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RE: File Reference No. 1850-100, Exposure Draft of August 17, 2010 on Leases (Topic 840)

Thank you for the opportunity to comment on the exposure draft of the Proposed Accounting Standards Update on Leases (Topic 840).

CapinCrouse LLP serves the not-for-profit community with assurance, tax and advisory services. This has been our focus since 1972, when the firm was founded. With nine offices spanning from Atlanta to Los Angeles, we’re a national accounting firm with a practice approach that helps us leverage expertise and best practices from across the firm to best meet the specific needs of our clients.

My perspective on this topic is that of the not-for-profit organization and is provided in the context of answers to the questions posed by the exposure draft.

**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?

I support the proposed guidance regarding the right-of-use model. This will effectively eliminate the financial reporting differences that can result from minor calculation changes (whether inadvertent or intentional) performed in accordance with existing guidance. The recognition of a right-of-use asset and related obligation accurately reflects the recording requirements of an asset and liability.

(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?

Yes, I agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments. Some preparers have noted concern regarding the concepts permitted by paragraphs 16(a) and 20, which require that the interest method be used to amortize the liability, while allowing any “…systemic basis…” to amortize the asset. The concern is that this will produce a non-linear relationship between the asset and the liability as recorded in the financial statements. I do not share this concern. Current financial reporting models already produce non-linear relationships between capital assets and related long-term debt (as is the case with capital lease assets and liabilities). I believe the board should retain the requirements of paragraphs 16(a) and 20 without modification.
Question 2: Lessors
(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

I do not agree with either approach.

The performance obligation approach recognizes the same asset twice…once on the books of the lessee, and once on the books of the lessor. In addition, it creates an artificial liability on the books of the lessor (solely to balance the transaction for the lessor). Once the lessor has provided the right-of-use to an asset to a lessee, their obligation in the transaction has been satisfied.

According to the derecognition approach, a lessor should recognize as an asset the right to receive lease payments (seemingly a receivable of some sort), while simultaneously recognizing as an asset the remaining portion of the carrying amount of the underlying asset that represents the rights in the underlying asset that the lessor retains. This “residual asset” is the product of a defined calculation according to paragraph 50. Any rights that the lessor retains must be insignificant, or the performance obligation method must be used. It seems confusing to me why an organization would maintain, as an asset, any “insignificant” item. In addition, I believe users of a financial statement would be confused by two assets (the right to receive lease payments and the “residual asset”) relating to the same transaction.

(b) Do you agree with the boards’ proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

See answer to 2(a).

(c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

As stated in the answer to 2(a), I do not agree with the proposed revisions to lessor accounting. Should the board undertake a future project to consider lessor accounting, the issue of leveraged leases could be handled at that time.

Question 3: Short-term leases
This 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?

Yes, I agree that a lessee or a lessor should account for short-term leases in this way. This allows for a straightforward, non-complex manner in which to handle short-term transactions in a cost beneficial fashion.

**Question 4**

**Definition of a lease**

This 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 BC59BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

Yes. This simplified approach follows the guidance as established by the exposure draft and is straightforward in its definition.

(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?

No comments.

(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?

No comments.

**Question 5: Scope exclusions**

This 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?

Yes, I agree with the proposed scope. Regardless of the level status (first tier lessee or sub-lessee), any lessee should record its leases in accordance with the proposed guidance. This will provide consistency in financial reporting and disallow creative financing options in order to avoid the scope of the reporting requirements. Leases of intangible assets, biological assets, or the right to explore for or use minerals, oil, natural gas and similar non-regenerative resources are not common within the not-for-profit sector; therefore, I do not have any comments on these exceptions.
Question 6: Contracts that contain service components and lease components
This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, Revenue Recognition (Topic 606): 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) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.
(b) The 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?

Because I do not agree with the provisions of this exposure draft related to lessors, I do not agree with the IASB position.

I do agree with the FASB position as it requires the application of the exposure draft’s provisions to contracts that contain service and lease components in some fashion. Obviously, if the lease components of such a contract are immaterial, these provisions need not apply; however, this particular standard requires a careful and measured review of such contracts prior to making such a determination.

Question 7: Purchase options
This 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?

I agree that a lease contract should be considered terminated when an option to purchase the underlying asset is exercised. This is consistent with any other transaction where a buyer obtains full right to an asset and a seller exchanges their right for other consideration.

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?

No, I do not 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. The mere existence of an option to extend or terminate does not create an asset or liability. These options must be exercised before they can be recognized. The lease term would be defined as inception through the earliest measurable date of termination, whether by expiration or intentional termination (only once exercised).
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?

Generally, no, I do not 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. My answer to question 8 flows here as well...without the exercise of certain options, no such penalties or residual value guarantees would exist. I do, however, believe that this type of information should be clearly disclosed in a "what if" style presentation.

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?

Similar to the above question, no, I do not 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. Until such options are exercised, there is nothing to recognize. Again, this information should be readily available in the footnotes to the lessor’s financial statements.

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?

Yes, I agree that lessees and lessors should remeasure assets and liabilities arising under a lease in these circumstances. Just as other assets and liabilities are checked each year for fair value measurements, so should these.

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?

No comment.
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?

I agree with the proposed treatment for the right-of-use assets. Including these within property, plant and equipment seems consistent with the intentions of the exposure draft. Regarding the liabilities to make lease payments, I recommend allowing these liabilities to be included with other long-term debt on the face of the statement of financial position. The footnotes should then provide the detail underlying that particular line item.

(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totaling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

No comment.

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

No comment.

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

No comment.

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?

I think that materiality comes into play with this issue. The more significant the information may be to the reader, the more it would be necessary to include the disclosures on the face of the statement of activities. If this information is not included on the face of the statement of activities, it should be clearly disclosed in the footnotes.
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?

I believe cash flows arising from leases should be presented in the statement of cash flows in accordance with whatever line items the related assets and liabilities are reflected in the statement of financial position. For example, if the liability to make lease payments is a separate line item on the statement of financial position, then cash flows related to this liability should also be separated in the statement of cash flows. Whereas the right-of-use asset would be included with property, plant and equipment in the statement of financial position, transactions regarding the right-of-use asset would be included with similar transactions related to non-leased property, plant and equipment in the statement of cash flows.

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?

Yes, I believe these disclosures to be necessary as they are useful to the reader. I particularly agree that disclosures describing how leases may affect the amount, timing and uncertainty of the entity’s future cash flows would be very useful to the reader. Because I do not agree with the recognition and recording of options described in question 8, the “what if” disclosures included in paragraphs 73-86.

Question 16
(a) This 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 (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

Yes, I agree that the simplified retrospective approach is appropriate. Requiring a full retrospective approach could potentially generate more cost than benefit, particularly in the not-for-profit community.

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

Yes, I believe the full retrospective application should be permitted. The usefulness of this disclosure may be particularly important to an organization based on its facts and circumstances.

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

No comment.
Question 17
Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

Yes, I agree with the boards’ assessment that the benefits of the proposals would outweigh the costs (as related to lessee accounting – I do not support the proposed changes to lessor accounting). As I stated in my answer to the first question, I support the proposed guidance regarding the right-of-use model as it will effectively eliminate the financial reporting differences that can result from minor calculation changes (whether inadvertent or intentional) performed in accordance with existing guidance.

Question 18
Do you have any other comments on the proposals?

No comment.

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?

Regardless of the type of entity, a lease transaction should be reported in accordance with one set of guidance. There should not be different guidance for non-public entities.

Thank you again for the opportunity to provide comment on the exposure draft of the Proposed Accounting Standards Update on Leases (Topic 840). I am available to discuss any questions you may have regarding my comments.

Sincerely,

S. Griffin
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Partner
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