December 1, 2010

Technical Director
File Reference No. 1850-100
FASB, 401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Sent via Email to director@fasb.org

Re: Proposed Accounting Standards Update – Leases (Topic 840)
Re: Lease Term – Question 8

Dear Sir,

I read with interest your recent Exposure Draft for a Proposed Accounting Standards Update for Leases. However, I am concerned that the current version is not consistent with the boards’ stated Basis for Conclusions in that it may still permit material financial structuring to circumvent comparability of accounting.

In paragraph BC6, the boards consider that the proposed right-of-use model would address many of the problems in existing US GAAP. In particular, paragraph (c) suggests the new standard would “increase comparability of the statement of financial position and the income statement for users of financial statements and reduce the opportunity to structure transactions to achieve a desired accounting outcome.” However, the proposed language to be used when considering the term of the lease suggests that some simple, creative structuring of lease arrangements may continue to permit preparers to keep most of the value of leased assets and liabilities off their balance sheets.

For example, consider a situation with leases of 100 identical items, each with lease payments of $1 per year for 10 years – payable at the end of each year. Assuming an interest rate of 10% per annum, the proposed standard should result in an initial asset and liability of $614.

Now consider a more creative structure where all leases have an initial term of 1 year. At the end of the first year, a random number generator is used to determine whether the lease is extended (49.9% of the time it is extended, 50.1% it is terminated) for 9 years. In the event that the lease is extended, the lease payment is changed to $2 per annum. In the event that the lease is terminated, the lessee keeps the asset at no additional cost.

The expected payments under this structure are, for all intents and purposes, identical to the original 10-year lease and, given sufficient number of comparable assets being leased, could be structured to have minimal variance. However, it is clear that the longest possible lease term that is “more likely than not”
to occur is ONLY the initial one year period. As such, my understanding of the current proposed language would require only $91 (at most) to appear on balance sheet at lease initiation.

The structure can be extended relatively easily to keep the value of lease assets and liabilities outside the currently proposed draft wording throughout the life of the leases.

To resolve this concern, the boards may wish to consider an approach for grouping leases of similar assets when considering extension terms - which would presumably prevent the structure I mention above. Alternatively, it may be feasible to give additional weight to the expected outcome technique to ensure that increases in payments such as those mentioned above do not fall below the evaluation of the lease term in a sequential evaluation of what should be included.

Thank you for your consideration of this matter. Please do not hesitate to contact me should you require any further clarification of my comments.

The views expressed in this letter are my own, not necessarily those of other Faculty and Staff of Northwestern University.

Yours faithfully

Craig Chapman