when incurred and can be reliably determined. Before then, they should be disclosed in the notes.

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?

Yes, but we are perplexed by this question. If something can't be reliably measured, why even THINK of including it as an asset?

#### **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 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? Why or why not? If not, what other basis would you propose for reassessment and why?

No. Reassessment should be a very rare occurrence. Option periods shouldn't be included in the original estimates unless they are supported by sufficient objective evidence and contingent rentals should only be included in the initial calculations if there is a very high probability of the contingent rentals being paid.

### 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 for 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 and leases. If the contract represents a sale of the underlying asset, the leaseback also would 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

Do you agree with the criteria for classification as a sale and leaseback transaction?

#### 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 BC142–BC159).

## 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-BC145)? 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, BC148 and BC149)?
- (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 within property, plant and equipment (paragraphs 60, BC154 and BC155)?
  - We are concerned about the subjectivity of the derecognition approach. Why or why not? Do you think that a lessor should disclose this information in the notes instead?
  - Yes, we believe that note disclosures are more appropriate.
- (e) 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 BC156)?

No, disclose in the footnotes if material.

Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

Yes.

### **Question 13: Income statement**

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)?

We wonder what the purpose of this presentation is. If the purpose is to assist users in recasting the financial statements, then why go through the exercise? We envision instances where preparers could be listing the income and/or expense throughout the income statement; as a component of cost of goods sold, selling, general and administrative, and research and development.

#### 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 (paragraphs 27, 45, 63, BC147, BC153 and BC159)?

Yes

## Why or why not?

After going through all the trouble of creating assets and liabilities and amortization of right of use asset and interest expense on lease liability, how could you not extend the disaggregation to the statement of cash flows?

If not, do you think that a lessee or a lessor should disclose this information in the notes instead?

#### **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? YES, to both (a) and (b)

#### **Transition**

#### **Question 16**

- (a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate?
  - Yes.
  - Yes.
- (b) Do you think full retrospective application of lease accounting requirements should be permitted?
  - No, it is too time consuming without sufficient value added.
- (c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

### **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?

No. We believe the Board has significantly underestimated the costs of the proposal and has somewhat overestimated the benefits. The need to reassess when there is a significant change is likely to be very costly. What is a significant change? In many cases, the simple passage of time is a significant change and many leases will need to be reassessed each year just because of the passage of time. In addition, most loan documents will need to be renegotiated and revised because they are based on GAAP measures that will no longer be valid. Furthermore, the initial cost of gathering the data

and maintaining it over the entire life of the leases will be huge for many companies. It may require significant, costly, system revisions and the hiring of added staff to manage and analyze the data.

With regard to the benefits of the proposal, there are aspects of financial reporting that may be improved. However, there are other aspects of financial reporting will suffer. The application of a "more likely than not" standard in determining the lease term and contingent rentals will, in many instances, lead to unnecessary volatility and the lack of comparability in financial reporting. Thus, applying the standards as proposed could actually reduce the usefulness of financial statements rather than improve financial reporting. The standard to apply to optional and contingent rentals should be "highly likely". This higher standard will reduce the need for, and thus the cost of, reassessment, and it will improve the reliability of financial reporting.

#### Other comments

#### **Question 18**

Do you have any other comments on the proposals?

Practitioners will benefit from examples for both lessors and lessees of the initial application of the new standard under paragraphs 88 through 95. Similarly, they would also benefit from an example of applying paragraph 18 (a). Also, under that paragraph, how does the entity report the change in net income? Is it reported as components of interest and amortization? Or is it reported under some other caption? The requirements for disclosures relating to changes in accounting estimates should be emphasized.

The standard should address how lease usage rights and payment obligations conform to the concepts statement definitions of assets and liabilities.

In Appendix A under the definition of the "date of inception of the lease" states "The earlier of......and the date of commitment....." The "and" should be replaced with "or".

The standard should also mention "informal leases" which are frequently used by smaller reporting entities involved with related parties and may not be reduced to writing. For example, how is the expected lease term determined? Should there be special disclosures? We see issues in determining the imputed interest in cases where there is no remaining debt on the leased asset.

How should the lessor and lessee report lease termination payments made by the lessor to the lessee? Example: Lessor currently has a 20 year real estate lease with tenant A at \$10,000/month and there are 7 years left on the lease. Lessor can replace tenant A with tenant B who will pay \$20,000/month on a new, 20 year lease. In order to get tenant A out of its lease early, lessor pays tenant A \$500,000.

How should the lessor and lessee account for tenant fit-up allowances? Example: Lessor has vacant space in an existing building. A new tenant wishes to move in but desires a higher grade of interior finish (carpeting, tile, wallpaper, relocation of existing walls requiring teardown and construction, upgraded cabinetry and counters, and upgraded exterior windows and doors, etc.). The lessor proposes three options: 1) the lessor pays for all the fit-up and the rent will be \$30,000/month, 2) the lessor pays the

lessee \$300,000 to spend on fit-up and the rent will be \$23,500/month, or the lessee pays for all of its fit-up and the rent will be \$20,000/month.

There are no illustrative financial statement presentations or notes, except for one minor illustration regarding a sublease. This is such a pervasive change and one that will affect so many users, that the guidance should be provided in a textbook format with examples to illustrate all critical calculations and financial statement presentation.

The board should consider the cost and effort of compliance and try to simplify the implementation. Also more detailed implementation examples should be provided to help the preparer.

What about the interplay of FIN 46R? Would this lease accounting approach effectively eliminate 46R issues for companies that are renting their facilities from the consolidated (under FIN 46R) leasing company?

We believe the broad applicability of this proposed accounting standards update that may move the profession further toward two sets of standards, one for public companies and a second for closely-held companies. This concerns us because it would reduce the consistency of reporting.

Smaller firms do not have subject matter experts whose job it is to interpret the changing standards. We emphatically request more examples including examples for initial implementation and differential implementation dates.

The committee wonders what the relevance of the income statement will be as more transactions are reported on the balance sheet.

## Non-public entities

## Question 19

Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)?

Possibly.

If so, which requirement(s) and why?

In the case of non-public entities, specifically, closely-held companies, related party leases for real estate and sometimes machinery and equipment are quite common. The leases are usually written to achieve the objectives (tax, financial, or otherwise) of the owner(s) of the company and the owner(s) of the underlying asset, which are usually the same person. As such, the leases are subject to manipulation to create the desired tax return or financial statement result. We suspect that many related party leases will be rewritten to make them short term leases.

Consideration of the impact to small non-public companies and whether any scope exceptions will be granted should be considered. We believe the cost to comply would

outweigh the benefit as proposed, we recommend a simplified approach. Would the users benefit from this proposal as written?