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O'Connor Davies Munns & Dobbins LLP ("ODMD") is pleased to submit our comments on the Proposed Accounting Standards Update; Leases (Topic 840), (the "Proposed ASU"). ODMD is a regional accounting and consulting firm with six offices located in New York, New Jersey and Connecticut. We have approximately 280 professionals, including 45 partners. Our clients include a wide range of commercial, governmental and not-for-profit clients ranging in size from a few million a year in revenue to nearly \$2 billion.

We have reviewed the Proposed ASU and we have the following general comment followed by our response to those questions included in the Proposed ASU which are of particular concern to us and our clients. Our primary concern regarding the Proposed ASU is as follows:

Any benefits of the Proposed ASU are significantly muted, if not offset completely, by the subjectivity being introduced with respect to lease terms and contingent payments. Financial statements should be reliable. The requirement to record leasing transactions using significant estimates that are based on subjective, unempirical assumptions about future events significantly reduces the reliability and comparability of financial statements and will necessitate the need for continuous, costly reassessment and adjustment. We believe that the Proposed ASU would result in improvements to financial reporting if: a) lease renewal options were simply disclosed, but not included in the computation of the right-to-use asset and associated lease liability and, b) contingent payments were based on "reliable measures" and not an "expected outcome technique". These simple, sensible modifications to the proposed standard would result in improved reliability and comparability and a decreased need for reassessment.

We appreciate the opportunity to present our comments. Should there be any questions, please feel free to contact Bruce Blasnik at 203-323-2400 or bblasnik@odmd.com or Bob Rollmann at 914-381-8900 or brollmann@odmd.com.

Very truly yours,

O'Connor Davies Munns & Dobbins LLP

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?

We agree that a lease obligation represents a liability and generates a right-to-use asset to the lessee. However, we believe that the cost of accounting for short-term leases as proposed in the ASU will exceed the benefits. Accordingly, we believe that short-term leases that do not meet the requirements for capitalization under current ASC 840 guidance, should be scoped out of the Proposed ASU and continue to be accounted for as operating leases. We would define short term leases as those with terms of 36 months or less. This would scope out many leases for small office equipment (copy machines, postage meters and the like) and automobiles, but not larger equipment. If the final ASU does not exclude these short-term leases from the proposed requirements, we suggest that the simplified method for determining the right-to-use asset and liability be extended to leases with terms of up to 36 months.

In addition, we do not agree with the proposed requirement to use the lessee's incremental borrowing rate to calculate the lease liability, the use of which we believe lessens the comparability of the financial statements between entities with different credit ratings. We believe that the use of a risk free rate of interest should be used instead.

(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, but only for leases with terms exceeding 36 months. Of particular concern is the cost of accounting for the multitude of short-term (12 to 36 month) leases entered into by owners of residential real estate. The cost of accounting for a large number of short-term leases with rolling expiration dates in the manner outlined in the Proposed ASU, far out-weigh the benefits to users, particularly when note disclosures are sufficient.

Question 2: Lessors

(b) 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?

Paragraph 50 of the Exposure Draft implies that less than an entire asset can qualify for derecognition. We do not believe that the derecognition approach should be allowed in circumstances where less than the entire asset qualifies for derecognition. If a lessor retains

risks and benefits associated with any portion of an asset, then the derecognition approach should not be allowed.

Question 3: Short-term leases

This Proposed ASU provides 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).

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?

As stated above, we believe as a practical matter the definition of a short-term lease should be extended to include leases with terms of up to 36 months.

Question 4

(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 believe that there is a need for additional clarification for distinguishing leases from service contracts. For example: Is a lease for storage space in a server farm with an outside data center a lease or a service contract? There are, no doubt, numerous other examples for which the proposed standards do not provide adequate guidance.

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?

We do not understand why leases for intangible assets would be scoped out. The right-to-use an intangible asset is as much an asset as the right-to-use a tangible asset, and the commitment to make payments for the use of an intangible asset is as much a liability as the commitment to make payments for the use a tangible asset.

Question 6: Contracts that contain service components and lease components

This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, Revenue Recognition (Topic 605): Revenue from Contracts with Customers, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) The IASB proposes that:

(i) A lessee should apply the lease accounting requirements to the combined contract.

(ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.

(iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We agree with the IASB approach because this approach will enhance comparability and standardization. However, with respect to lessee accounting and lessor accounting for leases to which the performance obligation approach applies, we believe that there

should be an exception even for distinct service components where those distinct service components are diminimis in relation to the contract as a whole. We would define “diminimis” as those distinct service components that represent less than 10% of the lease payments due. We believe that, within reason, simpler is better. Within our practice we see countless leases that contain service components that could be considered “distinct” but where the costs of attempting to separately account for these service components exceed the benefits. Consider, for example, a lease for office space where the lessor provides certain services, such as daily trash removal and cleaning twice per week, or 24 hour security. These are distinct services that are often separately stated within the lease agreement and the cost of these services could be estimated. But doing so provides little or no value to the users of financial statements.

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?

With the exception of lease renewals that are reasonably assured, we do not agree that renewal options should be included in determining the lease term!

As discussed below, we do not believe that the lease term should include options to extend or renew unless renewal of the lease is “reasonably assured” as used in the context of the definition of lease term (ASC 840-10-20), whereby it is clear at the lease inception that failure to renew the lease would impose a penalty on the lessee.

In all but a very few cases it is virtually impossible to predict what is “more likely than not” to occur in the future. Furthermore, the accuracy of those future predictions declines the further into the future the predicted event is to occur. For accounting standards to be based on such a “soft”, unquantifiable concept like whether it’s more likely than not that a lease will be extended is just plain wrong. Such a subjective standard would be prone to variability (and likely manipulation) based on management’s judgment and it would lead to reduced reliability and comparability in financial reporting. Furthermore, it would result in lessees and lessors recording contingent assets and/or contingent liabilities in their financial statements, since an option is just that, an option, not a commitment. Can you imagine a standard that allows a company to record a sale when they believe it is more likely than not to occur? Furthermore, we do not believe that the option to renew meets the definition of a liability pursuant to FASB Concept Statement number 6, which definition is enumerated below:

35. Liabilities are probable²¹ future sacrifices of economic benefits arising from present obligations²² of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

²¹ *Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary*, p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).

²² *Obligations* in the definition is broader than legal obligations. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth (*Webster's New World Dictionary*, p. 981). It includes equitable and constructive obligations as well as legal obligations (pars. 37-40).

We believe that the only exceptions to including renewal options in determining the lease period are:

- 1) Those lessees that have substantial leasing activities and significant empirical data to support the determination of a “probable” lease term that exceeds the initial term of the lease (a considerably higher standard than “more likely than not”). Consider, for example, an airline company that has significant historical data to support its leasing activities for certain types or classes of airplanes. It may, in this situation, be appropriate to record a right-to-use asset and offsetting liability based on the company’s leasing history.
- 2) Those leases where it is clear at the lease inception that due to the imposition of a penalty on the lessee, renewal appears to be reasonably assured.
- 3) Leases between commonly owned entities, where the lessee does not consolidate the real estate entity pursuant to guidance on variable interest entities. For these type leases, it is probably reasonable to assume that due to the existence of the related party relationship, renewal of the lease is probable. .

Businesses will generally negotiate lease terms that make the most sense from a business point of view. Business needs and market forces determine the length of a lease and the terms of options. As accountants, we should account for what has taken place and provide adequate disclosure regarding the options and contingencies.

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?

We disagree with the proposed accounting by lessees. Both lessees and lessors should account for contingent rentals and expected payments only when and if they are probable and can be reliably measured. Perhaps in the theory it is possible for an expected outcome technique to generate reliable accounting information, however, in practice, expected outcome techniques are non-empirical models that are highly subjective and unreliable. If economists and financial analysts, with all their data points and sophisticated models can't predict the future how can we as accountants think that we can truly measure and report reliably when we're using subjective, non-empirical models? At some point, the statement of operations of a business becomes useless because it is merely a compilation of changes in unreliable estimates rather than a valid indicator of operating performance. The measurement of assets and liabilities by lessees using an expected outcome technique will increase subjectivity and diminish the usefulness of financial reporting.

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 remeasurement should occur when changes in facts or circumstances indicate that it is probable that a significant change in the liability to make lease payments will occur. However, we would hope that the final ASU increases the threshold for how and when to use subjective estimates, as discussed above, thus reducing the need for frequent reassessment adjustments.

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?

At the highest level, we agree that leasing is a financing activity and it makes sense to report leasing transactions in a manner similar to other financing activities. However, we disagree with certain of the boards’ statements in its assessment of the benefits and costs:

- BC204 states that many users think the proposed model would increase the accuracy of information provided in the financial statements. There is nothing inaccurate about the current model. Operating lease information is clearly presented in the notes to the financial statements. This information is straight forward and easy to understand. Financial statement users can use this information in any way they choose.
- BC204 (b) states that financial statement users will receive better information about expected cash flows under the new standard. Cash flow information is perfectly adequate under the current standard. Current operating lease expense and future operating lease commitments are clearly disclosed. There is nothing in the proposed standard that significantly improves this information.

Any benefits of the proposed standard are significantly muted, if not offset completely, by the subjectivity being introduced with respect to lease terms and contingent payments. Financial statements should be reliable. The requirement to record leasing transactions using significant estimates that are based on subjective, unempirical assumptions about future events significantly reduces the reliability and comparability of financial statements and assures the need for continuous, costly reassessment and adjustment. Given the increased ambiguity being introduced, we can only say that the new standard is different, not better, than the current standard. To incur any cost that simply changes, and doesn’t improve, financial reporting is not justified.

The proposed standard would result in improvements to financial reporting if: a) renewal options were simply disclosed, but not included in the computation of the right-to-use asset and related liability and, b) contingent payments were based on “reliable measures” and not an “expected outcome technique”. These simple, sensible modifications to the proposed standard would result in improved reliability and comparability and a decreased need for reassessment. Furthermore, both the implementation and on-going costs associated with the proposed standard would be reduced, making the suggested modifications a win-win.

Question 18

Do you have any other comments on the proposals?

The Proposed ASU does not provide sufficient guidance for dealing with related leases where the related lessor is not subject to consolidation under FIN46. The lease agreements are often informal, not at arms-length and subject to change. Determining the right-to-use asset and related liability for such leases may not be possible given the nature of the relationships.

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?

The recognition, measurement and presentation requirements for leases should not be different for non-public entities,, particularly if the modifications proposed above, are incorporated into the final standard. Disclosure requirements for non-public entities should be stream-lined. Specifically, non-public lessees should not be required to include a reconciliation of opening and closing balances of right-of-use assets and liabilities to make lease payments, disaggregated by class of underlying asset and non-public lessors should not be required to include a reconciliation of the opening and closing balances for rights to receive lease payments, lease liabilities arising from leases accounted for using the performance obligation approach or residual assets arising from leases accounted for using the derecognition approach. This information is generally not useful for users of non-public entity financial statements.