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December 15, 2010

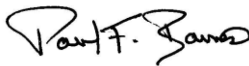
Reference: FASB Reference No. 1850-100, *Proposed Accounting Standards Update Leases (Topic 840)*

Duff & Phelps appreciates the opportunity to provide comments on the above referenced exposure draft.

Our valuation advice, particularly with regards to financial reporting, is sought by hundreds of global clients annually as we work with them in developing pragmatic solutions for applying fair value techniques that are acceptable to the public accounting community. We believe that our unique perspective in the practical application of accounting principles – both under United States generally accepted accounting principles (U.S. GAAP) and international financial reporting standards (IFRS) – in the context of valuations for financial reporting has particular relevance to the Board and its constituency – as it relates to the proposed accounting standard update referenced above.

Our comments and observations are in the attached document. We would be pleased to further discuss our comments with the Board and staff. Please direct any questions to either of us via the contact information set forth below.

Sincerely,



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Response to Proposed Accounting Standards Update - Leases (Topic 840)

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Overview

In studying the proposed Accounting Standard Update ("ASU" or "ED"), we find that many of the FASB's and IASB's (the Boards') arguments have merit. We agree that a distinction should not be made between operating and capital leases for lessees as they have the same economic substance. We agree with the (i) right-of-use asset concept, which is in essence an intangible right, and (ii) treatment of the related lease liability, which is consistent with the corporate finance notion that lease expenses are financing expenses.

As to the inclusion of renewals and contingent payments into the measurement of the right-of-use asset and lease liability of the lessee, we understand that such cash flows meet the definition of an asset or liability in the Conceptual Framework. From a measurement standpoint, the challenges surrounding their estimation are no different than those encountered in the measurement of contingent consideration, other contingencies or IPR&D. However, from a practical point of view, we recognize these measurement challenges would be amplified by the sheer number of leases in place at some companies and acknowledge that there are certain industries (e.g. retail) in which contingent cash flows and renewals may require significant rigor to estimate and the quality of such estimations may be questionable. While some of these challenges are inherent in more complex fair value determinations, the Boards did not go as far as to require fair value and have attempted to introduce a few practical expedients in the measurement (e.g. by introducing the notion of *lease term,* as defined in the ED, to address the accounting for optional periods). Yet in a way, the proposals blend accounting for existing contractual assets and liabilities with those arising from expected renewals, which is typically an element of a fair value framework. We urge the Boards to take a pragmatic approach to ease the implementation burden of the new lease model by revisiting the operationality of certain aspects of the proposed guidance. Perhaps adapting a 'portfolio level' unit of account override may be more workable also to the extent it is consistent with certain business practices in pricing leases.

Many of the above points apply to the proposed lessor accounting models as well. We also observe the additional qualification that lessors are to include contingent payments if they can be *reliably measured* would introduce further complexity and potential diversity in practice. Finally, we believe to the extent the Boards are more comfortable with setting forth a new accounting model for lessees it may be beneficial to proceed with that segment of the project while the lessor models are being fine-tuned.

* * *

We have provided some additional comments and observations on a few aspects of the ED in the following.

Present Value, Cost and Fair Value References

At times, the ED uses fair value interchangeably with present value and/or cost. This is confusing as it implies they are analogous. Our recommendation is to keep the concepts separate and not give the impression they are similar or the same in explaining the new lease accounting model. We understand the Boards have decided not to base the proposed lease accounting model on fair value for various reasons (including cost and complexity). Accordingly, we recommend references to fair value be removed where that is not the measurement objective.

> For example, paragraph 50 of the ED discusses the accounting for the residual asset at the inception of the lease which includes "allocating the carrying amount of the underlying asset at the date of inception of the lease in proportion to the *fair value* of the rights that have been transferred and the *fair value* of the rights that have been retained by the lessor." Paragraph BC107 of the ED states: *"*The reassessment of the lease term may result in changes to the relative *fair values* of the lessee's right to use the underlying asset and the rights retained by the lessor.*"* [emphasis added]

Further discussions in the ED demonstrate the fair value referred to above is in fact present value.

Apart from the fact that the initial measurement of the right-of-use asset under the ED includes capitalized direct costs (and, therefore, is not a fair value measurement), the notion that purchase cost is typically representative of fair value[1], as the case may be for many PP&E items, does not translate easily in the context of a lease transaction. For example:

- A lease transaction includes, in addition to the underlying asset being leased, a financing component which is to a great degree a

[1] For example, discussions in the ED to that effect include the following:

> "At initial recognition, cost represents a reasonable approximation of the fair value of the right-of-use asset." (BC 71)
>
> "In the boards' view, the present value of lease payments, discounted using an appropriate discount rate, is a reasonable approximation to fair value. However, the boards concluded that it would normally be less complex for lessees to determine the present value than fair value." (BC 65)
>
> "Furthermore, initial measurement of the right-of-use asset at cost is easier and less costly for entities to apply than fair value measurement because there is usually no active market for right-of-use assets and cost usually provides a reasonable approximation to the fair value of the right-of-use asset at its inception." (BC 72)

function of counterparty risk and lease economics[2]. Therefore, the fair value of a right-of-use asset cannot be viewed in isolation from the credit standing of the entity and possibly other entity- and transaction-specific factors (other borrowings; security for the lease, if any; etc.);

- The lease rates are specific to the transaction between lessee and lessor and are likewise affected by the credit standing of the lessee and lease economics;
- Since fair value is an exit price, the cost of the asset may not necessarily be its fair value (i.e., the exit value for the lessee may be different from that of the lessor due to different exit markets, etc.); and
- A fair value measurement of the right-of-use asset would consider the expected lease term, rather than the longest possible lease term more likely than not to occur.

Similar considerations as discussed above apply to the lease receivable for the lessor[3]. Therefore, we recommend that the Board remove the references to fair value where it is not the measurement objective.

It appears that the few instances in which fair value measurements required under the ED include the lessor's accounting under the derecognition approach. Under this approach, the *fair value* of the underlying asset represents an input in the calculation to determine the amount of the residual asset, and upon initial application of the proposed guidance, whereby the residual asset is to be recorded at *fair value*.

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[2] An alternative to making an adjustment for counterparty risk in the discount rate may be to adjust the cash flows for the probability of default component (addressing the counterparty risk of performance) and use an expected yield. This is consistent with the flexibility allowed by other models used in the accounting for contracts between two parties with a defined payment stream (e.g. financial instruments).

[3] For example, the ED states the following:

> "The boards considered whether a lessor should measure the right to receive lease payments at fair value on initial measurement. However, the boards propose not to require fair value measurement for the right to receive lease payments for reasons similar to those for not proposing fair value measurement of the right-of-use asset, as described in paragraph BC 72." (BC 94)

Impairment of Right-of-Use Asset (Lessee) and Lease Receivable (Lessor)

The proposed guidance would require ongoing reassessment of the right-of-use asset by the lessee. Specifically, the ED requires an ongoing reassessment of the *term* of the liability to make lease payments with an adjustment to the right-of-use asset, as well as a reassessment of *contingent cash flows* also with an adjustment to the right-of-use asset, if such cash flows relate to future periods. It appears the adjustment to the right-of-use asset pursuant to a reassessment is in substance impairment. Given that, testing the asset for impairment under other GAAP guidance (ASC 350) seems redundant, in whole or in part.

Further, the ASC 350 impairment test of long lived assets may generally not be sensitive enough to recognize a potential impairment of the right-of-use asset. Under the current guidance, the level at which the recoverability step of the impairment test is performed is based on the lowest level of identifiable cash flows. This often results in analyzing cash flows for an entire asset group or even an entire reporting unit. In addition, in the recoverability step of the impairment test, cash flows are analyzed on an undiscounted basis, which provides an additional shield against impairment.

We recommend that the Board clarify the interplay of the reassessment proposed in the ED affecting the right-of-use asset and the potential impairment testing of the right-of-use asset under ASC 350, as to whether both evaluations are necessary.

Similar considerations as above may apply on the lessor side with respect to the lease receivable – its periodic reassessment under the proposal of the ED and its potential impairment testing under ASC 310.

Revaluation of Right-of-Use Asset (Lessee)

The ED proposes an option to revalue the right-of-use asset under IFRS. Paragraph BC78 of the ED states:

> "Revaluation of right-of-use assets by lessees using IFRSs would be consistent with the accounting permitted by other IFRSs for nonfinancial assets that are initially measured at cost. Accordingly, in situations in which the underlying asset is property, plant or equipment, the revalued right-of-use asset would be comparable to property, plant and equipment that is revalued in accordance with IFRSs."

However, we observe that the right-of-use asset of the lessee is not directly equivalent to a PP&E asset as it also includes a financing component. As discussed earlier, a lease transaction includes, in addition to the underlying asset being leased, a financing component which is to a great degree a function of counterparty risk and also affects the lease economics. Therefore, the fair value of a right-of-use asset cannot be viewed in isolation from the entire lease arrangement.

In this light, the option to revalue a right-of-use asset under IFRS raises the question of whether it should be revalued based on the underlying PP&E fair value, or as an intangible right. Paragraph BC79 of the ED states:

> " The IASB considered whether lessees should apply the revaluation model in IAS 38 to the revaluation of the right-of-use asset. … [T]he IASB proposes to permit revaluation of the right-of-use asset in accordance with IAS 38 but to remove the requirement for entities to determine the fair value of the revalued right-of-use asset by reference to an active market"

We observe that even if the asset is treated as an intangible, it still includes a "financing component" (in addition to the value of the PP&E that it conveys right-of-use to). If the asset is to be revalued as an intangible right, it seems that the context of the valuation would be a hypothetical transaction including the related financing liability (the entire lease arrangement). In other words, the fair value of the right-of-use asset may need to be determined assuming a new transaction as of the revaluation date at market terms with the entity as counterparty.

If this is the intent of the Boards, it should be clarified or we recommend that the revaluation option be removed from the guidance, notwithstanding the fact that a right-of-use asset may be included in the same class of assets for which the revaluation option is available under IFRS.

Present Value of Lease Payments

We believe the guidance in the ED should explicitly state that the determination of the lease payments (for the lessee and lessor) is a two-step process. The first step of this process involves determining the lease term (i.e., the longest possible lease term that is more likely than not to occur), and the second step of this process involves determining the present value of expected lease payments (including contingent rentals, residual value guarantees and term option penalties) over this term.

We recommend that the Board make a clarification along those lines. This would be very helpful for the following reason. When lease payments and contingent rentals (expected payments) are assessed the tendency may be to reflect the probability of each possible outcome (including that of the lease term) in the measurement. Paragraph B120 (c) articulates this issue well:

> "…an 80 per cent probability that an option to extend a lease will be exercised is incorporated into the measurement of the liability to make lease payments or the right to receive lease payments by weighting the extended term by 80 per cent and the shorter term by 20 per cent. Although some respondents to the discussion paper expressed support for a probability weighted measurement approach, most said that such an approach would add complexity without providing more relevant information. *The boards noted that uncertainty over the lease term affects whether an asset or a liability exists to be recognized, rather than the measurement of that asset or liability. In the boards' view, a probability-weighted approach is not appropriate to determine whether an asset or liability exists*." [emphasis added]

Given that the determination of the *lease term*, as defined in the ED, is based on an accounting convention that addresses the recognition of the asset or liability in light of the Conceptual Framework, the guidance should make it clear that the lease term establishes the length of the cash flow projection period.

Lease Term Determination

We recommend a simplification of the mechanics of determining the lease term, in accordance with the proposal in the ED. The concepts set forth in the current illustration in the ED (B16 & B17) may become difficult to apply in situations with more than two lease term renewals as the current example uses cumulative probabilities. An alternative illustration would break down the process into estimating the probability of renewal at each renewal date, which is consistent with the way many (or most) constituents evaluate renewal probabilities. We recommend that the final guidance include such an illustration.

Currently, paragraph B17 provides an illustration of the determination of the lease term with the following assumptions:

a) 40 percent probability of 10-year term
b) 30 percent probability of 15-year term
c) 30 percent probability of 20-year term

These assumptions result in a conclusion of a 15-year lease term, consistent with the definition of *lease term* in the ED. However, the process of arriving at this conclusion is not entirely intuitive. It is more common to assess renewals as discrete decision points at each decision date based on an assessment of expected future events. The example can be restated as a series of discrete renewal assessments as follows:

Renewal	Period ***(Preparer Input)***	Renewal Probability ***(Preparer Input)***	Cumulative Probability (a)	Lease Term
Initial Term	10	100%	100%	10
1	5	60%	60%	15
2	5	50%	30%	20

(a) Longest period with a cumulative probability that is more likely than not to occur is deemed to be the lease term (highlighted).

This approach also results in a 15-year lease term but is founded on a more intuitive approach to assessing the renewal probabilities.

Consider a more complex scenario with an initial 15-year term and the potential for five 5-year renewals. A more intuitive way of implementing the proposed guidance would be to estimate the renewal probabilities discretely at each renewal date. In this case the concluded lease term in accordance with the proposed guidance would be 25 years.

Renewal	Period ***(Preparer Input)***	Renewal Probability ***(Preparer Input)***	Cumulative Probability	Lease Term
			(a)	
Initial Term	15	100%	100%	15
1	5	**90%**	90%	20
2	5	**75%**	68%	25
3	5	**60%**	41%	30
4	5	**45%**	18%	35
5	5	**25%**	5%	40

(a) Longest period with a cumulative probability that is more likely than not to occur is deemed to be the lease term (highlighted).

If the facts in this example are translated to the form of the current example in paragraph B17 of the ED, they would be presented as follows (note the percentages are not rounded for the purpose of reconciling the calculations):

(a) 10 percent probability of 15-year term
(b) 23 percent probability of 20-year term
(c) 27 percent probability of 25-year term
(d) 22 percent probability of 30-year term
(e) 14 percent probability of 35-year term
(f) 5 percent probability of 40-year term

The nature of the above presentation ((a) through (f)) calls for a probability assessment that is not nearly as intuitive as that presented in the table and makes the assessment of the lease term more challenging.

In summary, the determination of the lease term should be presented within a framework that is consistent with a typical probability assessment. Providing an example in the tabular format suggested above may reduce some of the perceived complexity related to this aspect of the ED.