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December 4, 2020

Ms. Hillary H. Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference No. 2020-700
Re: Proposed Accounting Standards Update, *Leases (Topic 842): Targeted Improvements*

Dear Ms. Salo:

Deloitte & Touche LLP is pleased to comment on the FASB's proposed Accounting Standards Update (ASU) *Leases (Topic 842): Targeted Improvements.*

We continue to support the Board's efforts to continually evaluate and improve certain aspects of ASU 2016-02, *Leases (Topic 842)*. We also highlight and support the ongoing critical need to address stakeholder feedback on the standard in a timely manner.

Issue 1 — Sales-Type Leases With Variable Lease Payments

We support the proposed amendments related to this Issue. We believe that they address important matters and would enhance the alignment of the accounting outcome with the underlying economics of transactions.

Issue 2 — Option to Remeasure Lease Liability

We believe that the proposed amendments related to this Issue could help preparers reduce costs and complexity, particularly for entities that report under both U.S. GAAP and IFRS Standards, as well as provide more useful and up-to-date information to investors about a lease liability. We encourage the Board to continue to conduct outreach to gauge preparers' interest in adopting the proposed amendments. We believe that given the timing of the amendments, preparers may determine that the cost of changing their processes and controls outweighs the benefits of electing the remeasurement option. Accordingly, we support the proposed amendments as long as preparers continue to indicate that the benefits of adopting them outweigh the costs.

Issue 3 — Modifications Reducing the Scope of a Lease Contract

We recommend that Issue 3 be removed from this project and dealt with at a later date in connection with a broader reconsideration, if necessary, of the modification framework for leases. We support the Board's efforts to improve the operability of the standard and reduce potentially unnecessary costs by making adjustments to the modification framework. However, we continue to have significant reservations about making piecemeal changes to the modification framework, particularly if the Board believes that additional and perhaps more sweeping revisions are likely in the future. We are concerned that any such future changes to the model may undo or alter the proposed guidance in Issue 3. In addition, the proposed changes for Issue 3 may result in further divergence between ASC 842 and IFRS 16. This would be in contrast to the proposed amendments for Issues 1 and 2, which the Board expects would increase convergence between the two standards. We view these outcomes as contradictory, and we would encourage the Board to identify a consistent framework for determining which proposed amendments to consider addressing through the standard-setting process.

The appendix below contains our responses to the proposed ASU's questions for respondents and provides additional details about our positions on each of the Issues identified in the proposed guidance.

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We appreciate the opportunity to comment on the proposed ASU. If you have any questions concerning our comments, please contact James Barker at (203) 761-3550.

Yours truly,

Deloitte & Touche LLP

cc: Robert Uhl

Appendix
Deloitte & Touche LLP

Responses to Proposed ASU's Questions for Respondents

Issue 1: Sales-Type Leases With Variable Lease Payments — Lessor Only

Question 1: *Are the amendments in this proposed Update operable? Why or why not?*

Yes. We believe that the proposed amendments are generally operable as written since the accounting model for lessors in operating lease arrangements is already well-established and understood. We also believe that using the "predominance" threshold is operable since that is the same threshold applied by the lessor when determining whether a combined component should be accounted for under the revenue or leasing guidance.[1] We identify a separate potential alternative to predominance that also may be appropriate, as further discussed in Question 3.

We do believe that there is potential for confusion regarding the proposed guidance in ASC 842-10-25-3A, which states, in part:

> . . . .a lessor shall classify a lease with payments that are predominantly variable lease payments . . . as an operating lease **at lease commencement**. [Emphasis added]

We believe that as written, the language suggests that a modified lease would be excluded from the scope of ASC 842-10-25-3A. Accordingly, we recommend that the Board add the following underscored language to the amendments:

> . . . a lessor shall classify a lease with payments that are predominantly variable lease payments . . . as an operating lease at lease commencement <u>or at the modification date if the lease is subsequently modified</u>."

Alternatively, if the Board believes that a lessor's modified lease should not be subject to the guidance in ASC 842-10-25-3A, we request that the Board clarify its intent in the Basis for Conclusions.

Question 2: *Should a lessor be required to classify and account for a sales-type lease with predominantly variable lease payments that do not depend on a reference index or a rate as an operating lease? Why or why not?*

We support the Board's proposed amendment that would require a lessor to classify and account for a sales-type lease with predominantly variable lease payments that do not depend on a reference index or a rate (hereafter referred to as "variable payments") as an operating lease. Because ASC 842 requires lessors to exclude variable payments from measurement of the "net investment in the lease" asset, leases with a significant amount of variable payments at times

[1] See ASC 842-10-15-42B.

result in the lessor's recognition of a day 1 loss for accounting purposes even when the economics of the arrangement are expected to be profitable. In addition, the subsequent variable payments are recognized in their entirety as lease revenue instead of being allocated between a reduction of the net investment in the lease and interest income. We believe that this outcome does not faithfully represent the economics of the transaction both at lease commencement (i.e., day 1 loss) and over the lease term (i.e., higher lease income). The proposed amendments rectify the divergence between the accounting outcome and the economics, which will improve the decision usefulness of the information available to investors. In addition, we understand that the prevalence of these types of arrangements is expected to increase, which elevates the need for the proposed changes to the standard.

Question 3: *Should "predominant" be the threshold for determining when a lessor should classify a lease with variable payments that do not depend on a reference index or a rate as an operating lease? Alternatively, would another threshold be more appropriate and operable (for example, "substantially all")? Please provide your rationale.*

We believe that "predominant" is an appropriate threshold for the proposed amendments. As discussed above, predominant is already the threshold lessors use when assessing whether a combined component should be accounted for under ASC 842 or ASC 606. We believe that the proposed threshold would be appropriate in the great majority of transactions in which the accounting outcome does not currently reflect the economics.

However, we also believe that it would be appropriate for the lessor to evaluate whether the combination of all undiscounted fixed lease payments and the expected residual value of the leased asset are equal to or greater than the fair value of the asset. In cases in which those combined amounts are less than the fair value of the leased asset, the lessor would classify the lease as operating. This would ensure that no arrangement that is expected to be profitable would result in the recognition of a day 1 loss. Conceptually, the test would ensure that the lessor's rate implicit in a sales-type lease is at least zero.

Regardless of which threshold the Board ultimately adopts, we strongly agree with the Board's statement in paragraph BC15 of the proposed ASU. Specifically, we do not believe that these amendments should be viewed as "affect[ing] the principles related to transfer of control in Topic 842 . . . but, rather, would be a practical solution only for lessors with a day-one loss issue."

Question 4: *Would the proposed amendments provide improved decision-useful information for users of financial statements? Why or why not?*

Yes, as discussed in Question 2, we believe that the proposed amendments would provide improved decision-useful information to users of financial statements because the accounting outcome would better reflect the economics of the arrangements.

Issue 2: Option to Remeasure Lease Liability — Lessee Only

Question 5: *Are the proposed amendments operable? Why or why not?*

Yes. We believe that the proposed amendments are generally operable as written since they are modeled on the guidance in IFRS 16, which has proven to be operable.

However, we believe that the example in the proposed ASU is not sufficiently aligned with the example in IFRS 16. Example 14A in IFRS 16 illustrates the application of remeasurement for a change in the reference index or rate. In Example 14A, the change in the index is determined at the beginning of the year, which is the same period in which the next payment is due; however, the liability is remeasured before the lease payment is made. Since the index is known and takes effect before the payment is made (i.e., the payment at the beginning of year 3 in Example 14A), the liability is remeasured before (and not after) the payment. This is sensible because before the payment can be made by using the revised index, the index must be known and effective. By contrast, the example in the proposed ASU notes that the remeasurement occurs after the lease payment is made. This guidance seems inconsistent with the IFRS 16 example and with the principle of remeasuring the lease liability when the change in the index takes effect (i.e., the change in index had to take effect before the payment was made because it revised the required payment).

Since the Board intended to conform the proposed ASU with IFRS 16, we believe that the guidance in ASC 842-10-55-231A should align with that in Example 14A of IFRS 16 to the extent possible.

Lastly, we believe that the Board intended to conform the proposed amendments to the guidance on lessee accounting with the guidance in IFRS 16. While IFRS 16 is silent on whether lessors are required to apply remeasurement guidance to changes in a reference index or rate, we have observed that many stakeholders have interpreted IFRS 16 to allow lessors to remeasure their lease balances as an accounting policy election. Because the proposed amendment specifies that it is related to lessee accounting, we believe that it would be appropriate for the Board to clarify whether lessors would be able to apply this guidance.

Question 6: *Should a lessee be provided with an option to remeasure lease liabilities solely for a change in a reference index or a rate on which payments are based? Why or why not?*

We support the Board's proposed amendment to give lessees an option to remeasure lease liabilities for a change in a reference index or rate on which payments are based when the change in the index or rate takes effect. We believe that the amendment is supportable conceptually. Further, the Board has acknowledged that remeasurement provides the most up-to-date information about a lessee's future lease obligations. The current requirements under ASC 842 are based on a determination that the benefits of remeasurement did not justify its costs to preparers. However, given the divergence between U.S. GAAP and IFRS Standards, preparers that report under both sets of standards have not been able to avoid those costs. We believe that giving lessees the option to remeasure will possibly reduce preparation costs and complexity without significantly affecting the comparability of entities' financial statement information.

Further, we believe that any reduction in comparability would be offset by the benefits financial statement users gain from receiving updated information about future lease obligations.

However, in discussing the proposed amendments with certain dual-reporting clients, we have found that many do not expect to elect the provided option. They noted that if it had been available when they adopted ASC 842, they would have elected it then, but at this point they believe that the costs of changing their processes and controls would outweigh the potential benefits of converging the guidance under IFRS Standards and U.S. GAAP. We encourage the Board to conduct outreach to ensure that there is still demand from preparers on this issue and, if not, to potentially reconsider the proposed amendment.

Question 7: *Should a lessee be required to make an entity-wide accounting policy election to remeasure lease liabilities solely for a change in a reference index or a rate on which payments are based? Why or why not? If not, at what level should that accounting policy election be required to be applied?*

Yes. We believe that the election should generally be made on an entity-wide level. As we discussed in Question 6, we believe that the benefit of this proposed amendment is to reduce costs and complexity for entities that report under both ASC 842 and IFRS 16. IFRS 16 requires remeasurement in all cases for changes in a reference index or rate. Accordingly, an entity's election to remeasure only for a specific type of asset class or on some other basis would not comply with IFRS 16. If the election were made on a more granular basis than entity-wide, the comparability concerns described in Question 6 would be exacerbated since entities may differ with respect to the degree to which they apply the option. Further, any reduced costs and complexity that resulted from such an election would be offset by expenses associated with establishing separate processes and controls, depending on the basis on which the entity was electing the option.

However, if the Board elected to expand the scope of the amendments to include lessors, entities might be given an opportunity to make a separate election for their lessee contracts in which they are the lessee as opposed to lessor. We suggest that the Board and staff conduct additional outreach with preparers and financial statement users on this potential option.

Question 8: *Would the proposed amendment provide improved decision-useful information for users of financial statements? Why or why not?*

We believe that an entity's election of the option would provide improved decision-useful information to users of the financial statements. We agree with the statements in paragraph BC16 of the proposed ASU, in which the Board indicates that it "recognized that remeasuring the lease liability provides the most updated information about a lessee's future cash obligations."

As discussed in Question 6, we acknowledge that the option offered under the proposed ASU would decrease the comparability of entities reporting under U.S. GAAP. However, we do not believe that the decrease would be significant or impede financial statement users. We also support the proposed ASU's requirement for entities to disclose their election of the option.

Question 9: *Would the comparability of information be significantly affected by the option to remeasure lease liabilities solely for a change in a reference index or a rate on which payments are based?*

No. See our responses to Questions 6 and 8.

Issue 3: Modifications Reducing the Scope of a Lease Contract

Question 10: *Are the proposed amendments operable? Why or why not?*

While the amendments may be operable, we believe that establishing these requirements is premature and could lead to greater financial reporting costs. Despite our reservations about this guidance, however, we support making adjustments to the modification framework to improve the operability of the standard and reduce potentially unnecessary costs. In general, we support evaluating whether amendments to the modification framework are necessary; however, we believe that changing the modification framework in a piecemeal fashion may result in unintended consequences or complexities if the Board attempts to further revise it at a later date. In addition, we have the following specific concerns regarding this proposed guidance:

1. We have questions related to whether the proposed guidance will be applicable in most circumstances. The Board notes that the guidance would apply to cases in which partial early termination does not economically affect the remaining lease components. However, we question whether situations would occur frequently in which a reduction in scope would not affect the economics of the remaining lease components. In reducing the scope of the lease, the lessor is giving up value to relieve the lessee of its contractually bound obligations and typically recovers that value through a termination payment or increased future lease payments for the remaining components. Furthermore, we believe that some of the scenarios that appear to be contemplated in the proposal would not be modifications since they are often contemplated in the original lease terms (e.g., casualty events). See item (7) below for further discussion.

2. The proposed requirements may result in further divergence from IFRS Standards. Adoption of the proposed amendments in Issue 1 and 2 would improve the overall alignment of IFRS 16 and ASC 842. While the modification framework for the two standards is generally aligned, the proposed requirements could create additional cost and complexities, especially for dual reporters. This appears to contradict a principal goal of Issue 2, which is to reduce divergence and thereby reduce costs for dual reporters.

3. We believe that the proposed requirements would create confusion and complexity regarding the interaction between ASC 842 and ASC 606. Currently, the framework of accounting for a contract modification by a lessor under ASC 606 is substantially aligned with that under ASC 842. The proposed ASU introduces a separate model for the accounting treatment of certain eligible changes to contracts. We believe that this would create challenges, particularly in circumstances in which there are lease and nonlease components in a single contract that have not been combined by the lessor under ASC 842-10-15-42B. We believe that the guidance is not clear regarding how an entity should consider changes to a contract that has both lease and nonlease components. For example, what is required under the framework if the change to a contract leaves the lease components "economically unaffected" but the contract amendment stipulates that the lessor receives significantly more consideration related to the nonlease component? May an entity conclude that the termination of a lease component does not affect the remaining lease components even if the nonlease components are affected? If an entity is supposed to allocate total consideration changes to lease and nonlease components, how should it do so? Should it use updated stand-alone prices (or stand-alone selling prices), or should it use the original prices determined at lease inception? We believe that alignment of the contract modification guidance in ASC 842 and ASC 606 offers significant benefits (and cost reductions) and that the divergence created by the proposed requirements will result in increased cost and complexity for both preparers and users of the financial statements.

4. In paragraph BC21 of the proposed ASU, the Board cites preparers' concerns related to unjustified cost and complexity as part of its rationale for proposing the amendments for this Issue. We believe that the proposed requirements may result in minimal net change in cost and complexity to preparers. That is, the cost and complexity associated with applying the screens described in ASC 842-10-25-8B would effectively offset any benefit the preparer would gain by not having to apply the modification framework. In particular, the need to assess whether total payments are "substantially the same" before and after the modification would introduce additional complexity and require the use of additional judgment by both preparers and auditors.

5. As currently drafted, the proposed guidance and discussion in the Basis for Conclusions make it clear that an entity does not need to reassess lease classification or the discount rate if the partial termination meets the requirements in ASC 842-10-25-8B. However, the proposed amendments are currently unclear about whether an entity (1) is required to reassess the stand-alone price (or stand-alone selling price) of its lease and nonlease components or (2) should continue to use the respective prices as determined on the lease inception date.

6. We have concerns regarding the costs to change controls, processes, and IT systems as a result of the proposed changes. We understand that many (but not all) lease accounting systems have been designed to perform the partial termination accounting in accordance with ASC 842. Presumably, these systems would have to be reprogrammed to conform to the proposed amendments. It is also unclear whether these costs would be warranted, particularly given that we do not believe that the circumstances outlined in ASC 842-10-25-8B will be prevalent and that the changes outlined in the proposed ASU may be subsequently overridden by later amendments to the lease modification model. We suggest that the Board conduct additional outreach with preparers regarding this concern before it finalizes this guidance.

7. Proposed ASC 842-10-25-8B(c) indicates that in assessing whether total payments for remaining lease components are substantially the same, entities should exclude payments made to purchase the underlying asset or for casualty losses if those payments are made in accordance with the terms and conditions of the contract. We are concerned that this could result in inconsistencies attributable to the structuring of arrangements as well as in accounting treatment that does not reflect the economics. The proposed amendments seem to be based on an implicit assumption that the stated terms of the contract will reflect the transaction's underlying economics, which contradicts other guidance in ASC 842 that requires entities to allocate consideration to components on the basis of stand-alone price and prevents such entities from manipulating accounting outcomes via the structuring of the contract.

   We also have questions regarding the purpose of the language in proposed ASC 842-10-25-8B(c), which discusses the exclusion of purchases of the underlying asset or casualty losses that are in accordance with the terms and conditions of the contract. The language in this paragraph seems to imply that the Board believes that in the absence of the proposed amendments, if these purchase or casualty loss provisions are enforced, there has been a contract modification. The ASC master glossary defines a lease modification, in part, as "a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease." If the outcome is consistent with purchase or casualty loss provisions that were always part of the contract (i.e., since inception), we do not believe that the entity's enforcement of such provisions is a contract modification. While the Board may have intended the proposed amendments to provide relief from modification accounting in instances of a casualty event, we do not believe that current GAAP requires modification accounting in such circumstances.

8. We believe that the treatment of termination payments under the proposed amendments would result in contradictory outcomes. Under ASC 842-10-25-11, if a modification occurs, the remaining consideration in the contact must be allocated to the remaining lease components. ASC 842-10-25-11 neither requires nor permits entities to allocate a

portion of the remaining consideration to the terminated component(s) of the contract. However, if a modification meets the criteria in ASC 842-10-25-8B, the proposed amendments would require the entity to recognize the termination payment in earnings, in the period in which the termination occurs, to prevent the accounting for the remaining lease components from being affected. These outcomes are contradictory and, in addition, the lessor's up-front recognition in earnings of a termination payment is incongruent with the treatment of a termination payment under ASC 606. We understand that to satisfy the conditions of the proposed amendments, such payments would generally be expected to be insignificant, but the proposed guidance would nevertheless result in treatment that is otherwise prohibited by ASC 842.

9. Lastly, the proposed amendments to ASC 842-10-25-13 and ASC 842-10-55-177 indicate that if a lease contract contains only a single lease component, the entity would not be able to apply the provisions in ASC 842-10-25-8B under which the accounting for the remaining lease components would not be adjusted. We believe that clarification would be helpful regarding the proposed ASU's process for assessing whether a contract contains only a single lease component. Specifically, the example in proposed ASC 842-10-55-177 indicates that the lease of the 10,000 square foot building that is reduced in scope to a lease of 5,000 square feet requires the application of the modification framework because it "is a single lease component." However, it is unclear which facts support the conclusion that the contract has a single lease component, particularly when this example is contrasted with the one discussed in paragraph BC29 of the proposed ASU. In that paragraph, the Board states that a reduction in the scope of a building lease may be an indicator that the contract consists of separate lease components even if an entity did not identify and separate the lease components on the commencement date. It would be helpful if the Board explained how it concluded that the example in ASC 842-10-55-177 is a single lease component.

Question 11: *Would the proposed amendment provide improved decision-useful information for users of financial statements? Why or why not?*

For the reasons outlined in Question 10, we do not believe that the proposed requirements would provide improved decision-useful information for users of financial statements.

Question 12: *Are there other aspects of the modification accounting model in Topic 842 that could be improved without compromising the decision useful of the information provided?*

If the Board determines that multiple adjustments to the modification framework are necessary to improve the operability of the standard and reduce potentially unnecessary costs, we believe that those adjustments should not be made on a piecemeal basis. Examples of potential adjustments could include changes made to address concerns about whether a lease modification should result in a revision to the lease classification solely because of the passage of time, as described in paragraph BC21. In addition, it may be helpful for the Board to consider whether the application of a less burdensome model may be appropriate for minor lease modifications. However, we believe that continued convergence with IFRS Standards and, for lessors, alignment with the modification requirements under ASC 606 should be prioritized if changes are needed to the modification framework unless there are clear benefits to divergence.

Transition

Question 13: *For entities that have not adopted Topic 842 by the effective date of a final Update of these proposed amendments, should the propose amendments be applied at the date that an entity first applies Topic 842 using the same transition methodology in accordance with paragraph 842-10-65-1(c)? Why or why not?*

We agree that an entity that has not yet adopted ASC 842 should apply the proposed amendments on the date on which it first applies ASC 842 by using the same transition method in accordance with ASC 842-10-65-1(c). Allowing entities that have not yet adopted ASC 842 to adopt the proposed amendments at a different time would, given the different adoption dates, decrease the comparability of an entity's financial information. In addition, the proposed amendments permit prospective adoption. If an entity adopted the proposed guidance separately from its adoption of ASC 842 and applied it prospectively, it would account for similar transactions differently. Though the prospective approach may be appropriate for entities that have already adopted ASC 842 because of the cost of a retrospective approach, we support the Board's efforts to generally minimize instances in which similar transactions are accounted for differently on the basis of the periods in which transactions are entered into. If entities adopted all the requirements of ASC 842, in accordance with their applicable effective dates, on the basis of their filing status, the comparability of entities and periods would be improved.

Question 14: *For entities that have adopted Topic 842 by the effective date of a final Update of these proposed amendments, should the proposed amendments be applied either retrospectively or prospectively as described in this propose Update? Why or why not?*

We generally believe that retrospective application is preferable conceptually since it would minimize differences in how similar transactions are accounted for in different periods. However, given the cost of a retrospective approach and the costs already incurred by entities that have adopted ASC 842, we support permitting prospective adoption of the proposed amendments for those entities that have already adopted the standard.

We also support the Board's proposal to permit entities to independently adopt and apply separate transition methods to each Issue of the proposed ASU. We view the Issues addressed in the proposed ASU as distinct and believe that the degree to which entities may be affected by the proposed changes, or be ready to adopt them, could differ significantly. The ability to independently adopt and apply separate transition methods to each Issue would permit entities to align their implementation of the guidance with their specific circumstances.