



December 15, 2010

Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

File Reference No. 1850-100

Dear Technical Director:

The Healthcare Financial Management Association's (HFMA's) Principles and Practices (P&P) Board appreciates this opportunity to comment on the Financial Accounting Standards Board's (FASB's) exposure draft of the proposed Accounting Standards Update, *Leases (Topic 840)*, which would require that assets and liabilities arising under leases be recognized in the statement of financial position.

HFMA is a professional organization of more than 35,000 individuals involved in various aspects of healthcare financial management. In 1975, HFMA founded the P&P Board, a special group of experts to serve as the primary advisory group in the areas of accounting principles and financial reporting practices to meet the unique characteristics of health service organizations.

### **General Comments**

In the exposure draft, FASB noted that since leasing is an important source of finance, it is important that lease accounting should provide users of financial statements with a complete and understandable picture of an entity's leasing activities. The existing accounting models for leases require lessees to classify their leases as either capital leases or operating leases. FASB says that those models have failed to meet the needs of users of financial statements because they do not provide adequate representation of leasing transactions. In particular, FASB says these models omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the Board's conceptual framework.

FASB also says that the models have led to a lack of comparability and undue complexity because of the sharp 'bright-line' distinction between capital leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.

FASB sought comments on all matters in the proposal, including a number of specific issues and questions. Our comments herein will center on these issues, and also will reflect the P&P Board's longstanding efforts to balance two important goals:

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1. Financial reporting should improve the level of understanding between those who provide financial information and those who seek and use this information, and
2. Reporting requirements should be feasible in the context of the unique characteristics of the healthcare field.

Our comments will take the perspective of the lessee. We are generally supportive of the “right-of-use” model described in the proposal. We do, however, have specific recommendations for improving certain attributes of this approach.

Below are the P&P Board’s responses to FASB’s specific questions:

### **The Accounting Model**

The exposure draft proposes a new accounting model for leases in which:

- (a) A lessee would recognize an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortize the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.
- (b) A lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23–BC27).

### **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 agree with the concept of an asset being recognized when there exists a right-of-use asset and a corresponding liability related to the obligation. However, we are concerned the proposed accounting model requires significant estimates and judgments about uncertain future events which may unnecessarily complicate the estimation of the asset and obligation to be recognized.

- (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?

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We agree the right-of use asset should be amortized over the lease term (or the useful life if shorter) using a systematic and rational manner. Additionally we concur with the recognition of interest expense using the effective interest method for the lease obligation.

**Question 3: Short-term leases**

The 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?

We agree that the simplified requirements for short-term leases as defined in Appendix A to the exposure draft are an appropriate accommodation for both the Lessees and Lessors. However, we also believe that the cost associated with implementing this guidance for short-term leases would far outweigh the benefits afforded to readers of the financial statements, even with the accommodation referred to above. The short-term nature of these agreements would create a significant use of resources to set up, monitor, and record the activity for leases that could be as short as one month.

We believe that permitting these leases to be accounted for as operating leases and disclosing the nature of the agreement, related assets, and amount of current year operating lease expense would be sufficient.

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### **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–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?

We do not agree with the scope of the proposed guidance and believe the definition of a lease should be clarified that only leases of property, plant, and equipment are within the scope of the proposed guidance. Additionally, more clarification would be beneficial. For example, more guidance may be needed in distinguishing a purchase from a lease for those contracts which offer multiple options to purchase the asset over the course of the lease.

(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?

The contracts that are considered to be the purchase or sale of the underlying asset are excluded from the scope of the proposal. So the leases that call for the automatic transfer of title to the underlying asset to the lessee and those that contain bargain purchase options will not be accounted for as leases under the exposure draft. We need greater clarification how these arrangements will be accounted for when they are no longer considered leases and provisions for the transitions for such arrangements will need to be outlined.

(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?

See Question 6.

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## Scope

### **Question 5: Scope exclusions**

The 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 do not agree with the scope of the proposed guidance and believe the definition of a lease should be clarified that only leases of property, plant, and equipment are within the scope of the proposed guidance.

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

The 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) FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.
- (b) The International Accounting Standards Board (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?

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We believe the service components should be accounted for separately from lease components. We believe all services should be excluded from the amounts recognized for leases and accounted for separately by both lessees and lessors in accordance with existing accounting standards. This should be required and not elective.

### **Question 7: Purchase options**

The 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?

We agree that the parties should account for purchase options only when they are exercised. Purchase options give the lessee the right to purchase the leased item on or after a specified date. We agree that purchase options should not be recognized as separate assets.

### **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).
- (b) 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). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value 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 BC132–BC135).

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**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 do not agree with FASB's proposal that the lease term be determined 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. We believe that the more likely than not criteria is highly subjective, difficult to accurately determine in an effective manner, and would result in inconsistent application among various organizations. In addition, we do not believe that options to extend should be taken into account until they have been exercised as an option to extend that has not yet been exercised does not meet the definition of a liability, as defined in Statement of Financial Accounting Concepts No. 6. We believe these highly subjective estimates, coupled with the variability that will be evident as lease terms either expire or are renewed in a manner inconsistent with previous estimates, will be detrimental to the level of confidence that financial statement users have with respect to financial reliability and integrity.

We believe that FASB should define the lease term as the noncancellable term of the lease as stated in the lease agreement, similar to the terms associated with disclosure requirements of future minimum lease payments for operating leases. We believe that this provides users of the financial statements with an accurate depiction of the liability outstanding for organizations at a given point in time. We also believe that this approach would provide preparers with a consistent basis by which to apply the proposed guidance, and would eliminate some of the judgment and potentially inconsistent application among various organizations that would impact users of the financial statements.

**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?

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We do not agree with FASB's proposal that contingent rentals, expected payments under term option penalties, and residual value guarantees be included in determining lease assets and liabilities. We believe that a reliable estimate of whether they will be incurred is typically not determinable at the inception of the lease. In addition, recording a liability for estimates of these items is not appropriate as no events have occurred which result in an outstanding obligation. As a result, we believe that contingent rentals, payments under term option penalties, and residual value guarantees should be expensed as the contingencies are resolved and penalties incurred in such a way that the lessee is obligated to make such payments.

#### **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?

Assuming the use of noncancellable lease terms (see response 8) and further assuming that penalties and contingencies are not recognized until the underlying obligation is "incurred" (see response 9), we agree with FASB's proposal 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. The assets and liabilities arising under leases should be reassessed when certain facts or circumstances occur that affect the noncancellable lease term or payments, such as the exercise of an option to renew or extend the lease.

#### **Sale and Leaseback**

The 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? Why or why not? If not, what alternative criteria would you propose and why?

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In general, we agree with the criteria for the classification as a sale and leaseback transaction. We do believe that many more transactions will be accounted for as financings (i.e., as a borrowing by the seller-lessee and a lending by the buyer-lessor) than under current practice.

## **Presentation**

The 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?

We do not agree that the lessee should be **required** to present the liability to make lease payments separately from other financial liabilities statement of financial position. Although there may be circumstances where this presentation could be appropriate and meaningful, we do not believe this would be relevant in every case. We do believe that when the lease payments are not presented separately on the statement of financial position they should be disclosed in the footnotes to the financial statements.

We do agree that the lessee should present the right-to-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease. However this presentation could be included in the footnotes to the financial statements where organizations have elected to present one total for property plant and equipment on the face of the financial statements and disclose the separate asset categories in the footnotes.

### **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)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

We do not agree that lessees and lessors should be **required** to present lease income and lease expense separately from other income and expense in the income statement.

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Although there may be circumstances where this presentation could be appropriate and meaningful, we do not believe this would be relevant in every case. We do believe that when lease income and lease expense is not presented separately from other income and expense in the income statement they should be disclosed in the footnotes to the financial statements when material.

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

We do not agree that lessees and lessors should be **required** to present cash flows arising from leases separately from other cash flows. Although there may be circumstances where this presentation could be appropriate and meaningful, we do not believe this would be relevant in every case. We do believe that when cash flows arising from leases is not presented separately from other income and expense in the income statement they should be disclosed in the footnotes to the financial statements when material.

**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 BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

We believe disclosures, either within the footnotes or on the financial statements, with respect to the amounts recognized in the financial statements arising from leases as well as the impact on future cash flows will improve the level of understanding between those who provide financial information and those who seek and use this information.

**Transition**

**Question 16**

(a) The 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

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(paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

We agree with the proposal of measuring long-term outstanding leases as of the date of the initial application using a simplified retrospective approach. We believe that the resources necessary to implement the full retrospective approach would be extremely costly and challenging to implement.

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

We agree with permitting the full retrospective approach; however, as noted above, we believe that the resources necessary to implement the full retrospective approach would be extremely costly and challenging to implement.

(b) Are there any additional transitional issues the Boards need to consider? If yes, which ones and why?

As noted previously in this letter, we believe that there needs to be better guidance on how to account for leases that exist at the time of implementation that would be considered sales under the proposed lease accounting model. Also, the Boards should address a similar issue for existing sale leaseback transactions that may not meet the criteria for sale leaseback under the new lease accounting model.

## **Benefits and costs**

### **Question 17**

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

We are concerned that the significant estimates and judgments about uncertain future events currently required by the exposure draft will unnecessarily complicate the estimation of the asset and obligation to be recognized and thus require significantly more effort. While the Board’s objective of addressing the off-balance sheet concerns associated with leasing activities will have been addressed, significant costs will be expended to apply the guidance as currently drafted which we believe outweigh the benefits achieved.

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## **Other comments**

### **Question 18**

Do you have any other comments on the proposals?

#### Impact on Reimbursement for Patient Care

Certain healthcare providers continue to receive cost-based reimbursement for providing patient care. Critical access providers receive such reimbursement under the Medicare program, and certain states provide some portion of Medicaid reimbursement based upon costs. In some cases, operating expenses are considered separately and reimbursed in a manner different than capital expenditures. A change in the accounting practices would have a direct impact on reimbursement in these instances. In some cases the impact would result in increase payment for services, and in other cases, there may be a decrease in payments received. These changes may drive further revisions to reimbursement rules, creating additional strain on an industry already burdened with unprecedented levels of change.

#### Impact on Debt Covenants of Not-for-Profit Organizations

One area in which not-for-profit healthcare organizations could be negatively impacted by FASB's proposal is with regard to certain covenants on outstanding debt. FASB's proposed changes would result in the recording of additional debt on the balance sheets of not-for-profit healthcare organizations, which would have a direct impact on certain debt covenants that are based on debt or debt service. Increases in debt and debt service could cause organizations to be in default as a direct result of a change in Generally Accepted Accounting Principles. This poses a significant problem to not-for-profit healthcare organizations as it is typically very difficult to amend a master trust indenture which defines the debt covenants and related calculations applicable to the entity.

The basic issue in amending master trust indentures is that the obligations issued under master trust indentures secure publicly sold bond issues. In many situations, there are not bank-lenders or a limited number of institutional investors who can be approached to obtain consent to master trust indenture amendments as may be the case for other organizations. Rather, one may need the consent of a majority of the holders of all bonds to accomplish a substantive amendment. Given that bonds issued by not-for-profit healthcare organizations are largely held under the Depository Trust Company book-entry system, the process of identifying bondholders is typically very difficult. In comparison, with a bank-lender, an organization might offer additional compensation (such as a higher interest rate) in exchange for consent to an amendment. Federal tax

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rules would make that approach very difficult or impossible in the case of the holders of publicly-offered tax exempt bonds. Additionally, the term of debt for not-for-profit organizations is generally fairly long (in some cases up to forty years), thus perpetuating the issue created for a very lengthy time period.

### **Non-public entities**

#### **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?

We do not believe that there should be different guidance for nonpublic entities. The P&P Board has continually strived for consistency in accounting and financial reporting. The healthcare industry is comprised of for-profit, not-for-profit, and governmental entities. The underlying substance of the transaction does not change based on ownership type.

Thank you for the opportunity to comment. We are always ready to provide additional comments, or meet with you or members of your board to discuss this matter further. If we can provide additional material or perspective on this issue, please contact Richard Gundling, Vice President of HFMA's Washington, DC office, at (202) 296-2920.

Sincerely,



P&P Board Chair