December 15, 2010

Leslie Seidman, Acting Chairman
Financial Accounting Standards Board
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Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6xh
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VIA Email: director@fasb.org

Re: File Reference No. 1850-100, Exposure Draft: Leases (Topic 840)

Dear Ms. Seidman and Sir David Tweedie:

Cisco Systems, Inc. ("Cisco") appreciates the opportunity to comment on the joint Exposure Draft, Leases ("Proposal" or "Exposure Draft"), recently issued by the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") (collectively, the "Boards"). We view this Proposal as potentially one of the most significant accounting standards resulting from the convergence efforts between the FASB and IASB as it fundamentally changes the way leases have been accounted for by lessors and lessees under U.S. GAAP and IFRS for over 30 years.

We generally agree with the Proposal's conceptual shift from the current bright-line analysis to a more principles-based framework and believe this to be a positive step in addressing criticisms of today's accounting guidance. While there are many improvements in the Proposal, we see several areas presented in the Exposure Draft that will impose additional complexity. Specifically, we are concerned with the changes being proposed will significantly increase the required management judgment related to estimating lease payments and will significantly increase the administrative burden on preparers by requiring this Proposal be applied on a lease by lease basis. Additionally, we believe that requiring such assessments on an on-going basis will be unduly burdensome on preparers without providing significant improvement to financial reporting during the term of the lease. Lastly, we believe the Boards should ensure symmetry between the revenue recognition framework under the Revenue Recognition Exposure Draft and this Proposal due to the close interaction of these standards in practice. We believe that symmetry between these two standards is more critical than between lessee and lessor accounting. Currently, there are several principal inconsistencies as further discussed in our letter.

We are supportive of the general principles of the Proposal, however, we believe that there are some key conceptual and application issues, as described below, to make the Proposal operational. We urge the Boards to address these concerns as they evaluate the results of outreach efforts and redeliberate the comments received on this Proposal.
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Overview and Summary

One of the Boards' objectives with the Proposal is to prevent economically similar transactions from being accounted for differently because of the current distinction between operating and finance leases. This distinction makes it difficult for investors to compare entities and the financial implications of different leases. However, we believe the Proposal will continue to allow economically similar transactions to be accounted for differently by the lessor and the lessee due to the significant amount of management judgment that will be required both at inception and during subsequent reporting periods. We believe this will result in more differences among entities when compared with current practice. In addition, in trying to compensate for the shortfalls in the current lease model, the Proposal requires recognition of the same underlying asset by both the lessee and the lessor (under the performance obligation approach), measured using their respective judgment and assessments. Therefore, the same transaction will continue to be inconsistently accounted.

We recommend that the Proposal provide an overall scope exclusion for leases that are not material, individually or in the aggregate, or that are related to non-core business assets (i.e., general administrative overhead assets such as printers and copiers). The proposed process seems onerous both at inception and with the subsequent remeasurement required for these lease categories, and we do not believe it would provide any significant benefit to the constituents of this financial information.

As noted above, we are generally supportive of the Boards' objective of creating a principles-based lease model which can be applied consistently across all transactions and industries. Furthermore, we agree with the Boards' objective of providing additional information to users of financial statements. However, the cost and substantial effort for companies to adopt this Proposal should be considered in conjunction with the perceived benefits as viewed by the Boards. We view that the significant level of management judgment (as detailed below and in the Appendix) as well as the transition process will be the most difficult and costly aspect of the Proposal. Preparers will be required to significantly modify or build new systems to gather and track information required by this Proposal. Although we have not fully analyzed the impact, we believe the labor and system costs alone to support the implementation of the simplified retrospective application of this Proposal would be approximately $50 million over the implementation period. We believe the Boards should simplify the approach, particularly around the ongoing lease accounting, which we believe would not compromise the overall objective of the Proposal. Such simplifications would result in an ease of transition which would allow preparers to adopt more quickly and lower the overall cost of adoption. In summary, there are several areas in this Proposal that require significant management interpretation and judgment, where we believe the Boards need to provide further clarity and in some cases reconsider. We have outlined those areas below and in our response to the questions in the Proposal.

Specific Comments

Our specific comments related to our concerns with the Exposure Draft are expressed below.

Lessor Accounting

We understand and agree with the Boards' approach to allow for two lessor accounting models given the diversity in the business models inherent in the leasing industry. Under the Proposal, each lease must be assessed as to whether "significant risks or benefits" are retained to determine whether to follow the performance obligation model or the derecognition model. We request further clarification regarding the determination of "retaining significant risks or benefits." As it is currently written, this would potentially result in applying different approaches to similar transactions due to the ambiguity regarding the distinction between a purchase or sale transaction and a lease as further described in our response to Questions 2 and 4 in the Appendix.
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The business strategy consideration should be the primary criteria for determining the appropriate lessor accounting approach based on a unit of account as determined by management. We believe this suggestion aligns with the Board’s basis of conclusion as indicated in paragraph BC27; an entity’s business model will indicate whether a derecognition or a performance obligation approach would be appropriate. As currently drafted, because the assessment would be made on an individual lease basis, a lessor would not be able to assume that all of its lease contracts, for a particular business strategy, would be accounted for under the same approach.

Lastly, the lessor accounting model under the Proposal is based on a “risks and rewards” model and conceptually inconsistent with the “control” model under the Revenue Recognition Exposure Draft. We believe this conceptual inconsistency undermines the efforts to enhance the financial reporting standards and the overall convergence project of the Boards and they should reconcile this discrepancy as part of the issuance of final revenue recognition and lease standards.

**Embedded Service Contracts**

We believe more guidance should be provided for distinguishing between lease and service components within a contract. As currently written, the guidance could result in entities accounting for similar transactions in significantly different ways. More specifically, we believe that the Boards should reconsider the guidance in paragraph B2 relating to when a “contract depends on providing a specified asset.” Paragraph B2 states that an asset is implicitly specified “if a lessor can substitute another asset for the underlying asset, but rarely does so in practice.” We believe that if the asset can be interchanged by the lessor, even if rarely done in practice, the lessee inherently does not unilaterally control the underlying asset. In these arrangements, the lessee typically does not believe it controls the underlying asset, but rather that the lessor controls the asset that is a component of the overall services contract. Such assets should not trigger lease accounting and the combined contract should follow the guidance under the Revenue Recognition Exposure Draft and be accounted for as a services arrangement.

In addition, there are several elements in this section of the Proposal that reference the Revenue Recognition Exposure Draft for guidance. There should be consistency between the two proposals in regards to bifurcating the service and lease components and subsequently allocating the payments. Based on the guidance provided in the Revenue Recognition Exposure Draft, the payments would be required to be allocated between the service and lease components only if they are deemed to be distinct. However, as mentioned in our comment letter on the Revenue Recognition Exposure Draft, we believe there should be more clarity on the definition of the term “distinct.” We also disagree with the strong link in the guidance between performance obligations and identifying the associated cost or profit margin. We believe that companies should be able to estimate margins as they would for selling price in the determination of whether an item is considered distinct. The primary focus should be whether or not the item is or could be sold on a stand-alone basis. An improved approach would be to use a top-down approach starting at the contract level where an entity would analyze the contract for what the vendor could practically sell on a stand-alone basis, as applicable to its normal course of business and its industry. We believe this approach is more practical and will result in more consistency between companies which will result in more decision useful information for users of the financial statements.

Furthermore, if the values of the separate components of the contract are not observable then the entity is required to estimate the values based on transaction price per the guidance provided in paragraphs 50–52 of the Revenue Recognition Exposure Draft. However, this concept is inconsistent with the concept of “payments required by the contract” as indicated in the Leases Exposure Draft. As such, we request the Boards resolve this inconsistency.
Management Judgment

The Proposal will introduce new areas of significant management judgment. While we are supportive of a principles based approach, we are concerned that these new areas of judgment could result in inconsistency in practice and significant complexity. As such, we recommend that further clarity and simplification be provided in the Proposal. The areas of particular concern are as follows:

Term and Contingent Rent – We understand the financial statement user community believes that the expected cash flows to be paid (rather than the minimum lease payments) would provide decision-useful information. However, options and contingent rentals are not present obligations that are probable and estimable arising out of a past event, and as such do not meet the definition of a liability. Such contingent amounts are not a constructive obligation that the lessee has little or no discretion to avoid. Similarly, for lessors contingent amounts are not an enforceable right to cash, but rather an expectation of a future right to cash weakening the current definition of a receivable. Since the lessee is not obligated until it exercises the option and it has wide discretion over whether or not it will incur the economic sacrifice, we do not believe it has incurred a liability as defined. In addition, we are concerned that in an effort to forecast future behavior, the amounts recorded at inception will be highly subjective and subject to significant adjustment, particularly towards the end of certain milestones in the lease contract (e.g., renewal period). This could result in significant volatility during the lease term due to subsequent reassessments and would defeat the objective of ensuring consistent practice as well as meeting financial statement users’ needs to understand expected cash flows. While we are supportive of a principles based approach in this area, we would recommend further practical guidance to ensure consistency in practice and avoid artificial volatility.

Probability Weighted Approach – We understand that a probability weighted assessment is fundamental to any estimation process. There are many models and techniques that are available that contemplate probability. We ask the Boards not be so prescriptive in the approach, but instead allow management to determine the most suitable methodology. The final standard should set a principles based framework that has flexibility to encompass future business practices and allow for specific facts and circumstances as opposed to presupposing management’s judgment as to the selection of the most appropriate estimation methodology. The goal should be to select the method that arrives at the expected value of right-of-use asset under a lease contract. The proposed probability weighted approach will likely result in amounts which are not reflective of an expected value, but rather a mathematically derived amount that is not reflective of the underlying economics of a transaction.

The Proposal presents greater challenges than existing guidance. The extensive use of estimates could lead to inconsistencies in interpretation and practices. Although, the approach may appear to have theoretical purity, the ongoing costs of performing this analysis on thousands of leases each reporting period does not provide a lot of value to investors and negate its benefits. Our recommendation is to not be prescriptive on the use of a probability weighted approach, but to allow companies to use management judgment in the determination of the most appropriate methodology based on facts and circumstances.

From a practicality and operability perspective, we are concerned that this change will require entities to incur significant costs to track and account for at inception and in subsequent reporting periods. We recommend simplification of the ongoing lease accounting without compromising the overall objective of the Proposal.
Disclosures and Transition

We agree with the Boards' objective of providing additional information to investors and other users of financial statements, but the quality of the information and quantity of disclosure should be carefully considered against the cost and burden imposed on preparers of financial statements. We have specific concerns about the requirement to disclose the significant assumptions and judgments and any changes in those assumptions and judgments as we believe it will confuse users with too much additional information. In our opinion, the current maturity disclosure requirements to reconcile future minimum lease receivables/payments, interest income/expense, to the receivable asset/payment liability, by both the lessor and lessee, is sufficient to provide useful financial information to the users. Any further disclosures should be at management's discretion based on particular facts and circumstances and what management believes will provide decision useful information to users of their financial statements. We believe it would be prudent for the Boards to address disclosure requirements in the Proposal in conjunction with the other pending convergence projects. We believe the volume of proposed additional disclosures when taking all of the projects into consideration is onerous and we do not believe will necessarily improve financial reporting. It is important to not only assess disclosure requirements for each standard individually, but also in consideration of other standards to ensure that disclosures are meaningful in the broader context. It is often difficult to assert that any individual aspect of disclosure is unimportant and, consequently, it is key to understand how disclosures from other standards will interact and whether truly critical disclosures are obfuscated when too much disclosure of non-critical areas is provided.

While we agree that the simple retrospective application would provide users of financial statements with useful information, this would be extremely costly for many entities. In addition, this relief of allowing the simplified retrospective approach over full retrospective approach does not provide much reduction in effort, costs or lead time to implement the proposal as the incremental transactional level information is currently not tracked or managed in a systematic manner. We believe that the simplified retrospective application should be an alternative, but also allow full retrospective or prospective application for all new contracts as of an effective date. Prospective application would ease the administrative burden of applying this new Proposal, which may shorten the lead-time necessary to adopt this standard for many preparers. The transition method should be at management's discretion based on what the users need balanced with the cost of providing that information. Full retrospective application would be consistent with the Revenue Recognition Exposure Draft and potentially more appropriate for contracts with both service and lease components.

Consistency Across Convergence Projects

As the Boards make progress on the convergence projects, the ultimate goal should be consistency among the accounting standards. Throughout our responses, there are currently inconsistencies in the proposed transition approaches for leasing, financial instruments, revenue recognition and other projects, which will result in financial statement presentations in intervening periods not being comparable. We are particularly concerned that the Boards ensure that there is consistency between this Proposal and the Proposed Accounting Update on Revenue Recognition (Topic 605): Revenue from Contracts as these two standards are closely related and should provide clear and consistent guidance on definition of a performance obligation, the interaction between the two standards, and transition and disclosure requirements. These issues need to be resolved before either standard can be implemented in an effective way by preparers and meaningful to users.
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Selected Questions

Please refer to the Appendix for our detailed responses to selected questions raised by the Boards.

We thank the Boards for the opportunity to provide our comments on this Exposure Draft. If you have any questions regarding our letter or would like to discuss our views in further detail, please feel free to contact me directly at (408) 526-7815.

Sincerely,

Prat Bhatt
Vice President, Principal Accounting Officer and Corporate Controller
Cisco Systems, Inc.
Appendix: Detailed Responses to Selected Questions on 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?

(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?

Response:

We support the Boards conclusion that a lessee has a right-of-use asset and an obligation to make payments. We agree with the amortized cost-based approach for the right-of-use asset and the incurrence of interest on the liability to make lease payments. However, we believe the expense associated with leased assets should match the cash flows (assuming ratable payments throughout the lease). We propose that the lease obligation be amortized utilizing a simple straight-line methodology. In addition to a closer match with the associated cash flows, we believe the simple straight-line method might be more cost effective to implement versus the effective interest method. At a minimum, we recommend the final standard be less prescriptive as to methodology and more principles based and thereby permit any systematic and rational method that reasonably approximates the lessee expense as measured under current GAAP.

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?

(b) Do you agree with the board’s 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 approach would you propose and why?

(c) Do you agree that there should be no separate approach for lessor with leveraged leases, as is currently provided for under US GAAP (paragraph BC 15)? If not, why not? What approach should be applied to those leases and why?

Response:

Under the Proposal, lessors should apply one of two approaches based on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset either i) during the expected term of the lease; or ii) after the expected term of the lease. From this guidance, it is not clear when “significant risks or benefits” would be retained and as such, we request the Boards provide further clarification. We suggest the risk and benefit assessment be considered as a part of the overall business strategy analysis. The business strategy consideration should be the primary criteria for determining the appropriate lessor accounting approach. We believe this suggestion aligns with the Board’s basis of conclusion as indicated in paragraph BC27. As stated in paragraph BC27, an entity’s business model will indicate in most cases whether the derecognition or performance obligation approach would be appropriate. This is especially pertinent for manufacturing companies that also maintain a captive finance subsidiary. For these captive finance subsidiaries, we believe the derecognition model is more reflective of the business model and management strategy. As drafted, the Proposal will allow for similar transactions to be accounted for differently if determination is on a lease by lease basis.
Additionally, we suggest that this assessment should be allowed on a unit of account, as defined by management, based on the nature and characteristic of the lease portfolio, as opposed to a lease by lease assessment. For example, a unit of account could be defined as industry sector of lessee, underlying asset type, or geographic distribution, similar to that of the guidance provided for disaggregation of financing receivables per Topic 310, Receivables.

Furthermore, we suggest the Boards provide clarification for determining when a transaction would meet the scope exemption under the purchase or sale transaction per paragraph 8. More specifically, we request further clarity on the level of difference in significance between "all but trivial amount of the risks and benefits" as defined for the purchase or sale exclusion in paragraph 8(a) as compared with the "significant risks and benefits" concept as defined for determining the appropriate lessee approach. It is currently unclear as to whether "trivial" is less than or equivalent to "not significant."

We also believe it is not clear in the Proposal how to account for those transactions that qualify for the purchase or sale scope exemption. The Proposal does not adequately address how this type of contract should be accounted for during the term of the contract when it is not considered a lease.

We agree with the Boards' Proposal to develop two models relative to lessee accounting. However, we do not believe the performance obligation model is reflective of the economics of a lease transaction for a lessor that is in substance providing financing. At inception, the lessor records a liability that represents a pending performance obligation for the lessor at the same time they recognize an asset for delivering on their obligation to the customer. This approach is neither conceptually consistent nor symmetrical with the lessee's right-of-use model and the recognition of a performance obligation liability is inconsistent with the premise that a right-of-use asset has been transferred to the lessee. Requiring a lessor to record a performance obligation at inception of a lease suggests that the lessor still has to perform during the lease period. The lessor's performance obligation should be considered extinguished when the lessee accepts the asset for use for the term of the lease. The requirement to record the underlying asset twice on the balance sheet by the lessee and the lessor would result in double counting the potential cash flow stream.

The performance obligation approach appears to be the more appropriate accounting model for the businesses that aims to generate a return from the management of the underlying assets, as indicated in BC27. If the Boards decide to keep the proposed amortization method, the straight-line pattern of income recognition, as currently recorded for operating leases, would more accurately reflect economics of the transaction rather than the accelerated earning pattern as required under the Proposal. The current accounting treatment provides a match between the cost (i.e. depreciation/amortization of underlying asset) and the benefit. In other words, under the Proposal, the amortization of the performance obligation liability appears to focus on how the lessee uses the underlying asset and not on how the lessor satisfies its performance obligation to the lessee. We note that this is in contradiction with the Revenue Recognition Exposure Draft which focuses on the seller's satisfaction of the performance obligation which is evidenced by a transfer of control. Additionally, this will not provide useful information to users of financial statements.

We recognize that the derecognition approach resolves some of the performance obligation model's weaknesses, but this model also has unique issues. Specifically, the residual value is frozen at inception of the contract and subsequently reassessed for impairment. However, we believe the current accounting of incorporating the time value of money and accreting the residual asset over the lease term is more appropriate.
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 and subsequently, (i) the liability to make lease payments at the undiscounted amount of 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 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 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 lessor 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 paragraph 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

Response:

We appreciate the Boards providing relief from the present value calculations for the lessee and permitting lessor to retain current operating lease accounting for short term leases. However, we request the Boards to consider the same relief provided to the lessee to the lessee as well. Although the present value calculation is not required for lessees under the Proposal, the process and resources to gather transaction information to determine/measure the asset and liability at transition would not be reduced; or at a minimum, provide certain materiality exemptions, individually or in the aggregate. We believe the cost to adopt this will be significant without the necessary significant benefit or insight.

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 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?

(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?

(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?
Response:

As noted in response for Question 2 above, we request the Boards provide further clarification on the difference between the definition of “all but a trivial amount of the risks and benefits” as defined for the purchase or sale exclusion in paragraph 8(a) as compared to the “significant risks and benefits” as defined for purposes of determining the appropriate lessor approach. It is currently unclear as to whether “trivial” is less than or equivalent to “not significant” in the level of significance.

For purposes of distinguishing between the lease and service components in a contract, paragraph B1 indicates that a contract is, or contains, a lease if the fulfillment of the contract depends on providing a specified asset. Paragraph B2 further states that “an asset is implicitly ‘specified’ if it is (a) infeasible or impractical for a lessor to provide alternative assets in place of the underlying asset during the lease term or (b) if a lessor can substitute another asset for the underlying asset but rarely does so in practice.” Although we acknowledge that the criteria for determining whether or not there is an embedded lease is generally not changing, the current accounting for operating leases and service contracts is often similar and does not result in different accounting for the arrangement. In practice, a service arrangement with an embedded operating lease is often accounted for as a service arrangement that does not contain a lease. However, under the proposed guidance, any embedded lease will result in the recognition of lease assets and liabilities. Specifically, we believe the distinction noted above of whether or not the lessor rarely substitutes the underlying asset, as proposed in paragraph B2, should not be relevant. We believe that if the asset can be interchanged by the lessor, even if rarely done in practice, the lessee inherently does not unilaterally control the underlying asset. In these arrangements, the lessee typically does not believe it controls the underlying asset, but rather that the lessor controls the asset that is a component of the overall services contract. We believe that such assets do not meet the definition of a lease and the combined services contract should follow the guidance within the Revenue Recognition Exposure Draft.

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?

Response:

We agree with the proposed scope and related exclusions for the reasons stated by the Boards in the Exposure Draft. However, we recommend that the Boards clearly indicate in the body of the exposure draft that non-depreciable assets (e.g. inventory) are not in scope. As drafted, this is implied only in paragraph BC33 as “Topic 840 applies only to leases of property, plant and equipment.”

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?

Response:

We agree with the concept that an entity should separate all elements in a contract. However, we request further clarification on the guidance for distinguishing between leases and service components. The Proposal has provided some guidance, but this distinction is highly judgmental and may result in a diversity of practice and accounting for similar transactions in significantly different ways. As such, we believe that the Boards should consider providing further clarification for the following:

1) As mentioned in our comment letter on the Revenue Recognition Exposure Draft, we believe there should be more clarity on the definition of the term “distinct”. The proposed definition leaves room for judgment that will lead to inconsistencies in application. For example, it is unclear from the Exposure Draft whether items such as property insurance, property taxes, freight charges, and maintenance would satisfy the distinct test. Non-lease components that are a cost pass-through (such as property taxes and property insurance) may not satisfy the distinct profit margin criterion of the distinct test. Whether other executory costs such as common area maintenance would satisfy the distinct test may depend on whether the lessee is paying for all of the common area maintenance associated with the underlying asset (i.e., the lessee leases 100 percent of the property) or is paying for only part of those costs (e.g., the lessee leases a single floor of a multi-story building). It may not be possible to meet the distinct function and distinct profit margin test for an allocated share of total common area maintenance charges because that might differ from the amount that would be charged for maintenance services provided only to the portion of the property used by the lessee.

We also disagree with the strong link in the guidance between performance obligations and identifying the associated cost or profit margin. We believe that companies should be able to estimate margins as they would for selling price in the determination of whether an item is considered distinct. The primary focus should be whether or not the item is or could be sold on a stand-alone basis. We are concerned that based on the guidance in the Proposal, if a company is unable to identify the resources necessary to deliver a software product that is always sold with support, it may be required to recognize it as a single unit of accounting. We do not believe this would reflect the underlying economics or business realities of these types of transactions.

2) As mentioned in our comment letter on the Revenue Recognition Exposure Draft, we believe that further clarification is required in that proposal’s paragraphs 32-33 regarding continuous transfer of goods or services. We believe transfer of control for services needs to be better defined. Also there should be better indicators to identify transfer of a “good” versus a “service”.

Transfer of control in the case of evolving business models such as “Software-as-a-Service” (“SaaS”), “Pay-as-You-Go” (“PAYG”), and “Cloud Computing” service type models need to be addressed. These models are generally hosting models, and are considered services in existing practice. The companies who purchase these services do not own the underlying resources that hold the computing and software capabilities, but rather have the right to access them for a monthly fee.
3) We support the principle that an entity should allocate the value of a contract to the separate components. If the values of the separate components of the contract are not observable then the entity should estimate the values consistent with the guidance provided in paragraphs 50-52 of the Revenue Recognition Exposure Draft. However, the concept of allocating components of a contract based on ‘transaction price’ is inconsistent with the concept of ‘payments required by the contract’ as indicated in the lease exposure draft. Payments required by the contract are not defined in the Exposure Draft and it appears the definition of lease payments is not the same as transaction price.

For instance, in considering an option to acquire additional goods or services, under the lease exposure draft, determination of the price is based on the more likely than not term. If it is expected that the option is not going to be exercised within the more likely than not term, the value of the option would be excluded. However, under the Revenue Recognition Exposure Draft, the determination of whether to allocate value to the option depends on whether the option is providing the customer with a material right they would not have received if they had not entered into the contract—regardless of when it is exercisable (Revenue Recognition in Contracts with Customers Exposure Draft IG24-26).

The FASB and IASB currently do not agree when the service component in a contract contains both service and lease components are not distinct or when the payments cannot be allocated. Based on the Proposal, we do not agree with the FASB’s nor the IASB’s (as lessee or lessor under the performance obligation approach) approach that under these circumstances, the entire contract should be accounted for as a lease contract including the elements that are executory in nature. As such this would result in recording assets and liabilities that do not reflect the underlying economics or business realities of the transaction. As mentioned above, we believe it is critical the Boards provide consistency between the lease and revenue recognition proposal.

Finally, we believe that an exception should be provided to the requirement to account for the service and lease components separately if either component is trivial to the overall contract. For example, if a services contract has an insignificant portion of dedicated equipment, the entire arrangement should be accounted for under the revenue recognition guidance. We do not believe that the benefit of bifurcating trivial portions of overall contracts and accounting for these trivial portions under a different accounting model, outweigh the costs and administrative burden. If the Boards are to finalize the standards as currently drafted, we suggest that a minimum, it allows for grandfathering existing contracts that contains both service and lease components.

**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 would you propose that a lessee or a lessor should determine the lease term and why?

**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 would 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?

**Question 10: Reassessment**
Do you agree that lessees and lessor 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 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?

Response:

We understand that the financial statement user community generally views that considering such terms as options, contingent rentals, and residual value guarantees, will provide decision-useful information. However, options to extend or terminate the lease term and contingent rentals are not present obligations arising from a past event, and as such do not meet the definition of a liability under the current conceptual framework.

In addition, we believe that the users of the financial statements would want to understand that any amounts reflected in the financial statements reflect highly probable future cash flow. We are concerned that in an effort to forecast future behavior, the amounts recorded at inception will be inherently inaccurate and subject to significant adjustment, particularly towards the end of certain milestones in the contract (e.g., renewal period), as each of the parties intents become more clear. Additionally, this will likely result in significant volatility during the lease period due to subsequent reassessments and the potential inaccuracy and volatility of estimating these future events will not provide decision useful information to users of the financial statements. Furthermore, the extensive use of judgments and estimates could lead to significant inconsistencies between the lessee and lessor for the same transaction. While we are supportive of estimation and the principles based approach in this area, we would recommend further practical guidance to ensure consistency in practice.

Further, should the Boards decide to proceed with the principle as drafted, we do not agree that a probability weighted assessment should be prescribed. We understand that a probability assessment is fundamental to any estimation process. There are many models and techniques that are available that take the concept of probability into account. We ask the Boards allow management to determine the most suitable methodology. The final standard should set a principles based framework that has flexibility to encompass future business practices and allow for specific facts and circumstances as opposed to presupposing management's judgment as to the selection of the most appropriate estimation methodology. The goal should be to select the method that best arrives at the expected value of right-of-use asset under a lease contract and the resulting income or expense. The proposed probability weighted approach may result in amounts which are not reflective of an expected value but rather a mathematically determined amount that is not reflective of the underlying economic realities of a transaction. Additionally, the implementation of a probability weighted model will increase operational costs without a corresponding improvement in the quality of the reported amounts. We fundamentally believe that the goal of measurement should align with the economic realities of the transaction and the objective in this area should be to arrive at the best estimate of the expected value.

In implementing this aspect of the Proposal, an entity will most likely will its estimates at time of certain milestones, or shortly prior, which will result in practices that are not significantly different from current practices. As such, while the Proposal will require significant processes and time on a regular basis beyond the current lease accounting requirements, the recording of these contracts will have similar accounting results on the financial statements. From a practicality and operability perspective, we are concerned that this change will require incurrence of significant costs to track and account for these contracts without the necessary benefit.
In addition, as mentioned in our response to Question 2 above, we suggest that the Boards allow management judgments to be applied on a unit of account as defined by management based on the nature and characteristic of the lease portfolio. For example, a unit of account could be defined as industry sector of lessee, underlying asset type, or geographic distribution, similar to that of guidance provided for disaggregation of financing receivables per Topic 310, Receivables.

Finally, we believe an overall scope exclusion should be provided for leases that are not material, individually or in the aggregate, or that are related to non-core business assets (i.e. general administrative overhead assets such as printers and copiers). To require the proposed onerous process at inception and subsequently for these lease categories would not be of benefit to any constituent of financial information. Our recommendation is to continue with the current accounting model at inception that companies have been using for years without significant issue. Any transparency regarding the contingencies should be addressed in more robust disclosure requirements.

**Question 15: Disclosure**

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:
(a) identifies and explains amounts recognized in the financial statements arising from leases; and
(b) describes how leases may affect the amount, timing and uncertainty of entity’s future cash flows?

(Paragraphs 70-86 and BC168-183) Why or why not? If not, how would you amend the objectives and why?

**Response:**

We acknowledge that the Boards allow discretion to an entity to aggregate or disaggregate disclosures so that information is presented to best depict the amount, timing, and uncertainty of the lease and related cash flows. However, the Proposal currently requires disclosures about significant assumptions and judgments and any changes in those assumptions and judgments. Depending on the nature of a company’s lease portfolio, this requirement would be impractical to summarize in a meaningful manner; it would only be practical for a homogenous portfolio. For example, for a multinational company where the terms and conditions of office leases are quite disparate depending on the local and/or national legal and regulatory environment as well as local business practices. In a worst case scenario, it could result in disclosure on a lease by lease basis.

Further, the Proposal requires the reconciliation of opening and closing balances for the right-of-use asset, receivable asset, liability, and residual asset, as applicable. However, we believe may not provide meaningful information, while at the same time causing significant burden to preparers of the financial statements who have to provide this information. Fundamentally, we believe the current maturity disclosure requirements to reconcile future minimum lease receivables/payments, interest income/expense, to the receivable asset/liability, by both lessor and lessee give financial statement users sufficient information in regards to the magnitude of receivables or obligations outstanding, respectively, without causing undue burden to the preparers of financial statements. Any further disclosures should be at management’s discretion based on assessment of various risks and better suited for management, discussion and analysis section of interim and annual filings.
Overall, we believe it would be prudent for the Boards to address disclosure requirements in the Proposal in conjunction with the other pending convergence projects. We believe the volume of proposed additional disclosures when taking all of the projects into consideration is onerous and we do not believe will necessarily improve financial reporting. It is important to not only assess disclosure requirements for each standard individually, but also in consideration of other standards to ensure that disclosures are meaningful in the broader context. It is often difficult to assert that any individual aspect of disclosure is unimportant and, consequently, it is key to understand how disclosures from other standards will interact and whether truly critical disclosures are obfuscated when too much disclosure of non-critical areas is provided.

Additionally, we request further clarification regarding the disclosure requirements for interim financial statements. We believe if the current proposal is adopted as is, the amount of disclosures required under paragraphs 70-82 is overly extensive for interim reporting purposes.

Overall, we believe it would be prudent for the Boards to address disclosure requirements in the Proposal in conjunction with the other pending convergence projects. We believe the volume of proposed additional disclosures when taking all of the projects into consideration is onerous and we do not believe will necessarily improve financial reporting.

**Question 16: Transition**

(a) This exposure draft proposes that lessees and lessor should recognize and measure all outstanding leases as of the date of the initial application using a simplified retrospective approach (paragraphs 8-96 and BC186-199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

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

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

**Response:**

To appropriately account for leases under the Proposal, most companies will have to build custom lease system solutions, which may span multiple ERP systems. The lead times to design and test the system changes and provide three years (and potentially five years including financial highlights) of comparative financial data would be significant. The application of the Proposal requires specific transactional level analysis and accounting considerations which will need to be accumulated and processed. Additionally, for many financial statement preparers, particularly those with large and complex multiple-element arrangements such as Cisco, that provide service arrangements with potential embedded leases would have significant difficulty implementing this standard even under the prospective application. If required to adopt the standard under the retrospective or simplified retrospective method, the proposed guidance would require preparers to track such contracts under dual principles for the retrospective period(s). The effort to track and report under dual principles for extended periods of time would be costly and time consuming.
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Despite current guidance on accounting changes in Topic 250 and IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors requires retrospective application to a change in accounting policy unless it is impracticable. We noted in the Boards’ Basis for Conclusion that they acknowledge that the retrospective application of this Proposal would be costly, and provided the relief of a simplified retrospective adoption. However, we do not believe this relief provides much reduction in costs or lead time to implement the proposal as currently the incremental transactional level information is not tracked or managed in a systematic manner since this information is not required for accounting or reporting purposes today. As such, the time and effort to develop a solution, improve or implement (multiple) system enhancements are the same whether a full retrospective or simplified retrospective approach is required. Accordingly, we believe that simplified retrospective application should be elective allowing also the full retrospective or prospective application on all new contracts as of an effective date. The ultimate transition methodology should be consistent with the final Revenue Recognition standard.

The prospective application of this standard on new contracts as of an effective date would ease the administrative burden of applying this new Proposal. In addition, prospective application would shorten the lead time necessary for preparers to adopt the Proposal. Additional quantitative and qualitative disclosures regarding the current and expected future impact of this standard would be appropriate based on the transition methodology.

The Boards should conduct significant field trials to understand the complexity and lack of existing system capabilities before concluding on any form of retrospective application. Although we have not fully analyzed the impact of simplified retrospective application, we believe the labor and system costs would be approximately $50 million over the implementation period. We believe the Boards need to undertake a robust cost/benefit analysis before concluded that retrospective application is required. We also request the Boards to consider grandfathering certain contracts (e.g. leases with maturity dates within 1 year from effective date or leases with maturities less than 3 years).

Finally, we request further clarity on transition to the following issues,
- whether the assessment of the purchase or sale scope exclusion should be made as of facts and circumstances at inception of the lease contract or at effective date of the Proposal;
- the transition guidance for those contracts that are currently accounted for as a lease but would be considered outside of the scope of the Exposure Draft if they qualify as in-substance purchase or sale;
- whether the determination of the lessor approach should be made as of facts and circumstances at inception of the lease contract or at effective date of the Proposal.

**Question 17: Benefits and costs**

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 benefits of the proposal would outweigh the costs? Why or why not?

**Response:**

We appreciate the fact that the Boards are evaluating the benefits as well as the costs of implementing the proposed guidance. However, from a practicality and operability perspective, we are concerned that this change will require significant costs to track and account for these assets and obligations. As we have studied this ED over the last few months, it is clear that the model will be administratively difficult to operationalize. Besides the initial implementation efforts, the costs of maintaining the proposed model will also be significant, especially as it relates to: (i) short-term leases; (ii) contingent rentals and payments under term options; (iii) reassessment of amounts recognized; and (iv) complying with the extensive disclosure requirements. The cost, time and effort to monitor the facts or circumstances of a particular lease to determine whether a significant change has occurred will also be costly for preparers especially with large volumes of leases.
Furthermore, we believe it will be difficult to capture the various terms, estimates and assumptions in the notes to the financial statements in such a manner that will provide additional benefit to users. The disclosures will be extensive and confusing, likely mitigating the perceived additional value to users. Therefore, the Boards should consider the operability as a prominent discussion topic at the upcoming round table sessions and consider extensive field tests prior to issuing the final standard.

**Question 18: Other comments**

Do you have any other comments on the proposals?

**Response:**

We believe the Boards should also consider the following items. The Proposal:

1) Indicates that the lessor’s residual asset should be evaluated for impairment under Topic 350, *Intangibles — Goodwill and Other*. We request further clarification in applying this impairment model as this could, in application, result in day 1 impairment.

2) Requires that the lessor’s right to receive lease payments should be evaluated for impairment under Topic 310, *Receivables*. However, per ASC 310-10-35-13(c), leases as defined in Topic 840 are excluded from application.

3) States that for subleases, the entity should record the contracts as a lessee and lessor. This will result in multiple assets and liabilities to be recorded which appear to be somewhat redundant and actually decreases the transparency. In addition, we request further clarification in determining the lessor lease model (performance obligation v. derecognition) under a sublease contract.

4) States that the discount rate to be used by the lessor is the rate the lessor charges the lessee. However, it is common practice in the financing industry for the lessor to provide highly discounted financing promotions such as 0% financing to the lessee, with the lessor receiving a discount directly from the manufacturer/supplier. In such situations, the rate that the lessor charges the lessee may not reflect the market rate for discounting purposes.

5) Does not provide guidance regarding how to account for incentives provided for a lessee, including up-front cash payments and the payment of certain costs (e.g. lease/tenant improvements) on the lessee’s behalf.

6) Does not provide guidance about whether to separately present current and non-current net lease assets and net lease liabilities for companies with classified balance sheets.