Re: File Reference 1850-100 Proposed Accounting Standards Update Leases (Topic 840) / Exposure Draft ED/2010/9

The Association of American Railroads ("AAR") appreciates the opportunity to comment on the joint Financial Accounting Standards Board/International Accounting Standards Board (the "Boards") Exposure Draft, *Leases* (the "ED").

The AAR is an incorporated, nonprofit trade association representing the nation's major freight railroads and Amtrak. AAR members include large (Class I) and small railroads operating in the United States and Canada that prepare financial statements in accordance with U.S. GAAP.\(^1\) In matters of significant and common interest to its members, the AAR frequently appears before Congress, the courts and administrative agencies on behalf of the railroad industry. This ED represents such a matter.

**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?

We agree that the right to use an asset during the term of the lease creates both an asset and an obligation to make lease payments.

(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 acknowledge that leases are commonly viewed as being effectively financing, although this is not true of all leases in which case the proposed accounting may not match expenses with revenue earned from the leased assets.

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1 AAR Members include Anacostia Rail Holdings; BNSF Railway Company; Canadian National Railway; Canadian Pacific Railway; CSX Transportation; Genesee & Wyoming; Iowa Interstate Railroad; Kansas City Southern Railway; METRA; National Railroad Passenger Corporation (Amtrak); Norfolk Southern; Union Pacific Railroad; Vermont Railway; Watco Companies; and Wheeling & Lake Erie Railway.
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Question 1: 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?

We agree that derecognition in situations which are effectively a sale is appropriate. The concern we have is over the need to use significant judgment to determine which model to apply. This decision will be important as it will lead to significantly different revenue recognition models (immediate gain or income over term). The new guidance appears to introduce the distinction between a capital lease and operating lease for lessors which was what the Boards were trying to avoid for lessee accounting.

Another general concern with respect to the performance obligation model is that the same asset will be on two companies’ statement of financial position in three different amounts (lessee: capital asset and receivable for the right to receive lease payments and lessee: right of use 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?

Discussed above in section (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?

No comment.

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.)
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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?

It is our belief that the simplified requirements will not mitigate the unreasonable cost of accounting for short-term leases as detailed tracking will still be required to meet the requirements in the proposed standard. The cost of tracking and recording a large number of short-term leases will be significant yet the benefits of recording these leases on the statement of financial position will be minor. We agree that users need to understand the nature and amounts related to these contracts.

Our preference would be to grant lessees the same option as lessors to not recognize short-term leases on the statement of financial position and recognize lease payments in the income statement over the lease term. If the Boards do not accept this option then we would ask that the final standard acknowledge specifically that the standard need not be applied to immaterial leases (individually and in the aggregate) and that for these leases the current accounting applied to operating leases be an acceptable alternative.

In the railway industry freight cars of one railway may be utilized by another railway under car hire arrangements. Car hire applies when an owned freight car leaves the owning railway’s line and is interchanged to another railway (foreign road). The foreign road delivers the loaded car to its destination and has the option of returning the car to the owning road immediately or using the foreign car to collect a load from a customer. While the car is operating on the foreign road the foreign road is required to pay car hire to the owning road. Car hire arrangements are usually short-term in nature and payment is made on a per diem basis. These arrangements are currently treated as rentals but it is unclear whether this would continue to be appropriate. Additional guidance with respect to the treatment of per diem rate and usage rate arrangements would be appreciated.

It would be very difficult to estimate the length of term for car hire arrangements. These arrangements do not specify a term and so long as the foreign road pays the car hire, it is entitled to continue to use the freight car. This would therefore require the railway to guess the intended usage by another railway company of its cars when they are interchanged. This is something that the originating railway cannot predict as specific foreign road customer traffic volumes and patterns are confidential and cannot be reasonably estimated. Many different factors will drive whether a railway will utilize a foreign car, and for how long, to move customers' traffic. Such decisions are made on a daily basis as a result of, among other factors, customer demand and freight car availability. These factors will vary on a daily basis, and moreover, as they relate to the foreign road are unknown to the other railroads. Therefore, we do not believe that car hire arrangements are leases and cannot feasibly be accounted for as leases under the proposals in the ED for short-term leases. Car hire arrangements are discussed further under Question 4 below.

Finally, railroads also have arrangements to use other railroads’ facilities, known as joint facilities, but like car hire these arrangements result in short-term usage.

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).
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**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 are generally in agreement with the definition of a lease. In most cases the twin criteria of a specified asset and control of the use of the specified asset should ensure that contractual arrangements are appropriately treated. However, in the context of certain agreements, the definitions of a specified asset and control may not necessarily be clear.

Car hire arrangements have already been discussed under Question 3 above. The definition of a lease is unclear for such arrangements. Initially the foreign road does not have control of the asset because although it has physical control of the freight car, it does not have the ability or right to operate the freight car or direct others to operate the freight car in a manner it determines. This is because the foreign road must deliver the loaded freight car to the customer. Generally under revenue contracts the specific routing to the customer is determined in advance, hence the foreign road is unlikely to have much control over how it completes the interline move that first brings the foreign car onto its property. Thereafter, it has some greater degree of control of the freight car in that it may use it to move customers’ traffic requirements for the payment of car hire. It may have control at this point. However, car hire arrangements are intended to promote the efficient use and timely return of freight cars to the owning railway. While, as noted above, the foreign road can chose to use the freight car for its own purposes, the intention of the car hire arrangements is not to provide the foreign road with control of the freight car in the sense normally understood in a lease.

Furthermore, car hire payments are based on usage and are at a per diem rate. This appears to suggest that the payments under car hire arrangements are specified at a fixed price or market price per unit of output (i.e. a day’s use of the foreign car). Therefore we would view these arrangements as daily rental arrangements (i.e. service contracts), consistent with their current treatment as rentals. However, we are concerned that this could be open to interpretation. We feel that further guidance or specific examples provided in the accounting standard would be helpful to clarify this. Certain car hire arrangements involve a railway freight car management company, jointly owned by the Class I railways, that administers the allocation of cars that it owns and certain other cars that the Class I railways own to ensure efficient utilization and to meet customer needs.

In addition, many railroads have agreements that do not appear to provide a clear right of use of an entity’s property but instead are worded such that a right of access to property is provided. In some of these agreements the right of access is provided to permit a company or party the ability to cross land, e.g. an easement, and this would not provide a right of use and hence should not be a lease. Other agreements, while defined in the contract as providing a right of access to an entity’s property may or may not actually provide a right of use of a specified asset or at least a portion of a specified asset, and therefore could constitute a lease.

For these circumstances we suggest that the final accounting standard should provide clarifying guidance as to the distinction between a right of use of an asset and the right of access to an asset and whether such a right of access meets the definition of a service contract. Specific contracts in our industry of this nature include fiber optic cables and telecommunication towers. In addition, clarification as to the unit of account is required as it is unclear whether an agreement to use a portion of an asset (less than the unit of account) would qualify as a lease. We believe this issue would apply to a broader group of companies
than just the North American railway industry as utility and telecommunication companies are likely to have similar circumstances in their contracts with property owners.

(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?

While some leases transfer title to the lessee at the end of the lease, the lessee does not have all the rights of ownership of the leased asset during the lease term, e.g. the lessee typically would not be able to sell the asset during the lease term. To classify such leases as purchase or sale contracts does not therefore reflect the actual reality of the control of the asset that has been passed to the lessee during the lease term.

In addition, a bargain purchase option does not guarantee a purchase and at the inception of a lease it may be very difficult to determine whether such an option will be exercised, given potential changes in economic and market conditions between that time and the end of the lease.

Therefore, to presume that a bargain purchase will result in purchase and transfer of title is inappropriate. Unlike current U.S. GAAP and IFRS where a bargain purchase option is presumed to be exercised to determine capital (finance) lease accounting treatment, the ED would require the accounting treatment to follow a significantly different revenue recognition model.

We are of the view that it would be inappropriate to treat lease contracts as purchase and sales solely on the basis of the existence of a bargain purchase option. Bargain purchase options should only trigger purchase and sale accounting when a lessee notifies to the lessor that they will be exercised. In this way they would be treated consistently with other purchase options under the ED which are accounted for only when exercised.

(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 do not believe that the noted paragraphs provide a sufficiently clear distinction between leases and service contracts and would appreciate the Boards providing additional clarifying guidance and examples in the accounting standard. Refer to our specific examples provided in our answer to Question 4 (a). We are concerned that the definition of a service contract is effectively taken from EITF 01-8 ‘Determining Whether an Arrangement Contains a Lease’ (now ASC 840-10-15). However, if an operating lease was determined to exist under this guidance the accounting treatment was not dissimilar from that for a service contract. Therefore the distinction was not critical. With the change in accounting treatment for leases, a clearer and more robust distinction between lease and service contracts is required. We feel that further clarifying guidance is needed for the definition of:

- the meaning of “payments are specified in terms of a fixed price per unit of output or the current market price per unit of output”;
- the meaning of “output or other utility”. It is possible that this could be interpreted to mean the use of a foreign freight car as occurs in car hire arrangements, which we do not believe should be considered a lease;
- the meaning of “ability or right to operate”. In car hire arrangements and those agreements providing a defined right of access this could be open to different interpretations by different entities or other parties (e.g. auditors); and
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- the meaning of "specified assets". This is a key concern for the railroad industry with respect to right of access agreements as the access provides a third party the right to locate their assets on railroad owned property. Is the property or a portion of the property (less than the unit of account) therefore deemed to be a specified asset as it is critical to the operation of the third party’s asset, even although the third party does not operate the railroad owned asset?

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?

As noted in our answer to Question 4 (a), easements and other contracts providing a right to access to another entity’s assets, but which do not provide a right of use of that asset, should be clearly excluded from scope. Clarifying guidance is required to provide preparers and auditors of financial statements with sufficient understanding of the difference between a right of use and a right of access. This is especially important as such differences may require significant judgment in interpreting.

While we understand that the definition of a non-core asset or non-core lease may be very difficult to determine, we are concerned that accounting for non-core and short-term leases will be an onerous and expensive commitment of time, resources and IT systems. Therefore, we think that lessees should not recognize short-term leases on the statement of financial position and should recognize short-term lease payments over the lease term.

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?
We are in agreement that lease components and service components of a contract should be treated differently. This reflects the fact that the service component does not relate to the right of use asset and could be performed by another party and would be priced on the basis of market forces relating to the service work and not to the economics of the right of use of the leased asset.

However, the ED proposes that where the service component of a contract is not distinct or where payments cannot be allocated between service and lease, the whole contract should be treated as a lease. We would suggest that it could be possible to establish a reasonable estimate of the service component. In addition, we believe that the definition of distinct in paragraph B7 is too rigid and should be expanded to encompass the economic substance of transactions. Bifurcating contracts on the basis of the economic substance of the transaction should be allowed and the final accounting standard should provide examples.

Moreover, this would get around the potential issue of accounting for the services before they are actually provided (and before the performance obligation is extinguished) created by accounting for the whole contract as a lease.

Finally, if the Boards continue with the requirement to account for the whole contract as a lease when the service component is not distinct or payments cannot be allocated, contracts that are primarily service contracts with embedded lease components will be accounted for as leases. This seems to be unnecessary as the most important aspect of the contract is not being given prominence in the accounting. If a contract is primarily service in nature then it would make more sense to treat the whole contract as a service contract when the distinction between the service and lease components cannot be made.

**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 that purchase options do not represent a lease payment but are a means of terminating the lease. To include termination payments in the lease contract obligation (and therefore right of use asset) would be inconsistent with excluding purchase and sales from the scope of the standard.

**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?

It is our view that renewal options that have not been exercised do not meet the definition of a liability. It is clear from the Basis of Conclusion (paragraphs BC116 and BC117) that the Boards understand that these options may not represent liabilities, but believes that the proposed requirement is a “practical solution”. We disagree as it is fundamentally inappropriate to recognize as assets and liabilities items that are not assets and liabilities as defined in U.S. GAAP at ASC 450-20-25-2. One of the benefits of a revision of lease accounting is that it will require lessees to recognize the asset that it has obtained and the liability it has incurred as a result of the leasing transaction. However, this benefit is negated if at the same time the lessee and lessor also recognize non-existent assets and liabilities which are neither “probable” nor “estimable”.

Moreover, in practice, it is highly unlikely, either at inception or during much of the non-cancellable term of a lease, that any management team will be able to say that it is more likely than not that a renewal option will be exercised. Management prepares annual budgets and multi-year plans that forecast business requirements for the next several years. However, in the rail industry, many leases are for non-cancellable terms that greatly exceed the business planning cycle.

The probability assessment for the lease term proposed by the ED requires management to make significant judgment about events that will occur many years in the future (10 years and 15 years in the future per the example at paragraph B17). We find it difficult to see how management will be able to assess the probabilities of different lease terms with any degree of confidence until much nearer the time that the decision to renew has to be made.

The ED outlines a number of factors at paragraph B18 that need to be considered when assessing likelihood of renewal. While these may well influence decisions, in many cases, management’s decision to renew is more likely to be driven by economic and market conditions which will only be able to be assessed closer to the date of the renewal option.

We are also concerned that the subjectivity involved in the determination of renewal options could lead to significant differences of opinion with external auditors and the adequacy of any audit evidence to support management’s judgment may be debatable.

We are also concerned with the volatility to income that changes in assessed lease term will have. The expense recognition model to be followed under the ED will result in increased interest expense in the initial years of a lease and this expense is further increased by the term of a lease. Should management overestimate the likelihood of renewal initially, then the initial years’ interest expense will be much higher than it would have been with a shorter estimate of the lease term. Truing up the amount of overstated expense when it becomes apparent that the lease term will not be renewed will add significant
volatility to the income statement. Moreover, the effective interest method may not necessarily correlate with how the economic benefits are realized according to usage of the leased asset.

Railroads also have perpetual leases and self-renewing. Railroads act as a lessor in thousands of such leases, most of which are individually immaterial. To continually reassess the terms of such leases will be cumbersome, time consuming and costly, yet not to do so could result in an overall material misstatement of earnings. Guidance should be provided as to how companies should account for such leases.

We are concerned that the proposals will result in significantly more work to assess lease terms yet the end result will be lease terms that are unchanged in the majority of leases from the lease terms determined under current GAAP.

**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 believe that contingent rentals and expected payments under term option penalties and residual value guarantees should only be recognized when companies have present economic obligations. Contingent rentals that are based on the future use of an asset do not give rise to a liability and should not be recognized until the future event that gives rise to the obligation (the actual use of the asset) occurs. Furthermore, this future event is not within the lessor’s control. Requiring lessors to estimate contingent rents would require speculation on the part of lessors as to the potential future behavior of lessees. Any estimated contingent rental would be highly subjective and likely unreliable.

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?

Agreed, lessors will often not have access to the information needed to recognize contingent rentals and expected payments under term optional penalties. The unfortunate result is asymmetrical accounting. Moreover, to recognize contingent rents would be inconsistent with contingency guidance whereby contingent gains are usually not recognized.

**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?

If the Boards require periodic reassessment, the final standard should provide guidance on the types of indicators to consider in order to determine if reassessment is required as it would be impractical to reassess each lease each reporting period.
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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).

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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 proposed changes, however, we would ask that the Boards provide guidance on the treatment of existing deferred gains from previously recognized sale and leaseback transactions on adoption. Should deferred gains related to historical sale and leaseback transactions be reversed through retained earnings or should the deferred balance continue to be amortized into income as it relates to a sale which is not in the scope of the leases standard? Alternatively would a full retrospective adoption method apply whereby companies would be required to go back to the initial transaction to evaluate if the initial transaction qualified as a sale under the new guidance?

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 are in agreement that the lessee should present the right of use asset in property, plant and equipment but separately from owned assets. This will provide users with information about the assets used by the entity to operate its business and distinguish between those with different rights and obligations. This, however, could be achieved through note disclosure unless the carrying amount of leased assets was material to the total property, plant and equipment line on the statement of financial position.

We are also in agreement that the liability should be separately distinguished, but again this could be achieved through note disclosure.
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(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 do not agree with the Boards’ proposals that a lessor should present the underlying asset and the rights to receive lease payments under the performance obligation model. This will result in a duplication of accounting as the lessor cannot have both the underlying asset and the lease receivable on their books at the same time. It is also inconsistent with the accounting model to be followed by the lessee which will capitalize the leased asset through its right of use asset. Therefore the two entities will both recognize effectively the same asset as the right of use asset and the underlying asset (that portion being leased) are inextricably linked. Moreover, the lessor should not show the whole of the underlying asset on its balance sheet as well as a receivable that the underlying asset has in effect been exchanged for through the lease contract. Again it does not make sense for the lessor to duplicate what is effectively the same asset.

We are therefore in support of a derecognition model for all lessors to be compatible with the recognition model used by lessees.

However, if the Boards continue with the performance obligation model it would be more appropriate to present a net asset on the face of the balance sheet and provide the composition of this net asset, linked underlying asset, receivable and lease liability in the notes to the financial statements.

(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?

Again we are in agreement with distinguishing right to receive lease payments from other financial assets as these receivables are linked to the obligation of the lessor to continue to provide the leased asset to the lessee. Additionally, residual assets should be presented separately from other capital assets that are currently used in the operations of the business as the residual asset is one that will be used only in the future, after the current lease term has expired. However, this can be achieved through note disclosure.

(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 agree but would prefer this to be presented in the notes to the financial statements.

As previously noted many railroads are lessees, lessors subject to both the derecognition and performance obligation models, and lessees with sub-leased leased assets to other parties that will qualify for both the performance and derecognition models.
Therefore the statement of financial position for properties, following the proposals in the ED, would look like this for most companies in the industry:

<table>
<thead>
<tr>
<th>Property, plant and equipment – owned</th>
<th>XXX</th>
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<tbody>
<tr>
<td>Property, plant and equipment – leased</td>
<td>XXX</td>
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<tr>
<td>Property, plant and equipment – residual amount owned</td>
<td>XXX</td>
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<tr>
<td>Property, plant and equipment – residual amount leased</td>
<td>XXX</td>
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<tr>
<td>Property plant and equipment subject to lease</td>
<td>XXX</td>
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<tr>
<td>Right to receive lease payments</td>
<td>XXX</td>
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<tr>
<td>Performance obligation under lease</td>
<td>(XXX)</td>
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<tr>
<td>Net lease asset</td>
<td>XXX</td>
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<tr>
<td>Property plant and equipment subject to sub-lease</td>
<td>XXX</td>
</tr>
<tr>
<td>Right to receive sub-lease payments</td>
<td>XXX</td>
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<tr>
<td>Performance obligation under sub-lease</td>
<td>(XXX)</td>
</tr>
<tr>
<td>Net sub-lease asset</td>
<td>XXX</td>
</tr>
<tr>
<td>Total property, plant and equipment</td>
<td>XXX</td>
</tr>
</tbody>
</table>

At thirteen lines this is very cumbersome to present on the statement of financial position and is totally unnecessary as this level of detail would be much better presented in the notes to the financial statements.

**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 do not agree that lessees should present the amount of amortization expense of the right of use asset and interest expense separately in the income statements unless these are sufficiently material to an entity that presentation on the face of the income statement is warranted. Otherwise, we believe these amounts should be shown separately in the notes to the financial statements.

We also believe that lease expense and income should be netted, consistent with the net balance sheet presentation, as this is a reflection of the economic effects of a lease. We also think sub-lease income should be netted against lease expense.

**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 agree that presenting cash flows arising from leases as financing activities for lessees and operating activities for lessors makes sense where leases are entered into for financing purposes, which is often the case. However, lessees often enter into leases for other operational reasons and not to finance the acquisition of assets. In such circumstances presenting the cash flows as financing would not reflect the substance of the transaction. Moreover, to classify leases that are not for a financing purpose, but are operational in intent, as financing activities would be contrary to the current guidance under U.S. GAAP.
for cash flow treatment as this requires transactions that contribute to net income should be operational activities (ASC 230-10-20).

**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 are concerned that the ED proposes a significant increase in the amount of disclosure regarding leases which will be time consuming, and potentially costly, to capture and may not provide users of financial statements with necessary information.

**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?

(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?

We have no specific comments on transition.

**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?

We believe that the right of use model to recognize in the lessees’ financial statements assets and liabilities created in leasing transactions will be beneficial. However, we are concerned about the significant systems costs for many companies, including our member companies, to track individual leases, aspects of their terms and conditions, and to implement additional controls and procedures in order to facilitate re-assessment.

We are also concerned that the benefits of recognizing assets and liabilities in the lessees’ financial statements will be significantly negated by the complexities that have been added to lease accounting and the requirement to recognize contingent payments, renewal options and residual value guarantees that do not currently meet the criteria for recognition.

AAR members also have to provide financial statements to regulators in Canada and the United States which are prepared in conformance with regulatory accounting standards set by the Canadian
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Transportation Agency ("the Agency") and the Surface Transportation Board ("STB"), respectively. These accounting standards, while generally in accordance with GAAP, have a number of specific accounting requirements that differ from GAAP. It is unknown at this time whether the Agency or the STB will modify their respective accounting requirements to harmonize with the proposals of the Boards. If harmonization was not to occur, North American railways, and likely other transportation companies in North America, would be subject to two markedly different accounting models for leases. This would significantly increase the complexity and cost of accounting systems to capture, record and report leases and the time required to implement the new accounting standard.

We would urge the Boards to discuss with regulators that set their own accounting standards the proposals in the ED.

Other comments

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

Terms in leases are often driven by a preferential tax treatment for either lessors or lessees. We are concerned that the proposed changes could change the motivation for leasing altogether which could result in a significant decrease in the availability of leased assets. In addition, those assets available for lease may not be at a price that is competitive, as many leases are currently. This could result in a stifling of capital available to companies at a time when we anticipate capital expansion, investment and financing requirements once the global economy recovers.

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?

Several of our members are privately owned short-line railroads. For these companies, which do not have the resources available to larger public companies, the proposals in the ED will be excessive and unnecessary. Owners of private companies have much greater access to management and operating and financial information through their involvement with the company.

We would be pleased to answer any questions that the Boards may have and discuss further any of the comments made in this letter on behalf of AAR members.

Sincerely,

Jeffrey Marsh
Vice President & Chief Financial Officer