One New York Plaza
New York, NY 10004

Morgan Stanley

September 12, 2013

Ms. Susan Cosper
Technical Director
File Reference No. 2013-270
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Re: File Reference No. 2013-270

Dear Ms. Cosper:

Morgan Stanley appreciates the opportunity to comment on the Proposed Accounting Standards Update, Leases (Topic 842), a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840) (the "ASU") issued jointly by the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") (together, the "Boards").

While we acknowledge that the proposals in the ASU are an improvement to those in the 2010 proposed Exposure Draft, we do still have significant concerns in respect of the operationality of the guidance in the ASU. As described in the paragraphs below, we believe that alternative approaches (e.g., through enhancements to current lease-related disclosures) may provide financial statement users greater transparency until the Boards can address constituents' operational and implementation challenges introduced by the ASU. In particular, we consider that greater clarity needs to be provided in respect of the definition of a lease, the distinction between property and non-property assets and on the interpretation of other key terms used in the definitions of Type A and Type B leases. Further, the calculation of lease assets and liabilities in general, and in particular the application of the guidance in the ASU on the reassessment of lease terms and the treatment of variable lease payments will be unduly complex and would result in

preparers incurring significant costs that are disproportionate to the benefit received by users of this information.

We also share the concerns of other responding constituents and certain dissenting Board members that the nature of the "Right-of-Use" asset recognized under the ASU is unclear and has not been subject to sufficient debate and discussion.

We are concerned that the ASU may result in substantial costs to businesses and lack sufficient meaningful benefits for users. At a minimum, it is unclear to us whether the potential benefits from the ASU will ultimately outweigh the significant burdens (e.g., in time and money) it will impose on both preparers and users of financial statements. Given this and the above practical and conceptual concerns, and the importance of ensuring a single converged accounting approach in this area, we question whether it is appropriate to implement the ASU (as currently drafted), at this time. We believe that before such changes are made, a better understanding is required of whether the information produced by reporting such assets and obligations would justify the incremental costs of the proposed change.

We recognize, however, that leasing is an area where users may require additional information than what is provided by the current accounting and disclosure framework. We therefore acknowledge that some improvements in this area may be warranted. As such, we would support the introduction, without delay, of an enhanced level of disclosure. Our recommended approach would essentially constitute most of the disclosure requirements in the ASU, with the exceptions of those relating to the Right-of-Use asset and those noted in our response #8 related to proprietary aspects of the options to extend or terminate leases. We would expect this enhanced level of disclosure to provide greater transparency and valuable additional information for users, while minimizing additional costs by avoiding many of the key complexities and implementation costs of the ASU (in particular those relating to the definitions of Type A and Type B leases).

Below are our responses to the specific questions posed in the ASU. Please note that these responses have been provided on the assumption that the Boards will not change the fundamental approach set out in the ASU. We recognize that adoption of an approach based principally on improved disclosure will involve significant changes to the structure of the ASU, such that certain of these questions would no longer be relevant.

Question 1: Identifying a Lease: 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.

Response: We generally agree with both the definition of a lease and the proposed requirements for how an entity would determine whether a contract contains a lease. However, we do have the following suggestions to improve clarity.

In particular, we believe additional clarity should be provided regarding the following:

- First, the guidance for determining whether a supplier's right to substitute an asset meets the "substantive" criterion as proposed in 842-10-15-6 should be amended. As proposed, it appears that the mere existence of <u>any</u> barrier to substitution of the asset would result in the right being considered non-substantive, such that the agreement may meet the

definition of a lease. We believe adding the word "significant" in 842-10-15-6(b)(1) would allow preparers to more appropriately determine the threshold required in applying this aspect of the definition. In addition, the example provided in 842-10-55-26(a) for a contract for medical equipment is unclear. The example does not offer sufficient context around the assumed magnitude of replacement costs for the equipment. As such, it is unclear why the "[s]upplier's substitution rights are not substantive because the costs of replacing the equipment create an economic barrier that prevents Supplier from replacing the equipment other than when it is not operating."

- Second, we also believe that more guidance is necessary on the intended interpretation of the term "highly interrelated with the other underlying assets in the contract", as used in 842-10-15-17(b). This would assist preparers when determining if a separate lease component satisfies both criteria noted in that paragraph.

- Lastly, as noted in our 2010 Response Letter, we agree that all service components represent executory arrangements and should therefore be excluded in the measurement of assets and liabilities arising from lease contracts. Therefore, we suggest that executory costs (e.g., relating to property taxes, insurance, maintenance costs, etc.), which are embedded as part of most operating leases in commercial office spaces, should specifically be characterized as non-lease components. By creating this distinction, preparers would have an improved ability to determine how to consistently allocate the payments to the lease and non-lease components of the arrangement and users would obtain a clearer understanding of the distinction between the lease and non-lease elements of arrangements relating to property costs.

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?

Response: We understand and support the Boards' decision to develop a principle that differentiates between Type A and Type B leases should be based on the extent to which the lease represents the lessee's consumption of economic benefits embedded in the underlying asset. We believe, however, that the final standard needs to be clearer in this respect.

Specifically, additional guidance is needed to help preparers and their auditors understand the Boards' intention when applying the classification criteria, in particular as it relates to the following **bold** terms referenced in paragraphs 842-10-25-6 and 25-7:

- The lease term is for an **insignificant** part of the total economic life of the underlying asset
- The present value of the lease payments is **insignificant** relative to the fair value of the underlying asset at the commencement date
- The lease term is for the **major part** of the remaining economic life of the underlying asset
- The present value of the lease payments accounts for **substantially all** of the fair value of the underlying asset at the commencement date

We acknowledge that in the Basis for Conclusion, the Boards state their preference to minimize the inclusion of "bright-lines" guidance and they emphasize the role of "judgment" in applying

the guidance in this area; however, given the varying degrees of subjectivity and the existing "grounded roots" in historical practices under current lease guidance, we believe the need for this additional clarification to ensure that practice evolves in accordance with the intentions of the Boards outweighs the desire for a strictly principles-based approach.

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

Response: We generally agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than a significant portion of the economic benefits embedded in the underlying asset. This "symmetry" in the accounting model is helpful in ensuring that, where applicable, the lessee and lessor would evaluate certain factors on a consistent basis. In accordance with our response to Question 2 above, we also believe that clarified definitions should be provided for key terms in lessor accounting (e.g., guidance related to key terms when determining classification between Type A vs. Type B leases).

Question 4: Classification of Leases: 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?

Response: If the Boards decide to apply a "two model" approach to the classification of leases, we would agree with the principle that the lessee's expected consumption of economic benefits embedded in the underlying asset should be used as the basis for this classification. We also appreciate the practical merits of applying a rebuttable presumption for the classification of leases based on the question of whether the lease relates to property or not, although given that both "property" and "non-property" leases are subject to further tests to confirm their classification, we are not convinced that the benefits of this approach are significant. If this distinction is to be operational, we believe that additional application guidance needs to be provided to assist preparers in determining the difference between property and non-property assets. For example, items such as oil storage tanks and data centers typically involve single assets which are arguably buildings, but have additional operational aspects beyond occupation of space and, therefore, it is unclear whether such assets would be regarded as "property" for the purpose of this distinction.

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?

Response: We note the Board's revised definition of lease term as "[t]he noncancellable period for which a lessee has the right to use an underlying asset, together with both of the following:

a) Periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option
b) Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option"

The decision for such a threshold is noted in the ASU's Basis for Conclusions par. BC 139, Item C:

> Some suggested increasing the threshold at which an entity would include options to extend in the measurement of lease assets and lease liabilities. They suggested thresholds such as "reasonably assured" (used in existing U.S. GAAP), "reasonably certain" (used in existing IFRS), and "virtually certain" (which would be a higher threshold that would almost equate to including only contractual minimum lease payments in the measurement of lease assets and lease liabilities).

While we consider that the revised definition of lease term is likely to be operational, we would question whether the benefits of changing the "reasonably assured" and "reasonably certain" thresholds under current accounting requirements (which, in practice are currently interpreted as being the same criterion) would justify a change to a criterion which currently works effectively. In the absence of such a need to change, we would suggest that if the Boards wish to adopt a converged lease term definition, they should be clear, perhaps in the Basis for Conclusions to the final standard, whether this revised definition is intended to change current practice.

In addition, consistent with our 2010 Response Letter, we believe that the requirement to undertake a continuous reassessment of the lease term, based on the prescribed factors, will create a significant administrative challenge, in particular for preparers that have multiple leases. We remain concerned that this requirement could be extremely onerous given that each lease contract will need to be almost continually monitored, analyzed and documented. We do not believe that such continual reassessment is the intention of the Boards and urge the Boards to simplify the approach to reassessment (e.g., by requiring reassessment only in response to significant changes in facts).

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?

Response: While we acknowledge that the approach proposed in the ASU is significantly more straightforward than that initially proposed in 2010, we continue to believe the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments, remains unnecessarily onerous to apply. As noted in our 2010 Response Letter and similar to the last paragraph in our response in Question 5, we believe that lessees and lessors should remeasure assets and liabilities when significant changes in facts or circumstances occur; however we are concerned that it will be difficult to assess whether such a significant change has in fact occurred.

We acknowledge that the ASU's Basis for Conclusion, paragraph BC175, states that "...the Boards noted that they have made significant changes to the proposal on the measurement of variable lease payments in this Exposure Draft, which are expected to reduce the costs and complexity of the proposals, ... Consequently, the costs associated with remeasuring lease liabilities should be lower as compared to the proposals in the 2010 Exposure Draft." However, we believe that the ASU's proposed model remains costly and overly complicated. We therefore recommend, for further simplification that all variable payments (other than "in-substance fixed" payments) be recognized when incurred rather than being taken as part of the initial and subsequent measurement of the right-of-use asset and liability.

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?

Response: We agree that a lessee and a lessor should be allowed an accounting policy election on how they wish to recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or full retrospective approach. Consistent with our 2010 Response Letter, we consider that preparers should be allowed greater flexibility in the selection between the two approaches based on their facts and circumstances.

We note the requirement in paragraph 842-10-65-1(n)(3) that all capital leases should be classified as Type A leases upon transition. While we accept that this classification will be appropriate in most cases, we are not convinced that this will always be the case. Accordingly we consider that former capital leases should be treated as Type B leases when they meet the relevant classification criteria.

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?

Response: As described in our response to the 2010 Exposure Draft, we remain concerned about the ASU's requirement for a lessee to disclose those lease options that are, and those that are not, recognized as part of the right-of-use asset and lease liability, as set out in paragraph 842-20-50-3(a)(3). We continue to believe that the provision of such information could be prejudicial to a lessee, as such information would provide lessors with information on the intentions of a lessee to exercise a lease renewal option, which may weaken the lessee's negotiating position. As a consequence, we do not believe this disclosure should be required to the extent that it is prejudicial to the commercial interests of the lessee.

Question 10 Related Party Leases (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?

Question 11 Related Party Leases Disclosures (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?

Response: We agree that related party leases should be recognized and measured in accordance with their legal form, in accordance with the treatment of "third party" leases. To the extent that additional disclosures are required in order to understand the significance of the lease counterparty being a related party of the reporting entity, these would be provided in accordance

with existing guidance on disclosures of related party relationships. As such additional guidance specifically for related party leases is not necessary.

Question 12 Consequential Amendments to IAS 40 (IASB Only): Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

Response: As we consider that the right-of-use asset would be in the nature of a tangible asset, we consider that it would be appropriate to apply the guidance in International Accounting Standard 40, *Investment Property* ("IAS 40") relating to investment property to such an asset. We note that the existing guidance in IAS 40 already applies to assets held by lessees under finance leases and we consider that the right-of-use asset, which would be recognized in accordance with the proposals of the ASU, is analogous to such existing lease assets.

*****

Again, we thank you for the opportunity to provide comments. Please contact me at 212-276-7824 if you have any questions.

Sincerely,

G. David Bonnar
Managing Director
Global Advisory and Policy