

JPMORGAN CHASE & CO.

Louis Rauchenberger
Managing Director & Corporate Controller

December 15, 2010

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

Re: File Reference No. 1850-100: Proposed Accounting Standards Update, *Leases (Topic 840)*

Dear Mr. Golden:

JPMorgan Chase & Co. (“JPMorgan Chase” or “the Firm”) appreciates the opportunity to comment on File Reference No. 1850-100: Proposed Accounting Standards Update, *Leases (Topic 840)* (the “Exposure Draft” or “ED”), issued by the Financial Accounting Standards Board (“FASB” or the “Board”). The Firm generally supports the Board’s efforts towards the development of a converged accounting framework for lessees to present lease obligations on balance sheet, consistent with the adjustments currently made by most financial statement users. However, we believe that the Board’s primary objectives could be achieved without introducing such a level of complexity into existing accounting practices and we encourage the Board to explore simplifications to the Exposure Draft.

In addition, we do not support the new accounting model for lessors, as we believe that the current accounting and disclosures for lessors are generally appropriate, have not raised significant concerns in practice, and would not be significantly improved by the proposed changes. We believe that the Board’s convergence objective could be more efficiently achieved by the adoption of the concepts in IAS 17, *Leases*, in International Financial Reporting Standards.

We also note the Board’s announcement on September 3, 2010 that marked changes to the Accounting Standards Codification will not be released for comments because “they are not necessary for an understanding of the proposals.” We believe that a public review of the proposed changes is an important step in the Board’s due process and urge the Board to expose for public comment marked changes to existing guidance prior to the issuance of final standards.

Our comments on the Exposure Draft are summarized below.

Lessee Accounting

We acknowledge that various users of financial statements often adjust a company’s financial statements to incorporate certain contractual obligations related to lease arrangements that are currently off-balance sheet. Accordingly, an accounting framework to present such lease obligations on balance sheet should generally reflect the adjustments that financial statement users make today and should not introduce unnecessary complexity to achieve that objective. However, the Exposure Draft’s treatment of renewal periods and contingent rent is conceptually flawed; the Exposure Draft requires additional subjective assessments that both introduce unnecessary complexity and potentially decrease comparability between

JPMORGAN CHASE & CO.

reporting entities and, may result in financial statement users needing to continue adjusting recognized liabilities in order to reflect an entity's true obligations.

Renewal Periods

The Exposure Draft requires lessees to incorporate both renewal and termination options, specifically based upon a model that requires "the longest possible term that is more likely than not to occur." We believe that such a framework is both theoretically flawed and difficult to apply in practice.

First, we do not believe that renewal options meet the definition of a liability under the Conceptual Framework, which defines a liability as "a present economic obligation for which the entity is the obligor." At the onset of a contract, a lessee is not obligated for terms extending beyond the initial lease term. Including such periods would provide misleading information to financial statement users regarding the reporting entity's actual obligations by including amounts that an entity is not contractually or economically compelled to pay. We believe the proposal should recognize liabilities that are contractually required by the lessee rather than incorporating uncertain amounts that are dependent on future events.

In addition, we believe that renewal periods are often included in lease agreements for the simple reasons of providing flexibility given unknown circumstances in the future and judgments regarding such future circumstances are very difficult and often would not provide reliable information to users of financial statements. For example, real estate lease contracts are generally long-term in nature; yet, the Firm's projections and business needs are typically based on five- or ten-year horizons. In practice, contracts are often extended, renegotiated, or even terminated prior to reaching the contractual renewal periods. Estimating such renewal options for large portfolios would be operationally cumbersome and create further confusion for users of the financial statements, especially since an entity may have various types of leases (e.g., commercial office space, retail space, data operation centers, and ATMs) with varying terms.

We understand that the Board may be concerned about potential practice issues involving the structuring of leases with unreasonably short base terms to avoid recognition of a liability. However, we believe such concerns can be adequately addressed by retaining the "reasonably assured" model for estimating lease terms as set forth in current standards. If, for example, a lease were structured with a base lease period that was not commercially reasonable such that the lessee would be essentially required economically to exercise its renewal option, then such renewal periods should be included as a present economic obligation.

Contingent Rents

Similar to renewal options discussed above, we do not believe that contingent rents meet the definition of a liability under the Conceptual Framework at lease inception. Contingent rentals are based on the occurrence of some future events that may or may not happen, and therefore should be excluded from the initial lease obligation and recognized in the income statement during the period it becomes probable that the contingent event will occur. Many agreements with contingent rents are based on transactional volume or revenue metrics that reflect the productivity of the leased asset. The Exposure Draft would accrue a liability for such contingent rents when estimated, rather than when such revenue or activity actually occurs, and we believe it is inappropriate to recognize the liability and the resulting expense related to such leasing activity in different periods or in a different pattern from the related revenue or activity.

We also believe that such projections of activity may be very difficult to make on a lease-by-lease basis. For example, the Firm currently has lease contracts for our ATMs where the lease amount is based upon monthly transactions and location. Transactional activity could be influenced by many different factors, such as location and the economic environment, which would further complicate obtaining a reliable estimate. Estimating contingent rents in the initial measurement creates a significant operational burden

JPMORGAN CHASE & CO.

with respect to an already complex and cumbersome model without an expected improvement in transparency.

Therefore, we strongly recommend that the Board retain the current method of recognition of contingent rentals (i.e., accrue rent once the achievement of the target is probable), which would align recognition of rental obligations to the periods when such obligations become true liabilities. If the Board retains the proposals to include contingent rentals in the initial measurement of the lease receivable and payables, then we urge the Board to use a best estimate approach for contingent rents and also revisit subsequent measurement provisions. Probability-weighted average approaches are often impractical because they require a level of precision that generally does not exist in practice. (For example, it is generally impossible to estimate the precise likelihood of a specific scenario far into the future, and therefore a probability-weighted approach implies a false sense of precision about the estimate.) In addition, we believe the reassessment of lease contracts every quarterly reporting period is excessively burdensome compared to the additional information provided. Instead, we recommend that such reassessments be required when there are facts and circumstances that suggest that a material revision is warranted.

Right-of-Use Asset

We agree with the Board that the right-of-use asset should be reported in the statement of financial position within property, plant and equipment because the Exposure Draft is based on the premise that leases are financing transactions, and the right-of-use asset is recognized as a proxy for the tangible leased asset. However, the impairment model in the Exposure Draft references accounting literature related to intangible assets, and this reference may result in unintended confusion regarding the nature or classification of the right-of-use asset. We suggest the ED be revised to eliminate the reference to intangible assets entirely, and to directly specify the impairment model, or alternatively, require that the right-of-use asset be tested for impairment *as if it were* an intangible asset directly subject to Topic 350 (Intangibles).

Other

Executory Costs

The Exposure Draft uses the concept of distinct versus non-distinct services similar to that used in the Revenue Recognition Exposure Draft issued in July 2010; however, such a concept is not appropriate within the ED. Real estate lease terms frequently include executory costs, which are currently excluded from minimum lease payments. Examples of such costs that may be included in the lease payments (e.g., as is the case in a gross lease) are real estate taxes, utility expense, maintenance, property management, snow removal, landscaping, security, and cleaning. The Exposure Draft does not specifically discuss executory costs or the accounting implications but it appears that costs such as property taxes most likely would not meet the definition of a distinct service and therefore would be included in the initial measurement. If an entity were to purchase the same asset, then such costs would be expensed as incurred, hence, this accounting guidance proposed within the ED would result in inconsistent treatment of such costs between owned properties and leased properties. We recommend that the Board retain the current definition and accounting treatment of executory costs provided within Accounting Standards Codification (“ASC”) 840.

Lease Incentives

The Exposure Draft fails to address accounting guidance for lease incentives that are common in many leases, especially real estate lease agreements. Common lease incentives include: up-front cash payments to the lessee, payments for certain moving costs or leasehold improvements, assumption by the lessor of a preexisting lease with a third-party, and free rent periods. Under the current accounting, incentives are

JPMORGAN CHASE & CO.

accounted for on a straight-line basis over the term of the lease as a reduction of rental expense. We believe that this treatment is appropriate, and encourage the Board to incorporate this guidance into the Exposure Draft.

Lessor Accounting

While we understand the Board's desire to maintain a certain level of consistency between the lessee and lessor accounting model, we do not believe that the proposed approach to lessor accounting will improve accounting and financial reporting. Lessor accounting under U.S. GAAP has not raised concerns from financial statement users, and we are concerned that the proposed approach will not be aligned with the economics and realities of leasing transactions, and will increase complexity, particularly with respect to lease classification and the requirements regarding lease term and contingent rents.

Accordingly, the Firm believes that it would be preferable for both the FASB and the International Accounting Standards Board (IASB) to decouple the lessor project from the lessee project in order to further consider alternatives to the lessor accounting proposed in the Exposure Draft. Specifically, if one of the Board's objectives is to achieve convergence, and if the Board believes that the ASC 840 includes too many proscriptive rules or bright-line tests, then we recommend that the Board consider the current IAS 17 accounting as an acceptable alternative. As further discussed below, the current IAS 17 accounting preserves the essential theoretical framework of the U.S. GAAP accounting model, but has the advantages of being more streamlined and principles-based.

The current lessor accounting framework in ASC 840 provides for four different lease classifications for lessors, which reflects the diversity in lease transactions, which range from the simple renting of an office copier to the financing of a power plant and aligns with the business models of lessors:

- Direct financing leases reflect the economics of the lease, which is essentially a loan, and the income recognition pattern reflects earnings based on the interest rate implicit in the lease.
- Sales-type leases (for manufacturers/dealers) permit up-front recognition of profit, consistent with a sale by the manufacturer.
- Operating leases (for lessors that retain asset risk) recognize the reality of the leasing business, which is that certain leases are merely the rental of property, as opposed to a financing, and therefore, recognizing income on a straight-line basis (or based on usage) over the lease term reflects the economic reality of those arrangements.
- Specialized leveraged lease accounting for leases financed in part by third-party nonrecourse debt reflects the investor's recovery of cash flows, and the accounting mirrors the unique structure of a leveraged lease where the lessor recovers its investment early in the lease life via tax benefits.

The Exposure Draft would replace this framework with just two approaches—a “performance obligation approach” used when the lessor retains exposure to significant risks or other benefits from the underlying asset, and a “derecognition approach” used for all other leases. The Exposure Draft suggests that an entity's business model will indicate which approach is appropriate, thus aligning the accounting with the business model. However, we do not believe this to be true in practice—one business could have leases recorded under both approaches depending on the lease terms and/or residual values assumed. For example, entities such as banks may have leases that would be classified using the performance obligation approach, even in cases where the business unit's model is not to generate a return from active management of the underlying assets (with the principal risk being asset risk), but rather is to provide financing (with the principal risk being credit risk). This is because while the general business model may focus on one type of transaction, the determination of whether “significant risk” is retained must be made at a transaction level, and we believe there will inevitably be transactions in which the “significant risk” determination is a close call, but results in a lease classification that is different than the lessor's general business model.

JPMORGAN CHASE & CO.

In addition, we are concerned that the Exposure Draft will increase complexity in at least two ways:

- Lessors must address what constitutes “significant” risks or benefits. This judgment seems at least no easier than the judgments required to apply IAS 17 (regarding whether the lease term is a “major part” of the asset’s economic life and whether the present value of lease payments represent “substantially all” of the asset’s fair value), and is much more judgmental than ASC 840, which provides quantitative guidelines to encourage consistency in those matters.
- Lessors must make important assumptions about the lessee’s behavior which are by no means certain or known to the lessor (e.g., whether the lessee will exercise renewal options) in addition to estimates of contingent rentals, residual value guarantees, etc.

Based on the complexities raised by the Exposure Draft’s framework and the lack of significant practice issues with current lessor accounting, we urge the Board to decouple the lessor accounting framework from the lessee framework, and consider the retention of the existing concepts in ASC 840 and IAS 17.

Leveraged Leases

As discussed above, we believe that the specialized accounting permitted for leveraged leases is conceptually appropriate because the accounting result reflects the economics of the underlying transaction and, therefore, it should be retained in any new lessor accounting model. Leveraged leases are specifically structured to reflect the tax attributes of the financing and the economic effect of those tax attributes are incorporated into the lease payments. The accounting treatment specified in ASC 840 for leveraged leases incorporates the tax consequences by reflecting the lessor’s investment, net of the related nonrecourse debt, on its balance sheet, with earnings recognized on a level-yield basis only during the periods in which net investment is positive.

In contrast, the Exposure Draft does not provide an approach that takes into consideration the uniqueness of the leveraged lease. As a result, the lessor would overstate its economic claim to the lease receivables (along with the nonrecourse debt), and the lessor’s income statement would no longer be aligned with the economics of its investment.

Sale-Leaseback

The Exposure Draft sets a high threshold for transactions to qualify for sale-leaseback accounting. Under current lease accounting, the sale and leaseback are evaluated separately—first, the transaction is reviewed to determine if it qualifies as a sale, and then the lease is classified (and gain on the sale is deferred in full or in part, if required). However, under the ED, the sale-leaseback is considered an integrated transaction. Thus, if the buyer-lessor leases the asset to the seller-lessee and does not retain significant risks and benefits (i.e., the lease would qualify for the derecognition approach), then the transaction will not qualify as a purchase, and the buyer-lessor would not record the purchased asset. Instead, the buyer-lessor would account for the transaction as a financing (recognize a receivable for any amounts paid the seller-lessee which will be reduced as the seller-lessee makes lease payments). Accordingly, only the performance obligation approach may be used by a buyer-lessor in a sale-leaseback transaction that qualifies for sale-leaseback accounting.

In practice, a lessee may purchase an asset which it fully intends to lease in advance of locating the buyer-lessor that will provide financing for the asset. We believe that such transactions are not in substance a sale-leaseback transaction, because of the short period of time in which the lessee owns the asset. However, the ED requires that the sale-leaseback provisions be applied, and sale-leaseback accounting would be precluded in cases where the lease would be accounted for under the derecognition approach. We believe

JPMORGAN CHASE & CO.

that a lessor's accounting for a lease should not depend on how the asset was acquired by the lessor, i.e., the lessor's accounting should not be impacted by the fact that the seller-lessee may have held title to the asset for a brief period prior to selling it to the buyer-lessor. Accordingly, we believe that the ED should be revised such that the sale/purchase is evaluated separately from the leaseback in determining whether sale-leaseback accounting may be used, as permitted by current guidance.

Residual Value

Under the derecognition approach, the lessor's residual interest in the asset represents the remaining economic benefits not transferred to the lessee. The residual asset is not subsequently remeasured except for impairment or when reassessment of the lease receivable results in a change in the residual asset. The Exposure Draft does not allow the residual asset to be accreted to fair value by lease end. We disagree with this approach, and believe that the residual asset should be accreted to its estimated fair value, as currently permitted under the leasing guidance. The estimated fair value represents an anticipated economic inflow to the lessor, just like other cash payments received, and should be included in the lessor's income stream during the lease to accurately reflect the lessor's economic returns from the lease transaction.

Rate Charged to the Lessee

The Exposure Draft states that the discount rate used to determine the present value of lease payments for lessors is the rate that the lessor charges the lessee. Paragraph B12 of the Exposure Draft states that such rate could be, for example, the lessee's incremental borrowing rate, the rate implicit in the lease or, for property leases, the yield on the property. We recommend that this definition be simplified, as the alternatives provided allow for differences in interpretation and therefore are likely to cause diversity in practice. We believe that the rate implicit in the lease is well understood by lessors and should be used as the sole definition for "the rate charged to the lessee."

Effective Date and Transition Issues Common to Both Lessee and Lessor Accounting

JPMorgan Chase plans to comment on the Board's Discussion Paper, *Effective Dates and Transition Methods*, which addresses the effective date of the Exposure Draft along with several other current Board projects. Our comments below address transition issues specific to the Exposure Draft.

If the Exposure Draft were finalized as proposed, then we believe that a simplified retrospective approach will be very onerous for both lessors and lessees due to the need to review the terms of all leases to obtain the information necessary to comply with the Exposure Draft. Such a review would require a significant investment in time and resources. Companies would need adequate time to obtain, develop, and test suitable technology systems; collect and input the relevant data; run parallel; and analyze outputs.

In addition, we believe that three transition issues should be clarified:

- Paragraph 91 of the Exposure Draft addresses the need to adjust the right-of-use asset to include recognized prepaid or accrued assets, but is unclear whether it includes straight-line rent adjustments that lessees currently have recognized on their balance sheets. We believe that it should include all related assets.
- For lessors, it is not clear whether the lease classification analysis at transition should assume the facts and circumstances that existed at inception or whether the lessor should consider facts and circumstances that exist as of the transition date. For example, assume an entity owns equipment that it has leased to a lessee under a three-year lease. At inception, the entity did not originally

JPMORGAN CHASE & CO.

expect that the lessee would renew but, at the transition date, which is during the last year of the lease, a seven-year renewal of the lease is under negotiation and expected to be signed. It is not clear whether the renewal should be considered or not in transition.

We believe that a preferable approach would be to simply permit existing finance leases and operating leases to be classified at transition using the derecognition approach and performance obligation approach, respectively. This approach would avoid the need to recreate facts and circumstances that existed at the inception of a lease, while also avoiding reclassification of a lease simply based on new facts and circumstances.

- It is not clear whether lessors are required to retrospectively review contracts to determine if the transaction would have qualified as a sale-leaseback at the initial measurement date (e.g., the lessee temporarily took title during the course of the transfer). The Firm, as buyer-lessor, does not believe that it would be practical to review all leases prior to transition to determine whether a sale-leaseback occurred and whether the purchase conditions were or were not met at that time. Accordingly, we recommend that the transition provisions of the Exposure Draft be revised to permit leases to be classified at transition without requiring a review to determine if the transaction qualified as a purchase at inception.

Finally, although analytical adjustments are often made to financial statement information to address existing operating leases, we note that those methods may differ from the changes suggested by the Exposure Draft. Furthermore, we believe that Exposure Draft may have implications to financial measures and ratios commonly used in credit arrangements (with lenders and suppliers), legal agreements, and regulatory standards. We believe that the Board must consider these issues in determining the effective date to ensure that preparers and other stakeholders have sufficient time to properly address the revisions or renegotiation of such arrangements.

* * * * *

We appreciate the opportunity to submit our views and would be pleased to discuss our comments with you at your convenience. If you have any questions, then please contact me at 212.270.3632 or Bret Dooley at 212.648.0404.

Sincerely yours,



Louis Rauchenberger