December 15, 2010

Financial Accounting Standards Board  
Attn: Technical Director  
401 Merrit 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

File Reference: 1850-100  
Re: Leases – (Topic 840)

Dear Sir or Madam,

Canadian National Railway Company (CN) is a publicly held corporation with its common shares listed on the New York and the Toronto Stock Exchanges. The Company is engaged in the rail and related transportation business operating approximately 20,800 route miles of track in Canada and the U.S. CN prepares its financial information based on U.S. generally accepted accounting principles.

We appreciate the opportunity to comment on the Financial Accounting Standards Board’s (FASB) Proposed Accounting Standards Update, Leases (Topic 840). We fully support the FASB’s continuing efforts to issue improved and converged global standards which remove inconsistencies in practice and improve comparability across industries, jurisdictions and capital markets. While we are generally supportive of the “right of use” model described in the proposed accounting standards update, we believe that some of proposed requirements would be overly burdensome on the preparers of financial statements, with little to no benefit to the users of the statements. CN supports the comment letter by the American Association of Railroads and further submits its response to the proposed accounting standards update questions that are pertinent to the Company.
Question 3: Short-term leases
This exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65).

(See also paragraphs BC41—BC46.)
Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

While we agree that simplified requirements should apply to short term leases we believe that the proposal included in the exposure draft provides little practical relief to the preparers of financial statements. In addition we believe that significant administrative efforts and costs would need to be incurred to track numerous short term leases which, if capitalized, would likely not have a significant impact on the balance sheet and would therefore be of little to no benefit to the users of financial statements. Given the short term of the lease, the asset would cease to exist and would be fully taken into expense within a 12 month period. This creates a burden on capital-intensive companies to identify and capitalize assets which will disappear within a year, and provide financial statement users little or no benefit. We suggest that greater relief be made available to lessees and recommend that short term lessees be permitted to recognize lease payments in the income statement over the lease term similar to the current accounting methodology for operating leases. This treatment would effectively mirror the simplified requirements currently being proposed for lessors in paragraph 65 in the proposed standard.
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 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?

It is our opinion that additional clarification regarding the definition of a lease is required to ensure consistency in practice. The exposure draft defines a lease as

B1. At the date of inception of a contract, an entity shall determine whether the contract is, or contains, a lease on the basis of the substance of the contract, by assessing whether: (a) the fulfilment of the contract depends on providing a specified asset or assets (the ‘underlying asset’) (paragraphs B2 and B3); and (b) the contract conveys the right to control the use of a specified asset for an agreed period of time (paragraph B4).

We believe that additional practical examples included in the appendix would help constituents distinguish service contracts from lease transactions and would provide additional clarification for concepts included in the definition of a lease such as “agreed period of time”, and “specified assets”. For example, it is debatable whether companies that enter into per diem agreements for the use of assets, drawn from a pool of similar assets would need to account for the agreement as a lease transaction or as a service agreement. An example specific to the rail industry, known as Car Hire may currently be interpreted as either a lease or service contract and as a result the lack of clarification may lead to the inconsistent application of the guidance in practice. Car Hire involves charges paid by a railway to a foreign car owner (another railway or leasing company) for the use of their Railroad Rated equipment for both loaded and empty time (computed in hours) and mileage (computed in miles). Car hire charges start immediately upon receipt of a foreign car in an interchange (i.e. the transfer of cars from one road to another so that they may be used on roads other than that of the owner) and remain in effect until the foreign car leaves the host carrier’s lines. In the
case where a railway receives a loaded car from another railway they would begin paying car hire once the loaded car comes onto its line (note this is further complicated as different types cars fall under different rules). At this point although the railway has physical control of the asset it does not have the ability or right to operate the asset or direct others to operate the asset in a manner that it determines, as they are obliged to deliver the loaded car to the ultimate customer. Once unloaded, the railroad is expected to return the car back to the foreign car owner. Notwithstanding the above, the railroad does have some control over the asset as the railway may determine that the most efficient use of the asset is to have it brought to one of their customers to be re-loaded and returned to the foreign car owner for ultimate delivery back on that party’s line. What’s more, while car hire charges are based on specific assets (each car has a unique identifying number), the industry agreements that the railroads are party to specify rates and charges for types of assets and do not identify specific assets.

It is important to note that the intention of car hire is to promote the efficient use and timely return of cars to their owner and is not normally the basis on which a company would obtain operating assets. It is our opinion that as the agreements governing car hire do not specifically identify individual assets, and do not include explicit terms that these agreements would not qualify as leases, however we feel that given the current definition of leases the standard may be interpreted differently by different parties potentially leading to inconsistency in practice.

As car hire charges are generally for very short periods of time, days or weeks (although there are instances where a foreign car could be online for over a year), we believe that this further illustrates the need for additional relief for short term leases (as discussed under question 3 above).

**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 agree that contracts should be bifurcated to account for service and lease components separately. We feel however that where the service component is not distinct that it is inappropriate to account for the entire contract as a lease. It is our belief that if a reasonable estimate for the service component can be derived it should be accounted for separately from the lease component of the contract.

**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 with the proposal in the exposure draft that purchase options should only be accounted for when they are exercised. Given the uncertainty involving the exercising of purchase options, requiring that they are accounted for only when exercised will ensure that they are accounted for consistently in practice.

**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?

We disagree with the proposal that the lease term should be 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. We believe, similar to many of the respondents to the original discussion paper, that determining the present value of the lease payments on the basis of the most likely lease term might result in the recognition of a liability that does not meet the definition of a liability. It is our opinion that the proposed “longest possible term that is more likely than not to occur” will overstate and misrepresent the actual financial commitments that the company has undertaken as there is a difference between an obligation and a non enforceable intention. We would recommend that
only the lease term to which the company is contractually obligated be included in the present value calculation, or at a minimum a higher threshold than “more likely than not” such as “reasonably assured” as was the preference noted by some Board members in BC119. We believe that this would more accurately reflect the financial obligations of the company and reduce subjective estimates which are based largely on management judgement and may diverge significantly in practice. We believe that these alternative proposals for measuring lease terms is more in line with the overall objectives of the exposure draft given that one of the objectives of the proposed standard is for the users of financial statements to have increased comparability between entities. In our opinion the subjective management estimate currently being proposed for measuring the lease term would decrease comparability between entities.

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 proposed changes, however, do not believe that there is sufficient guidance to properly assess and account for existing deferred gains related to previously recorded sale and leaseback transactions. Additional guidance and examples should be included in the final standard to ensure historical transactions are properly reflected.

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?
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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, totalling 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?

(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?

(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 that a lessee should present liabilities related to leases separately from other financial liabilities, as well as present leased assets within property, plant and equipment, but separately from assets that the lessee does not lease. We further agree that lessors applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross, totalling to a net lease asset or lease liability. We do not believe however that the proposed presentation for both lessees and lessors should be in the statement of financial position but rather should be included in the notes to the financial statements. We believe that adding the proposed complexity to the face of the financial statements is of little benefit to the users and detracts from the overall usefulness of the statements.

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 believe that the disclosures currently proposed in the exposure draft will result in a significant increase in the amount of disclosure regarding leases. This additional disclosure will further increase administrative costs associated with capturing the required information and preparing the financial statements and may include information which is unnecessary, confusing or irrelevant to the users. While the Company supports additional disclosure, we believe the current proposal too cumbersome, and would suggest a summarized disclosure that will not confuse or lose the financial statement users.

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 appreciate that the majority of users of financial statements think that the proposed model is an improvement to existing lease accounting and that under the new model users of financial statements would no longer need to make adjustments to operating lease information, however would ask the Board not to underestimate the administrative burden of the proposed standard. The proposed changes would entail significant changes in management reporting as well as management reporting systems. The costs associated with the implementation of the proposed standard will likely be significant for many companies with a large number of leases (whether they are lessees or lessors or both), with less of a corresponding benefit to the users of the statements. We would also ask that the Board not underestimate the time that will be required to implement the system changes that will inevitably be required upon adoption of a final standard as well as the time required to process and evaluate companies existing leases.

Yours truly,

Serge Pharand