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Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

File Reference No. 1850-100, Exposure Draft: Leases

Dear Technical Director:

I appreciate the opportunity to comment on the 2010 Aug 17 Proposed Accounting Standards Update, *Leases*. Please note that the views expressed in this comment letter are my own and not those of any of my employers, current or past.

I provide my opinions about the FASB's specific questions for comment as follows:

## The accounting model

The exposure draft proposes a new accounting model for leases in which:

- (a) a lessee would recognize an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortize the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.
- (b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23-BC27).

## Question 1: Lessees

(a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

- (b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?
- (a) Yes, I agree that a lessee should recognize a right-of-use asset and a liability to make lease payments. As noted in paragraph BC6(d), leasing transactions create, for the lessee, rights and obligations that meet the definitions of assets and liabilities. These assets and liabilities can be measured with reasonable reliability (and nearly any measure that a financial statement preparer could competently and ethically compute is more reliable and representationally faithful than "zero", which is what is on balance sheets under the current standards). Therefore, if material, there is no reason that these assets and liabilities should not be presented in the financial statements.

I find the Boards' response in paragraph BC7(b) to the executory contract objection to be persuasive. I can make the point less formally than explained in the exposure draft: Once the lessor turns over control of the underlying asset to the lessee (for example, drops off the keys to the building or delivers the equipment), the lessor has performed. In other words, "FOB has happened." This is not the case when a purchase order or long-term sales and supply agreement is signed. Under many leasing arrangements, the lessor has continuing service obligations (such as maintenance), but these are accounted for separately from the lease according to paragraph 6 and the related application guidance.<sup>1</sup>

(b) Yes, I agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments. The right-of-use asset provided by a lease is economically similar to ownership of the underlying property, plant, or equipment. Therefore, the use of this right should be accounted for in a similar manner to the use of property, plant, and equipment. The obligation to make lease payments is economically similar to debt financing. Therefore, the liability associated with this obligation should be accounted for in a similar manner to debt. The "front-loading" of expense under the proposed model, which is a concern to some, is actually a reflection of the true economics of the leasing arrangement.

# Question 2: Lessors

<sup>1</sup> Regarding the objection to the right-of-use model noted in paragraph BC7(c)—that the "existing guidance is well understood by both preparers and users of financial statements"—I would be interested to see data supporting that assertion. In my 20 years of working with financial statement preparers and users, I have met few who really understand the deep intricacies of the existing lease accounting model. Certainly anyone who objected to the right-of-use model as "too complex" (paragraph BC7(d)) would have a very hard time truly understanding the existing model! As for applying the models in practice, any financial statement preparer that can properly pull together the lease classification analyses at ASC 840-10-25-1(c) and (d) has the skills (and relevant information) to account for the lease using the right-of-use model.

- (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?
- (a) Unfortunately, I have not allocated sufficient time to the review of the exposure draft to offer a complete response to this question. However, there are a few points that I would like to raise.

As with lessees, leasing arrangements also have financial consequences for lessors that should be presented on a lessor's balance sheet for a representationally faithful presentation. These include a reduction in the value to the lessor of the direct use of the leased asset and rights to future cash flows that are, in substance, a financing arrangement. Therefore, these economics should be reflected in a lessors balance sheet and statement of operations.

However, I would caution against presentations that suggest that a lessor has a performance obligation associated with the use of the leased asset by the lessee. This would be inconsistent with my perspective on the economics of lessee accounting, which I discussed in my response to question 1 above, and does not seem consistent with the Boards' view of the economics of lessee accounting either. When it enters into a leasing arrangement, a lessor cedes control of the underlying asset for a period of time. This represents a loss of value of the leased asset to the lessor, which is replaced by a right to a cash flow stream. On the other hand, the Boards' should consider whether the lessor has performed upon ceding control of the asset to the lessee and consider presenting the leasing transaction in the lessor's financial statements in a manner consistent with this view of the arrangement economics. This would involve presenting a reduction in the asset value in all cases, and never presenting a lease obligation.

- (b) See my comments on (a) above.
- (c) Yes, I agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP. As long as the lessor has assumed the risks and rewards of ownership of the asset that it will lease, the method of financing the leased asset does not affect the lessor's benefits and obligations from the leasing arrangement. I find the Boards' rationale for their position documented at paragraph BC15 to be persuasive.

### **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?

I have no significant objections to the Boards' proposed simplified methods for accounting for short-term leases. In general, I oppose "bright-line" designations in accounting standards. I believe that lessees often may be able to apply the same accounting approach as suggested by the Boards by preparing reasonable documentation demonstrating that applying discounting when accounting for certain or all of their leases would not have a material effect on their financial statements. However, in practice materiality judgments can be extremely difficult to make and agree on. Therefore, given the potential high costs to some preparers of applying the complete lessee accounting model to short-term leases, I think it is acceptable for the Boards to insert their reasonable judgment on this materiality matter. The short-term lease guidance is even more helpful to lessors; the Boards' guidance clarifies that the appropriate way to consider the materiality of discounting for short-term leases is based on net effects on the financial statements.

To be clear, in theory I do not believe that it is the place of the Boards to make materiality judgments about the application of accounting standards. However, my 20 years of experience in accounting practice has shown that, in some cases, the lack of such guidance can lead to extreme applications of accounting standards for which the accounting and auditing costs outweigh the informational benefits. Therefore, I agree with providing materiality guidance in some accounting standards, while cautioning the Boards to approach this type of guidance with extreme restraint.

## Definition of a lease

This exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). This exposure draft also proposes guidance on distinguishing between a lease

and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59-BC62) and on distinguishing a lease from a service contract (paragraphs B1-B4 and BC29-BC32).

## Question 4

- (a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?
- (b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?
- (c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?
- (a) Yes, I agree that a lease is defined appropriately.
- (b) I have no comment on this guestion.
- (c) I believe that significant additional guidance is required to resolve issues that have arisen in applying the analogous guidance from IFRIC 4 and ASC 840-10-15-6 through 15-2 (formerly EITF 01-8) in practice. In particular, the Boards should clarify the meaning of "fixed per unit of output" in paragraph B4(e). There is confusion in practice about whether this means "the same throughout the term of a contract" or whether this means "all amounts for the entire term of a contract are fixed at the start of the term". Whatever the Boards' clarification of this is, it would also be helpful if they further explained the rationale behind their clarification. The fact that the gurus at the major accounting firms cannot agree on what this paragraph means suggests that they also cannot understand what the rationale for this condition is. And if they can't understand it, there is no hope for the rest of us.

Also, I have found it very difficult in practice to account for arrangements that contain both a lease component and a service or purchase (of, for example, inventory—not the underlying leased asset) component. I recommend that the Boards' include ample examples of the application of the standard to these situations. See also my comments to question 6 below.

# **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?

Yes, I agree with the proposed scope of the proposed guidance. It certainly seems that accounting for leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources should fit within the proposed lease accounting model. However, I am sure that the Boards' and their staffs' heads are exploding with all the new major standard setting activities presently going on, just like many of our heads are exploding out here in the practitioner environment. I think that the proposed standard addresses the most important issues related to the current lease accounting model, so I think that most practitioners and financial statement users will be comfortable concluding that these scoped-out matters can wait indefinitely for their due attention without concern that present practices under US or international GAAP are significantly off base.<sup>2</sup>

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?

I agree that contracts that contain service components and lease components should apply the guidance in the revenue exposure draft. I tend to prefer the FASB's approach for contracts in which the service

<sup>&</sup>lt;sup>2</sup> In a 2010 Jul 30 comment letter on the IASB's discussion paper, *Extractive Activities*, KPMG made an intriguing suggestion that perhaps there is no conceptual justification for separate accounting guidance for extractive activities. This is one example supporting the idea that one set of activities that is scoped out of the lease accounting exposure draft should indeed be reserved for careful consideration at a later date.

and lease components are not distinct, because of my concerns noted above about the Boards' lessor accounting proposals. I recommend that the Boards ensure that either this lease standard or the revenue standard provide ample examples about separating service and lease components of a contract. I have found this to be a very difficult concept to apply in practice.

# **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?

Yes, I agree that a lessee or a lessor should account for purchase options only when they are exercised. The subject purchase options cannot be net settled, so they are clearly not a derivative instrument subject to accounting at fair value in accordance with ASC 815. Furthermore, I do not think there is much accounting merit to attempting to separately account for a portion of the lease payment stream as pertaining specifically to a purchase option. To the extent that the lessee will be obligated to make the purchase obligation payments throughout the lease term, that obligation and the associated purchase right would be accounted for as an asset and liability, both at the commencement of the lease and subsequently, in a manner consistent with the accounting for the lease asset and obligation. Furthermore, I agree that upon exercise of the purchase option the lease is terminated; at that time, there is no longer an arrangement that meets the definition of a lease, and there is a transaction that, assuming all other relevant requirements are met, has the characteristics of a sale of an asset.

#### 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?

I have no comment on this question.

## 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 reliably measured? Why or why not?

I have no comment on this question.

## 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?

Yes, I 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. In general, I think that these remeasurments are necessary to faithfully present the value of the assets and liabilities arising under the lease, and specifically, I am

persuaded by the detailed justifications for this accounting treatment noted in the Boards' basis for conclusions.

#### 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?

I have no comment on this question.

### **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?
- (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?
- (a) I have no comment on this question.
- (b) I have no comment on this question.
- (c) I have no comment on this question.

## 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?

No, I do not think that lessees should present lease expense separately from other expense in the income statement. Rather, I think that disclosure in the notes to the financial statements of amortization expense on the right-of-use asset and of the interest expense on the liability to make lease payments is sufficient. ASC 360-10-50-1 permits disclosure of depreciation expense, which is economically very similar to amortization of a right-of-use asset. Interest expense on the liability to make lease payments is economically similar to other long-term financing arrangements, including the types that commonly support the acquisition of property, plant, and equipment, so I do not think there is any basis for separate presentation or disclosure of this particular expense. I think financial statement users are most interested in the total cost of an entity's debt financing burden, and disclosures in the notes are sufficient for financial statement users to predict future cash flows associated with debt financing, including that in the form of leases.

### 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?

No, I do not think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows.

I believe that a lessee's amortization of a right-to-use asset is sufficiently similar economically to depreciation of property, plant, and equipment that it can be classified with that depreciation in the

statement of cash flows, and I think that interest expense on a liability to make lease payments is similar economically to interest on other debt. I do not think this additional information on the statement of cash flows would provide substantial additional information that is useful for financial statement users; rather, I think it would add distracting clutter to that statement. I think that a lessee should classify amounts borrowed under a leasing arrangement as a non-cash financing transaction that may be included with other non-cash financing of property, plant, and equipment and should classify repayment of amounts borrowed as a financing activity that is separate from repayment of other debt.

I have no comment regarding statement of cash flow presentation by lessors.

### **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?

Yes, I agree that that lessees and lessors should disclose quantitative and qualitative information that identifies and explains the amounts recognized in the financial statements arising from leases and describes how leases may affect the amount, timing, and uncertainty of the entity's future cash flows. I think the Boards' proposed disclosure requirements meet these disclosure goals and do not require the accumulation of significant amounts of information that an entity that exercises reasonable care in managing its leasing arrangements will not already have readily available.

## **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?
- (a) I have no comment on this question.
- (b) I have no comment on this question.

(c) I have no comment on this question.

### **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?

I have no comment on this question.

### **Question 18**

Do you have any other comments on the proposals?

No, I do not have other comments on the proposals.

### 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?

No, none of the guidance should be different for non-public entities. The economic substance of leasing transactions does not vary based on the nature of the equity interests of an entity and the operational goals of an entity. Therefore, the accounting for leasing transactions should not vary based on the nature of the equity interests of an entity and the operational goals of an entity. Similarly, the importance of information about present and future cash flows associated with leasing transactions is the same for financial statement users, regardless of the nature of the equity interests of an entity and the operational goals of an entity. Therefore, the disclosures related to leasing transactions should not vary based on the nature of the equity interests of an entity.

Sincerely,

/s/ Scott E. Green

Scott E. Green, CPA, CMA

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