December 13, 2010

Technical Director
Financial Accounting Standards Board
Sent via email to: director@fasb.org

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

The Accounting Principles and Auditing Standards Committee ("the Committee" or "We") of the California Society of Certified Public Accountants ("CalCPA") is pleased to provide our comments to the Financial Accounting Standards Board (the "Board") on the proposed Accounting Standards Update.

The Committee is the senior technical committee of CalCPA. CalCPA has approximately 32,000 members. The Committee is comprised of 50 members, of whom 67 percent are from local or regional firms, 23 percent are sole practitioners in public practice, 5 percent are in industry and 5 percent are in academia.

The Committee supports the Board’s objective to revise current accounting standards for leases to better meet the needs of financial users. However, the Committee overwhelming believes that the model presented in this Exposure Draft fails to achieve this purpose. The Board is proposing to replace very difficult and complex existing standards that are not applied consistently from entity to entity with new literature that is still unduly complex and, because of its reliance on estimates, particularly with regards to contingent rents, will still result in wildly differing results in application from entity to entity.

In addition to the problems with contingent rents, the Committee was vehemently opposed to the notion of including rentals during unexercised option periods in the assets and liabilities recorded by the lessee and lessor. We believe that the recognition of assets and liabilities when no contractual rights or obligations exist is unprecedented and, more importantly, wrong. There are numerous situations where expectations of future events or actions are high, but this does not result in the recording assets or liabilities. We do not believe that payments that would occur if an option were to be exercised, without other actions or compelling factors, meet the definition of asset or liability.

Because the matters which we find objectionable are systemic to the proposed model, we do not believe it is possible to correct these issues by simply modifying sections of the exposure draft. Accordingly, we respectfully recommend that the Board withdraw the proposed Accounting Standards Update in its entirety.
The Committees responses to specific questions raised in the Exposure Draft follow:

**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?

Yes, we agree with the concept of this model.

(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?

We agree.

**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?

Committee members generally support the derecognition approach. However, the Committee was split on this issue of the performance obligation approach. Approximately half of the Committee members would retain the existing model for an operating lease when the lessor retains exposure to significant risks or benefits associated with the leased asset.

(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?

The Committee was split on this issue. Approximately half of the Committee members agree conceptually with the recognition of assets and liabilities for lease payments and the performance obligation. The remaining members would not recognize assets for the lease payments or a liability for the performance obligation.

(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?

Some members of the Committee were concerned that the Exposure Draft did not include an comprehensive analysis of the effects of eliminating a separate approach for leveraged leases. These members were concerned whether the proposed model of accounting for leases would make economic sense for leveraged leases, and recommend that the basis for conclusions include a more comprehensive discussion including a comparison of the results of applying proposed standards to existing standards for leveraged leases.
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).

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?

The Committee does not agree with this method. We believe that lessees and lessors should not record assets or liabilities for payments to be made for these types of leases.

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 BC39–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?

We find the definition adequate.

(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?

We agree with the criteria to distinguish a lease from a purchase/sale transaction.

(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?

We believe the discussion is adequate.
Scope

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?

We agree.

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 605): 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?

The Committee was split on this issue. The Committee on the whole does believe the IASB approach is more theoretically true to the underlying economics. Despite this, some members agree with the FASB approach because: (1) it is consistent with the basis used in the proposed standard on revenue from contracts with customers; (2) a requirement to allocate nondistinct services from the lease component will often result in unsupported, arbitrary allocations, and; (3) from a practical standpoint, the service component of nearly all contracts with both service and lease components that require derecognition will probably meet the definition of distinct services.
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?

We agree.

Measurement

This exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

(a) assumes 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 (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).

(b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be reliably measured.

(c) is updated 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 (paragraphs 17, 39, 56 and BC132–BC135).

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, the Committee emphatically disagrees with the Board’s approach for several reasons:

- The approach of taking into account the effect of options to extend a lease is inconsistent with the approach used for options to purchase the leased asset. Purchase options are only recognized when the option is exercised.

- The measurement of the lease obligation and right to receive lease payments would be highly judgmental making comparisons between enterprises less meaningful.

- Amounts receivable/payable during the option periods do not meet the conceptual definition of assets/liabilities. Although the Board uses the term “right to receive lease payments” consistently
throughout the ED, this terminology is contrary to the fact that the lessor has no rights applicable to payments which may be payable during an unexercised option period.

**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?

We do not agree with the use of the expected outcome technique as described in the ED.

We agree that term option penalties and residual value guarantees should be included in the measurement of assets and liabilities, except if the terms of these provisions make it probable that the lessee will exercise an alternative option to avoid payment of penalty or a residual value guarantee.

We do not agree that contingent rentals should be based on a probability-weighted average of possible outcome for a number of reasons:

- The measurement under this approach is extremely judgmental and unnecessarily complicated.
- Contingent rentals dependent upon an index or rate are to be based on “readily available forward rates or indices.” Numerous forward rates or indices of differing amounts are likely to be readily available for just about any particular rate or index.

A majority of the members of the Committee believe the Board needs to revise the measurement involving contingent payments by including a reliability condition as a minimum.

**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?**

The members who favor recognizing lease payment assets and liabilities under performance obligation leases agree in a reliability requirement.

**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?

We believe that the assets and liabilities should be remeasured under the circumstances described using the measurement standards that we discussed earlier.
Sale and leaseback

This exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents a sale of the underlying asset, the leaseback also would meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

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?

We agree with the criteria discussed.

Presentation

This exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

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?

We believe that a lessee can present the information in the notes to the financial statements. It is currently permissible to disclose categories of property, plant and equipment and the nature of various debt instruments in the notes. We do not believe that separate presentation on the face of the statement for lease assets and liabilities achieves better disclosure.

(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?

We believe that it is appropriate to allow disclosure of the proposed information in the notes. The information presented in the face of the financial statements should not contain so much detail as to obscure the financial picture of the enterprises activities. Neither should the information be aggregated to such a degree to make analysis unnecessarily difficult. The preparer of the financial statements should be provided latitude to achieve the appropriate balance.

(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?

We believe disclosure in the notes is sufficient.

(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?

We believe disclosure in the notes is sufficient.

**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?

We believe disclosure in the notes is sufficient.

**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?

We believe disclosure in the notes is sufficient.

**Disclosure**

**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?

We agree.
Transition

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?

We agree with the use of a simplified retrospective approach upon adoption.

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

The Committee was split on this issue. Half the members do not believe a full retrospective application should be permitted in order to promote consistency. The remaining members believe it should be permitted.

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

We did not identify any additional transitional issues.

Benefits and costs

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?

No. We do not agree with the boards assessment of the cost and benefits of the proposed requirements. Specifically, we do not believe the costs of assessing and reassessing contingent rentals and options to extend leases in the ED is unduly burdensome and will often result in speculative results that is neither more accurate nor more useful that using the approaches contained herein (using current indices and not recognizing payments during unexercised option periods).

Other comments

Question 18

Do you have any other comments on the proposals?

No.
Non-public entities

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?

The Committee believes that, while implementation of the proposed guidance as proposed would be a tremendous challenge for large international enterprises, implementation would be overwhelming for small and medium size enterprises. As a result, the time for implementation should be much longer for non-public entities.

We would be glad to discuss our comments further should you have any questions or require additional information.

Very truly yours,

JoAnn Guatteri, Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants