November 3, 2010

Financial Accounting Standards Board
401 Merritt Seven
PO Box 5116
Norwalk, CT 06856-5116
Attn: Technical Director
(File Reference 1850-100)

Thank you for providing the opportunity to comment on the Proposed Accounting Standards Update entitled "Leases (Topic 840)", issued on August 17, 2010 and hereafter referred to as the "Proposed ASU".

We are generally supportive of the "right-of-use" model described in the Proposed ASU from the perspective of the *lessee*[1], although we do have some suggestions for improving certain attributes of this approach.

We have more significant concerns regarding the application of the "right-of-use" model to *lessors*. In particular, we do not agree that two different accounting methodologies (namely, the performance obligation and the derecognition approaches) should be employed by lessors, depending on facts and circumstances. Instead, we would prefer that all leases be accounted for under one methodology – the derecognition approach.

The remainder of this letter sets outs our views in more detail. Please note that we have only responded to those questions posed in the Proposed ASU that address aspects of the proposed guidance with which we have comments or concerns.

If you have any questions or require further information regarding the contents of this letter, please contact Scott Ehrlich, President and Managing Director of Mind the GAAP, at +1 (773) 732-0654 or by e-mail at sehrlich@mindthegaap.com.

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[1] In fact, once the Financial Accounting Standards Board ("FASB" or the "Board") has completed the work outlined in the 2008 Memorandum of Understanding and the related Modified Joint Work Plan, we would encourage the Board to consider expanding this model to other types of executory contracts. We believe that the "right-of-use" model best reflects the financial obligation and rights afforded to the reporting entity under most – if not all – types of executory arrangements.

1. Question 2(a) - Lessors

We believe that lessors should apply a single approach in accounting for leasing arrangements. Our preference is for the derecognition approach.

We are concerned that mandating two potential, albeit mutually exclusive, accounting approaches for lessors will not provide decision useful information to investors and creditors, while adding unnecessary complexity for financial statement preparers.

As per the Proposed ASU, the determination of whether a lease should be accounted for under the performance obligation or derecognition approach depends on the extent to which a lessor retains exposure to risks or benefits associated with the underlying asset. Even after considering the guidelines in paragraphs 28-29 and B22-B27 of the Proposed ASU, making this determination would involve a significant – and in our view unnecessary – amount of judgment.

- It seems highly likely that companies with similar fact patterns would arrive at varying conclusions regarding the extent to which exposure to risks or benefits associated with the underlying asset is retained.

- Accordingly, the financial statements of these companies would vary significantly due to the considerable differences between the derecognition and performance obligation methodologies. This lack of comparability would make it quite difficult for users of the financial statements to analyze and evaluate the financial position and results of operations of the different lessors.

Preparers, too, would not benefit from having multiple approaches in accounting for leasing operations. For each and every lease, a reporting entity would need to determine which approach – derecognition or performance obligation – is most appropriate for that arrangement. The costs of establishing processes and systems for making this determination – in our view – would be quite prohibitive and, as noted above, would far outweigh any benefits that might be obtained by users of the financial statements.

Derecognition Versus Performance Obligation Approach

Given that we do not believe that two separate accounting methods should be mandated for lessors, our preference is that all leases be accounted for using the derecognition approach.

From a conceptual perspective, we believe that in every lease, the lessor transfers some portion of the economic benefits associated with the use of an underlying leased asset to the lessee.

The partial derecognition approach, as outlined in the Proposed ASU, appropriately records and measures the economic benefits retained by the lessor in the form of the residual asset. This holds true regardless of the type of lease entered into by the lessor.

For instance, if the lessor originates (using current GAAP terminology) a direct financing lease, the value of the residual asset would, in most instances, be lower than the value of the residual asset in an operating lease. This is because the economic benefits transferred by lessors to lessees are typically greater in direct financing (and sales-type) leases as compared with operating leases. Accordingly, the derecognition approach faithfully reflects the underlying substance of the leasing arrangement no matter its structure.

In contrast, the performance obligation approach creates for the lessor a new lease receivable asset that is incremental to and separate from the underlying leased asset. In our view, this approach "double-counts" a lessor's economic benefits from the leasing arrangement. That is, it seems that the lessor would report two assets of relatively similar values for the same leasing arrangement.

We also have several additional reservations about the performance obligation approach:

- ***The principles of the performance obligation approach appear to be in conflict with the definition of a lease.*** For a contract to be a lease, it must – among other criteria – convey to the lessee the right to control the use of a specified asset (see paragraph B1). However, the Proposed ASU justifies the performance obligation approach on the basis that some lessors do not lose control of the underlying asset (BC16). We struggle with this apparent inconsistency; it seems illogical that the right to use or control an asset can be conveyed to a lessee without the lessor having lost control of that same asset.

- ***The performance obligation approach is inconsistent with the proposed approach to lessee accounting.*** Under the Proposed ASU, the lessee will record a right-of-use asset representing the right to use an underlying asset over the lease term. It logically follows that the lessor must have given up some of the economic benefits associated with the underlying asset (or exchanged those economic benefits for another asset – that is, a receivable). This exchange is faithfully reflected in the derecognition approach. In contrast, the performance obligation approach creates three assets between the lessee and lessor: A right-of-use asset (lessee), a lease receivable (lessor) and an underlying asset (lessor). In aggregate, the performance obligation model overstates the sum total of the lessee and lessor's assets because the carrying value of the lessor's underlying asset overlap to a large extent with the economic benefits that are represented by the lessee's right-of-use asset.

- ***The transition to the performance obligation approach would be unduly burdensome to existing lessors.*** We agree with the Board's proposal for a simplified retrospective approach in transitioning to any new lease accounting standard. However, it would be quite burdensome to use this form of transition if a performance obligation approach were required for lessors. Specifically, upon transition, lessors would have to reinstate underlying assets as if those assets had never been derecognized. In order to do so, lessors would have to re-create asset registers for leased assets to calculate those assets' original cost, depreciation and impairment charges. Operationally, it would be far more efficient for lessors under the derecognition approach to simply record the fair values of any residual assets underlying existing lease arrangements as of the date of transition.

2. Question 4 – Definition of a Lease

We note that paragraphs B1-B4 of the Proposed ASU carry forward the long-standing guidance promulgated by EITF 01-8 *Determining Whether an Arrangement Contains a Lease* (codified as part of ASC 840-10-15) and IFRIC 4 *Determining Whether an Arrangement Contains a Lease*. Although these guidelines have been in effect for quite some time, we find in our experience that they can be quite difficult to apply in practice, as demonstrated in the examples below:

Example 1: A manufacturer uses approximately 90% of the water output produced by a municipality-owned treatment plant. The manufacturer pays an agreed-upon rate per gallon of water consumed (and subject to annual adjustment), calculated to cover the municipality's debt service obligations related to variable-rate bonds issued to build the plant. We are uncertain, based on the guidelines in ASC 840-10-15 whether this arrangement is or contains a lease.

Example 2: A wind farm operator enters into a land-use agreement with a farmer. The operator obtains the right to build and operate a wind turbine on the farmer's land, totaling 450 acres. The actual wind turbine will occupy about an acre of the land, and access roads will consume another two acres. The farmer retains the right to use the rest of the land (i.e., 447 acres) for agriculture, recreation, and exploitation of mineral rights below the surface, with the condition that the farmer will refrain from undertaking landscaping or building structures that impede wind flow. In return, the wind farm operator agrees to pay the farmer the greater of a specified rate per megawatt of the wind farm's generating capacity, or a specified percentage of revenues from sales of electricity generated by the wind farm. Again, we are uncertain whether this arrangement is or contains a lease based on the current guidance set out in ASC 840-10-15.

In any final pronouncement, we kindly request that the Board provide several additional examples of implementation guidance for these and other "real life" arrangements to help assess whether they would in fact be considered lease contracts within the scope of ASC Topic 840.

3. Question 6 – Distinguishing Service Components from Lease Components

Under the right-of-use model outlined in the Proposed ASU, it will be important for companies to distinguish between the service and lease components of a given contract. We acknowledge that it will be relatively simple to determine distinct service components for many leases of real property (e.g., maintenance, insurance, taxes, etc).

However, in other less straightforward situations, we have reservations about how to operationalize the guidance in paragraph B7 on determining whether a service component is distinct or not, as shown in the example below:

Example 3: A manufacturer/lessee uses 90% of the water output produced by a municipality-owned treatment plant. Assume that this arrangement is determined to contain a lease.

For the manufacturer to distinguish between the lease component (i.e., the lease of the underlying water treatment plant) versus the service component (the provision of water by volume), paragraph B7 requires practitioners to consider whether:

The entity, or another entity, sells an identical or similar service separately

- Practitioners may differ in answering this question. On the one hand, it would seem that the provision of water, in general, is not unique to the municipality-owned plant – for example, water could be trucked in from an outside source. On the other hand, one could argue that the provision of the quantity of water specific to the manufacturer's geographic location and needs cannot be met in practice by any other party besides the municipality through its treatment plant.

The entity could sell the service separately because the service has a distinct *function and a distinct profit margin*

- While it seems intuitive that the provision of water has a distinct function apart from the plant and equipment used to process it, we are not sure whether it has a distinct profit margin. On the one hand, a key resource used to provide the water is the plant itself; therefore the provision of water is also subject to the same risks as those facing the plant. One the other hand, one could also argue that the provision of water is subject to risks and resources distinct from the physical plant (e.g. tide levels, the implicit levels of salinity/chemical content/bacteria content in the water source, etc.).

Our underlying concern with the guidance in paragraph B7 revolves around the notion of "distinct", which we feel is unclear at best. We expressed similar views as part of our comment letter dated September 20, 2010, in response to the Proposed Accounting Standards Update entitled "Revenue Recognition (Topic 605): Revenue from Contracts with Customers". We request that the Board consider our views set out in that September 20, 2010 letter in developing an alternative method for distinguishing between service and lease components.

4. Question 5 – Scope Exclusions

We would ask the Board to reconsider its proposal to exclude leases of intangible assets from the scope of the Proposed ASU. We note that the Board, itself, has identified no conceptual reason why lease accounting guidance should exclude intangible assets (paragraph BC36).

In practice, many companies enter arrangements involving the right to use intangible assets – for instance, as part of intellectual property licenses. However, there is presently limited accounting guidance for these arrangements. Our view is that purchasers of rights to use intellectual property should record a right-of-use asset at the commencement of the license period and a related obligation for the future payments (as applicable), similar to the lessee accounting set out in the Proposed ASU.

5. Question 9 – Use of Expected Outcome Technique to Measure Assets and Liabilities arising from a Lease

We have fairly serious concerns as to whether the expected outcome technique for measuring contingent rentals will result in information that is relevant and reliable to the primary users of the financial statements. To illustrate:

Example 4: Assume a retailer (lessee) agrees to pay $1 million to a lessor if the retailer achieves specified revenue targets during the next year. There is a 51% chance that the retailer will meet these revenue targets, and a 49% chance that these targets will not be met. Assuming a discount rate of 6%, the retailer will include approximately $481,000 in the measurement of its right-of-use asset and liability to make lease payments at the inception of the lease.

	Likelihood of occurrence	Probability-weighted average	Discounted amount
Contingent rent is triggered	51%	$510,000 (51% x $1,000,000)	$481,132
Contingent rent is not triggered	49%	-	-

Our belief is that the retailer-lessee's right-of-use asset and liability to make lease payments is either overstated by $481,132 or more likely understated by $462,264 [($1,000,000 / (1 + 6%)) - $481,132]. This is because the future cash outflow related to the contingent rental will ultimately amount to either $1,000,000 or zero. There are no alternative outcomes where the retailer would settle its contingent rent obligation for $481,132 (or $510,000 on an undiscounted basis).

From a lessee perspective, our view (as previously outlined in Mind the GAAP's August 12, 2010 comment letter on the Proposed Accounting Standards Update entitled "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities") is that an expected outcome measurement for liabilities does not provide useful decision-making information for investors or other primary users of the financial statements. Simply, the lessee has no ability to settle the obligation at an expected outcome amount. We strongly believe that an expected outcome measurement technique mischaracterizes the amount of resources necessary for the lessee to settle its obligations to make lease payments and provides misleading information to investors and creditors.

From a lessor perspective, we also do not support recognizing contingent rentals when reliably measurable, since presuming that threshold is achieved, the measurement would also be based on an expected outcomes approach. For more information regarding our views regarding the recognition and measurement of contingent income, please refer to Item #3 of our September 20, 2010 comment letter in response to the Proposed Accounting Standards Update entitled "Revenue Recognition (Topic 605): Revenue from Contracts with Customers".

In lieu of the expected outcome technique, our preference is that a lessee (and lessor) should use the cumulative probability approach for recognizing measuring contingent lease payments – similar to the method for estimating the lease term as set out in the Proposed ASU.

Under this approach, a lessee would include in its estimated future lease payments the largest amount of contingent rentals that will more-likely-than-not be paid to the lessor (that is, the largest amount of contingent rentals that is cumulatively greater than 50% likely to be paid to the lessor). In making this determination, lessees would still undergo a rigorous process of evaluating the likelihood of reasonably possible contingent payment outcomes. However, the lease liability that is ultimately recorded will in fact be the largest amount that is more likely than not to be paid.

Example 5: Lessee A has to pay contingent rents based on a specified percentage of its retail sales. Lessee A estimates the probability of several possible contingent rent outcomes:

	Outcome 1	Outcome 2	Outcome 3	Outcome 4	Outcome 5
Amount of contingent rent that A might have to pay	$500	$400	$300	$200	$100
Likelihood of payment	10%	20%	25%	25%	20%
Cumulative likelihood of payment	10%	30%	55%	80%	100%

Under the “more-likely-than-not” approach, Lessee A would include $300 of contingent rent in its initial estimate of the future lease payment obligation.

Example 6: Lessee B agrees to pay $1 million in contingent rent if Lessee B’s sales exceed a specified target. There is a 50% chance that the Lessee B will achieve the sales target, and an equal chance that the target will not be met. Under the “more-likely-than-not” approach, Lessee B would include $0 contingent rent in its estimate of future lease payments.

Irrespective of our views set out above, there is a potential inconsistency in the proposed guidance for estimating contingent rentals.

Under the Proposed ASU, when contingent rentals depend on an index or a rate, the lessee and lessor should determine the expected lease payments using readily available forward rates or indices. If forward rates or indices are not readily available, the lessee and lessor should use the prevailing rates or indices.

Our experience suggests that many leases call for rent escalations based on the change in commonly available statistics, such as the consumer price index, or CPI. Furthermore, our understanding is that the CPI has been published since 1913. Similar indices in other jurisdictions have likely been around for substantial periods of time as well, although perhaps not as long as 97 years.

We also understand that forward rates are not published, at least by governmental agencies, for CPI. Accordingly, reporting entities would, in effect, factor no rental increases when calculating the lease payments to be made under the arrangement, even though historical data suggests that CPI almost always increases over time.

Given this background, we are unsure as to why the Board:

- Feels it would be difficult to forecast future index rates – particularly for measures such as CPI, for which there is rich historical data – but

- Is comfortable in having lease participants estimate other types of contingencies, such as those related to future sales revenue, which in our view are far more difficult to predict.

Our preference – for reasons of consistency and simplicity – is that all forms of contingent rentals follow a single model for recognition, initial measurement, and subsequent measurement. As noted above, we favor a cumulative probability approach for both recognition and measurement of all types of contingent rental provisions. Said another way, we would make no accounting distinction between contingent rents that are based on indices, rates, or other factors.

On a related and final point, we believe that the discussion in the Proposed ASU should be clearer around when forward rates can be used related to contingent rentals based on indices.

Paragraphs 14(a), 35(a), and 52(a) of the Proposed ASU indicate that readily available forward rates should be used in measuring contingent rentals that are based on an index. Paragraph BC131 further indicates that "if forward rates…are readily available for the period of the lease term (for example, *<u>from a government department or public service agency</u>*), using such forecasts would limit costs to adjusting the available rates or indices while providing better information to users of financial statements." [emphasis added]

In reading the aforementioned statements in the Proposed ASU, a few of our clients have inquired as to whether forward rates can only be considered "readily available" if they are published by a government or public service agency. It would be helpful if a final standard on lease accounting could clarify whether this is the case, or whether forward rates published by non-governmental organizations (for instance, by commercial banks or Nationally Recognized Statistical Rating Organizations, such as Moody's or Standard and Poors) can also be considered "readily available".

6. Question 13 – Presentation and Disclosure for Lessee in Income Statement

Under the Proposed ASU, lessees will record amortization expense on a right-of-use asset and interest expense on the related lease liability.

As compared with current U.S. GAAP guidelines, a number of lessees will report improved Earnings Before Interest, Depreciation and Amortization, or EBITDA, because the rental expenses previously associated with operating leases will instead be reported as amortization and interest expenses. As EBIDTA is an important performance measure for many financial statement users, we ask the Board to ensure that investors and creditors are appropriately informed – and approving – of the impact of the Proposed ASU on reported EBITDA.

If the proposal for lessees to split their lease rental expenses into amortization and interest expense is ultimately adopted, we strongly recommend that lessees should also be required to present in the footnotes a sum total of amortization and interest expenses arising from leases. Such disclosure will provide useful information to investors about the total costs of a lessee's leasing activities. We envisage that this information would be presented in the following tabular format:

Amortization of right-to-use asset	xx
Interest expense on lease liability	xx
Total effect of leasing activities on profit and loss	xx
Total cash paid for leasing activities	yy

7. Question 14 – Operating Classification for Lessors' Cash Flows

In many types of leasing agreements, a lessor is in substance financing a lessee's purchase of an underlying asset. Said another way, the economics of these arrangements are similar to a lender making a collateralized loan to a borrower.

Accordingly, we believe that the cash flows associated with leasing arrangements, from the perspective of a lessor, should be classified in the Statement of Cash Flows in the same manner as cash flows from lending activities. As currently set out in the Proposed ASU, this would not be the case:

- Paragraph 45 of the Proposed ASU requires that the cash inflows from lease payments received by a lessor be classified entirely as operating activities.

- Under existing U.S. GAAP (ASC 230-10-45-13(a) and ASC 230-10-45-16(b)), cash flows from loan payments received by a lender are apportioned between investing (for the principal repayments) and operating (for interest) activities.

We would ask that the Board reconsider the requirements for lessor classification of cash receipts under a leasing arrangement. Specifically, we suggest making these requirements consistent with the guidelines presently applied by traditional lending institutions, in which the “principal” portion of the lease payment is classified as a cash inflow from investing activities, and the interest portion of the lease payment is classified as an operating cash inflow.

8. Other Comment – Omission of Other Lease-Related Topics Currently Addressed in U.S. GAAP

Although the Proposed ASU addresses many features of lease accounting, there are certain aspects of current U.S. GAAP that were not specifically discussed in the Board’s proposals.

For example, we did not note any discussion around the accounting for lease incentives in the Proposed ASU. At present, paragraphs 6-7 of ASC 840-20-25 provide some guidance on the accounting for lease incentives in an operating lease. Although the notion of an operating lease is eliminated by the Proposed ASU, we do believe that lease incentives will continue to be offered by lessors. We are uncertain how to account for such incentives under the right-of-use model set out in the Proposed ASU, both by lessors and lessees.

- We assume that lessors should account for such incentives as initial direct costs. However, we note that the definition of an initial direct cost states that it must be “recoverable”, which may not be the case for some types of incentives.

- We are less clear about the accounting for lease incentives by a lessee, since the Proposed ASU does not specifically address this matter. Should such incentives be treated as a reduction in the lease payments? Should they be ignored for accounting purposes? We ask that the Board provide more clarity around this topic in any final pronouncement.

Another area not specifically discussed in the Proposed ASU involves transactions in which a lessee is involved in the construction of the asset to be leased. Current U.S. GAAP guidelines (notably, paragraphs 2-16 of ASU 840-40-55) describe when a lessee should be considered to be the owner of an asset during the construction period. It is unclear from the Proposed ASU whether this guidance will be carried forward following the issuance of any new leasing guidance, or whether it will simply be eliminated.

We are not necessarily averse to eliminating this “rules-based” guidance, but we are concerned that the Proposed ASU generally lacks guidelines on the accounting between (a) lease inception and (b) lease commencement – apart from perhaps paragraphs 73(b), BC35, and BC173-B174. In many cases, we acknowledge these two dates will be quite close to one another, and the need for specific guidelines is probably not necessary. However, in other circumstances (such as when a lease is signed prior to the construction of the leased asset), there could be a considerable delay between lease inception and commencement.

Our reading of the Proposed ASU is that unless the lease contract is onerous, no accounting recognition should be given to the arrangement between lease inception and commencement. However, disclosure of the lease commitment is required in the notes.

While we do not necessarily agree with these principles, we wouldn’t object to them either. This is because they are operationally simple to apply and provide users of the financial statements relevant information about a reporting entity’s lease commitments. However, we do ask that the Board better articulate in any final leasing standard its intent and rationale for not requiring companies to recognize the vast majority of lease arrangements (with the exception of onerous leases) until the date of lease commencement, particularly since this would be a significant change from current GAAP. We did not find the discussion in paragraphs BC173-BC174 particularly helpful in this regard.