December 13, 2010

Exposure draft: Leases

Dear Sir/Madam:

The Johns Hopkins Health System Corporation ("JHHSC") appreciates the opportunity to provide comments on the Proposed Accounting Standard s Update, Leases (Topic 840) (the "Exposure Draft"). JHHSC is a private, non-profit corporation based in Baltimore, Maryland that provides a full continuum of integrated health services in settings ranging from primary care physician offices and ambulatory care centers, to sophisticated quaternary patient care and acute care services provided through its five hospitals. JHHSC and its Affiliates employ approximately 19,000 employees and generate approximately $3.8 billion in total annual operating revenues.

We agree with and support the recognition of leases on the balance sheet through the recognition of a right-of-use asset and a corresponding liability to make lease payments. However, we have significant concerns regarding the implementation and the practicality of applying the guidance. Most notably we disagree with the inclusion of an estimate of lease term renewal extension options based upon an arbitrary measurement of 'the longest period more likely or not to occur'. We believe that this introduces a significant amount of uncertainty into the valuation of the liability that could result in the recording of unreliable long-term estimated liabilities in balance sheets. It would be more appropriate, we believe, for optional renewal periods to be included in the determination of the lease obligation and right to use asset only when the lessee has an unconditional obligation to make lease payments or when the exercise of the extension option is virtually certain. Furthermore, the use of the highest probability of occurrence approach in the application guidance, we believe, will produce a lease term that is not likely to be the same as the longest possible lease term. We feel that there is a difference between fifty-one percent likelihood of occurrence and a cumulative probability of occurrence. We believe that it would be prudent to clarify the proposed application guidance.

JHHSC enters into a significant amount of leases that are less than one year in duration and a significant number of leases for basic office equipment that are not individually or in the aggregate material to our
financial reporting. We believe that the requirement to record a lease obligation and a right-of-use asset for each of these short-term or immaterial leases will create an administrative burden that far outweighs any potential benefit in financial reporting accuracy. We do not see the benefit to the users of our statement of financial position that would be gained by grossing up assets and liabilities to include short-term lease obligations and assets. We would propose that the Board consider the use of the simplified requirements that are being offered to lessors such that short-term (twelve months or less) lease rentals are recognized on an accruals basis similar to the current operating lease accounting.

We also encourage the board to provide more specific guidance for distinguishing leases from service contracts. JHSC outsources functions within the area of information technology and certain operational services and has numerous supply-type contracts. We believe that the establishment of clear criteria for distinguishing leases from service and supply contracts would be beneficial in our assessment of the accounting treatment. We are concerned that the level of guidance that is included in the exposure draft could lead to diversity in practice in-so-far as the application of lease accounting to these types of contractual arrangements.

With respect to the accounting treatment for leases by lessors, we do not believe that the proposed 'hybrid approach' as set forth in the exposure draft provides an improved presentation of the financial position or the results of operations for lessors. We believe that the performance obligation approach is divergent from the proposals for lessee accounting and results in a double-counting of assets. Furthermore, we believe that the complexities in the implementation of the derecognition approach and the resulting maintenance under this approach would mitigate any benefits that result in the financial reporting. However, we do think that lessor accounting is inseparable from lessee accounting and that the boards should seek to develop a lessor approach that is consistent with lessee accounting.

The scope and significance of the proposed changes will necessitate a lengthy implementation period. Given the volume of leases throughout our organizations we are anticipating that we will need to make modifications to the accounting, purchasing, accounts payable and fixed asset modules of our enterprise resource planning system to accommodate the proposed changes in as systemic a manner as possible. These changes will require extensive involvement from our systems vendor and will also necessitate numerous changes to internal processes, procedures and workflows. In our opinion, the benefits associated with the proposed guidance will not outweigh the costs incurred in the transition to and implementation of the proposed guidance and the on-going maintenance and administrative requirements.

Our responses to the questions set forth in the Exposure Draft are attached. We thank the Board for its consideration of our comments and we appreciate the opportunity to share our views.

Sincerely,
Ronald J. Werthman
Vice President, Finance/Treasurer and Chief Financial Officer
Proposed Accounting Standards Update
Leases (Topic 840) – Invitation to Comment

Question 1: Leases
(a) Do you agree that a lease 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?

We agree with the proposal to recognize a right-of-use asset and a liability to make lease payments. We also believe that it is appropriate to recognize amortization of the asset and recognize interest on the liability to make payments.

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 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?
(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?

We support the boards’ initiative to develop a consistent model for both lessees and lessors, however, we do not believe that the proposed ‘hybrid approach’ achieves this goal. We believe that the performance obligation approach is not consistent with the boards’ proposal for lessee accounting in that the recognition by the lessee of a right-of-use asset is an indication that the lessor has performed under the lease agreement by making the asset available for use by the lessee. This performance thereby discharges the lessor’s obligation rather than creating an obligation. As indicated above, we also believe that the performance obligation approach results in double-counting of the asset.

We believe that the derecognition approach is consistent with the right-of-use model. However, we believe that the complexities in the implementation of the derecognition approach and the resulting maintenance under this approach would mitigate any benefits that result in the financial reporting. We do believe that lessee and lessor accounting is inseparable and that the boards should attempt to develop a lessor approach that is fully consistent with lessee accounting.

Question 3: Short-term leases
The 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 twelve 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 lease payments and (ii) the right-of-use asset at the undiscounted amount of the lease payments plus initial direct costs. Such lessees would recognize lease payments the income statement over the lease term (paragraph 65) (see also paragraphs BC41-BC46).

(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, or 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?

JHHSC enters into a significant amount of leases that are less than one year in duration and a significant number of leases for basic office equipment that are not individually or in the aggregate material to our financial reporting. We believe that the requirement to record a lease obligation and a right-of-use asset for each of these short-term or immaterial leases will create an administrative burden that far outweighs any potential benefit in financial reporting accuracy. We do not see the benefit to the users of our statement of financial position that would be gained by grossing up assets and liabilities to include short-term lease obligations and assets. We would propose that the Board consider the use of the simplified requirements that are being offered to lessors such that short-term (twelve months or less) lease rentals are recognized on an accruals basis similar to the current operating lease accounting.

Question 4: Definition of a lease

(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?

We agree that a lease is appropriately defined as a contract in which the right-of-use asset has been legally conveyed, for a usage period, for consideration. As indicated above we would like to see more specificity in the guidance regarding the distinguishing factors between a lease and a service or supply-type contract. We believe that it may be challenging to apply this guidance to practical arrangements and this may lead to differences in application by various organizations.
Question 5: Scope exclusions

The 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 with the proposed scope in the guidance.

Question 6: Contracts that contain service components and lease components

We agree with that it is appropriate to account separately for the service/executory components in a contract that contains both service and lease components. We believe that it is appropriate to exclude the service/executory costs from the payments the lessee uses in measuring the lease asset and obligation. We also agree with the guidance to apply the lease accounting requirements to the combined contracts.

Question 7: Purchase options

We agree that a lessee or a lessor should account for purchase options only when the purchase options are exercised.

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?

As we indicated above, we believe that renewal options that extend the term of a lease should only be included in the calculation of the lease obligation when a lessee has an unconditional obligation to make lease payments or that the exercise of the extension option is virtually certain. We believe that the subjectivity that will be introduced into the valuation of the liability will result in the recording of unreliable estimates of the liability. In the case of long-duration real estate leases that may extend decades into the future, we believe that the uncertainty and inherent subjectivity of assessing whether renewal options will be exercised could result in significant structuring opportunities. If a decision is reached to include renewal terms at a lower level of expectation then we do not support the cumulative probability approach described in the guidance. We believe that this approach will produce a lease term that is not likely to be the same as the longest possible lease term. The use of a statistical approach could result in a result that is different from the organization’s actual intent. Also, if a decision is reached to include renewal terms we believe that additional guidance is necessary regarding whether implied extension options should be considered (options not explicitly in the contract but that have been implied through the organization’s prior practices or expectations).
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?

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 measured reliably? Why or why not?

We agree that contingent rentals and expected payments under term option penalties and residual value guarantees should be included in the measurement of assets and liabilities arising from a lease. We, once again, believe that the complexity of estimating potential contingent rentals will lead to wide variations in application and interpretation of the guidance. We, therefore, believe that the guidance should be enhanced to include specific examples of the proposed application of the expected outcome approach.

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 agree that a reassessment of the estimates for the lease term and contingent payments makes sense for leases when new facts or circumstances indicate that there could be a significant change in the liability to make lease payments or the right to receive lease payments. However, we believe that the application of this to a large portfolio of leases will be a great administrative burden and note that the inclusion of only those lease terms that are virtually certain to occur would mitigate this burden.

Question 11: Sale and leaseback

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?

Yes. We agree that a sale and leaseback transaction has occurred only if the transfer meets the conditions for a sale of the underlying asset in conformity with proposed revenue standards.

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 or investment property as appropriate, 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?

(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?

(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 properly, 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 with the proposed financial statement presentation for a lessee and a lessor. However, believe that materiality criteria should be applied when considering the level of disclosure of the right-of-use asset and the obligations in the statement of financial position and what should be disclosed in the footnotes. As noted above, we do not support the use of the 'hybrid approach' by lessors, however, if the boards continue with this approach we would agree the guidance as to presentation.

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 profit or loss (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?

Similar to our response to question 12 above, we believe that an entity should decide whether separate presentation is necessary in the primary income statement or whether it is adequate to provide disclosure in the footnotes based upon materiality.

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?

See our response to question 13 above.

Question 15: Disclosure

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 with the disclosure proposals a lessee and lessor. However, we are concerned by the level of details required for the disclosures. The list of qualitative and qualitative information is extensive. We believe that there needs to be a focus on providing information that is useful to the users of the financial statements rather than providing information that is not relevant or material to the financial statements (such as reconciliation of the opening and closing balances and disclosure of amounts recognized for short-term leases). We believe that management is in the best position to determine the information that will prove to be useful to the users of its' financial statements. We support the aggregation or disaggregation of information based on management judgment and based upon the usefulness of the information.

Question 16: Transition

(a) The 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 support the proposal for use of a simplified retrospective approach to measure outstanding leases as of the date of initial application. However, we recognize and are concerned that this approach will result in an exacerbation of the effect of front-loaded expense. Furthermore, in the case of a portfolio of leases of long duration, it will take an extreme amount of years for expense normalization to occur. Therefore, we believe that the option to use the full retrospective application approach should also be made available.

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

Regarding lessees we believe that the proposed right-of-use model is an improvement over current accounting practice. We believe that the main benefit to financial statement users will be the inclusion of lease obligations and corresponding assets in the statement of financial position supplemented by a reasonable level of disclosures. However, we believe that the modifications to the proposed guidance that we note above in the areas of short-term leases, renewal extension options, reassessment requirements and disclosure requirements should be considered by the boards as a way to increase the cost benefit of this proposal to the user community.
Also as noted in our response to question 2 above, we do not support the proposed ‘hybrid approach’ in the exposure draft.

Question 18: Other Comments

Do you have any other comments on the proposals?

Under U.S. government cost accounting rules a portion of the interest expense would not be allowable for reimbursement as opposed to the lease expense. This could have a significant economic impact to organizations that contract with the government.

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?

We believe that the guidance should be applicable to public and nonpublic entities.