



December 15, 2010

Ms. Leslie Seidman
Acting Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116
United States of America

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

Dear Sir/Madam:

Citigroup appreciates the opportunity to comment on the Exposure Draft of the Proposed Accounting Standards Update, *Leases* (the "Proposed ASU," "Exposure Draft" or the "ED").

We support the FASB and IASB's efforts to achieve greater convergence and commend the Boards for developing essentially a fully converged proposal on leases. It is critical that the Boards continue that joint effort to produce a single set of high quality accounting standards.

However, the Exposure Draft as proposed would create tremendous operational complexity for financial statement preparers without a significant benefit to the users of those financial statements.

Our most significant comments and concerns with the proposed ED are as follows:

- We disagree with the proposal to include optional lease periods and all contingent lease payments in the measurement of the lessee lease payment liability (and in the measurement of the lease asset by the lessor) at lease inception. As the options and contingent rentals do not meet the definition of a liability (or asset for the lessor) at that time, we believe they should be excluded;
- With respect to the lessor accounting models, we do not believe that the lessor accounting is an area that is currently considered problematic by users or investors. Also, the proposed changes do not appear to be a significant improvement in financial reporting as both lessor models, and particularly the Performance Obligation model,

have some conceptual flaws. However, we believe lessor accounting only needs to change to make it symmetrical with the changes in lessee accounting.

- If the lessor accounting is being changed, we think there should be a single model that would result in the derecognition of at least a portion of the underlying leased asset;
- We ask that the Boards distinguish between core and non-core leasing activities for both lessees and lessors, and permit non-core leases to be accounted for using the existing accounting model for operating leases. As non-core activities are by definition less relevant to users of financial statements, it is operationally impractical and unreasonable from a cost-benefit point of view to apply the proposed financing model to every single lease, even if involves, for example, a coffeemaker for a bank;
- If the Boards disagree with the application of operating lease accounting to non-core leases, we recommend that, at the very least, interest relating to non-core leasing activities should be excluded from net interest revenue of commercial banks and be presented separately, to avoid distorting this key performance metric;
- Furthermore, if the Boards do not wish to adopt the principles-based core vs. non-core asset approach, we believe that there should at least be a more expansive scope exception for short-term leases with a term of up to three years, rather than the one-year term proposed in the ED. The current operating lease accounting model should continue to be applied for those short-term leases by both lessees and lessors.
- Finally, we strongly recommend that the Board adopt a prospective transition approach for leases existing as of the adoption date, with the cumulative effect recorded in retained earnings at the time of adoption, in order to ease the significant operational burden of the Proposed ASU.

We provide further detail on these points as well as other suggested improvements to the ED in the enclosed Attachment.

We would be pleased to discuss our comments with you at your convenience. Please contact me at 212-559-7721.

Sincerely,



Robert Traficanti
Deputy Controller and Global Head of Accounting Policy

Cc: Sir David Tweedie, Chairman
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Attachment***Term extensions should not be included in the measurement of lease term***

We strongly disagree with the proposed measurement of the lessee's liability to make lease payments (and therefore also the measurement of the right-of-use asset) which is based on the assumption of the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease. The same disagreement also applies to the proposed measurement of the lessor's asset for the right to receive lease payments as it relates to including optional lease renewal periods or terminations in the longest more-likely-than-not lease term. Correspondingly, we think that the lease payments during the optional lease extension periods as well as expected payments under term option penalties should be excluded by both the lessee and lessor.

We are very concerned about the reliability of measures that include subjective estimates of lease renewals. The amount of subjectivity involved is enormous considering that the measurement is based on management's estimate of the probability of alternative lease terms as well as estimated cash flows during the estimated lease renewal periods. Both types of estimates (renewal periods and cash flows during renewal periods) would have to look out many years into the future (for example, real estate leases, which are expected to have the largest financial statement impact to many banks, often have lease terms of 20-25 years, and in some cases even longer) and are effectively management's guess. We would like to point out that estimating the effect of any options to extend or terminate the lease would be even more difficult for a lessor that would have no visibility regarding the intent of the lessee. Such subjectivity could lead to a manipulation of these measures in the financial statements, since there is no way to verify the assumptions used by management. The subjectivity would also lead to a complete lack of comparability among the financial statements of different companies.

Regarding lease term, we agree with the dissent of the IASB Board Member Mr. Stephen Cooper,¹ who disagrees with the proposed inclusion of some optional lease periods in the recognition and measurement of the lessee's right-of-use asset and the lessor's receivable. We fully support Mr. Cooper's view that optional lease periods should be reflected in the measurement of recognized assets and liabilities only when the arrangement includes an incentive to extend the lease period, such as penalties payable on cancellation, reduced rentals during the optional lease period, or where costs of customizing the leased asset or purchased installations make lease renewal likely. For example, a lessee may not be willing to incur significant costs, directly or indirectly, in order to relocate leasehold improvements that are expected to have significant fair value to the lessee at the end of the base lease term.² However,

¹ Paragraphs AV1 through AV7 in the IASB exposure draft.

² However, it should be noted that since the lessor may not be aware to what extent the leasehold improvement assets constitute an incentive for the lessee to renew the lease, the lessor's estimate of the total lease term may be different than that of the lessee.

if the exercise of options to extend (or terminate early) merely depends on future business conditions, it is not appropriate to reflect those options in the measurement even if extension or renewal of the lease appears otherwise likely, since there is no legal obligation to exercise the option.

Options to cancel and extend leases are options, rather than commitments, and not part of the base contractual lease term because they allow reduction of risk by providing the lessee with flexibility to react to changing business circumstances (for example, by choosing not to renew a lease in a down market). Lease payments related to cancellations and renewals, which an entity has no contractual or constructive obligation to pay, do not meet the conceptual definition of a liability until the lessee has made a decision to exercise such options. Consider the following example. A Lessee estimates that it needs to rent office space of a certain size for the next 10 years. However, since the Lessee hopes to stay in business for longer than 10 years, the lessee is likely to need office space even after the first 10 years. The lessee can choose from the following alternatives: 1. Sign a lease with Landlord A for 10 years now and expect to negotiate with a different landlord to lease new office space elsewhere for an additional 10-year period at the fair market price at the end of the first 10 years; or 2. Sign a lease with Landlord A with a base contractual lease term of 10 years, but allowing the Lessee to renew the lease at a fair market rent at the end of the first 10 years for another 10 years. Alternative 1 would *require* the Lessee to move and incur additional moving costs regardless of whether the lessee's business actually expands, contracts, or stays the same during the first 10 years. Therefore, the Lessee would likely prefer alternative 2, because it gives the Lessee the flexibility to avoid paying the moving cost if the existing office space still meets the Lessee's needs after the first 10 years. We do not understand why under the proposed right-of-use model, alternative 2 would require the Lessee at lease inception to record a significantly greater lease liability and right-of-use asset than under alternative 1 even when the economic outcome under both alternatives is identical. We believe that the amount of the lessee's lease liability and right-of-use asset recorded at the inception of the lease should be the same under both of the above alternatives. The same principle applies to the lessor's measurement of the right to receive lease payments.

Additionally, we are concerned that in practice the proposed guidance in the ED would lead to the elimination of the renewal options in lease contracts and the execution of more short-term, fixed-rate leases, with resulting negative economic consequences for both lessees and lessors.

We also strongly agree with Mr. Cooper's conclusion that if all lease payments in more-likely-than-not optional lease periods are included in the recognition and measurement of the lessee's right-of-use asset, then the resulting liability and related measures of financial leverage would be overstated. Similarly, including all optional lease periods in the recognition and measurement of the lessor's receivable under both the performance obligation and derecognition models underestimates the business risk of the lessor. This overstatement of the receivable implies exposure to credit risk of the lessee when the reality is an exposure to underlying asset risk (i.e.,

exercise of the optional period is more a function of the condition and relative efficiency of the asset rather than the credit of the lessee). As such inclusion in the measurement provides misleading information to the users of financial statements, we believe that optional lease periods should be reflected in the measurement of lease assets and liabilities only when, and to the extent, the lessee has an incentive to extend the lease period. Without such incentive, optional lease periods should be included in the measurement of the lease term only when the lessee has made a decision and notified the lessor about the exercise of such options.

Accordingly, we recommend that the current U.S. GAAP definitions of lease term and minimum lease payments should be retained for lessors and lessees, where renewal options are included in the lease term only if they are “reasonably assured” of being exercised by the lessee because of contractual or non-contractual penalties for nonrenewal. We support disclosing information regarding lease renewal options and contingent rents in the footnotes to the financial statements, alongside minimum lease payment disclosures. This is more objectively measurable, promotes comparability and symmetry, and would result in liabilities that are true liabilities of the lessee and lessor in accordance with the Conceptual Framework. Such an approach would also accomplish one of the main objectives of the Proposed ASU of recording the lessee’s obligation on the face of the balance sheet without the added complications discussed above.

The Proposed ASU states that one reason for the proposed approach to optional lease periods (and contingent rentals, which are discussed below) is to avoid structuring opportunities.³ Here we again agree with Mr. Cooper’s Alternative View that, first of all, this concern should not outweigh the goal of providing relevant information to investors. Furthermore, it is possible to limit structuring opportunities through appropriate disclosure and by establishing principles for identifying where optional lease periods (and contingent rental arrangements) lack economic substance and represent disguised minimum rental payments.

Measurement of present value of lease obligation needs additional guidance

The guidance in the ED regarding estimating the present value of lease payments during the lease term needs to be clarified. The following paragraphs from the ED provide guidance regarding estimating present value of lease payments.

13. A lessee shall determine the *lease term* by estimating the probability of occurrence for each possible term, taking into account the effect of any options to extend or terminate the lease (see paragraphs B16–B20).

14. A lessee shall determine, using all relevant information, the present value of lease payments payable during the lease term determined in accordance with paragraph 13 on the basis of expected outcome. The expected outcome is the present value of the

³ Paragraph BC123(b)

probability-weighted average of the cash flows for a reasonable number of outcomes (see paragraph B21). In determining the present value of lease payments payable, a lessee shall include:

- (a) an estimate of contingent rentals payable. If the contingent rentals depend on an index or a rate, the lessee shall determine the expected lease payments using readily available forward rates or indices. If forward rates or indices are not readily available, the lessee shall use the prevailing rates or indices.
- (b) an estimate of amounts payable to the lessor under residual value guarantees. Residual value guarantees that are provided by an unrelated third party are not lease payments.
- (c) an estimate of expected payments to the lessor under term option penalties.

While we are very concerned about the reliability and subjectivity of probability estimates assigned to lease renewal periods as those probabilities are no more than management's guess, it is at least conceptually clear how one should estimate the lease term (based on an example presented in Paragraph B17) once the probabilities have been determined. What is not clear is what the next step should be once the lease term has been established. Based on the paragraph quoted above, the next step under the "present value of expected outcome method" may be that the probabilities for each lease term outcome need to be applied to the estimated cash flows during the full term of each respective outcome. However, since it is not clear whether that was the Boards' intent, we ask for additional clarification regarding how the lessee should calculate the present value of the liability to make lease payments (which would also clarify how the lessor should estimate the present value of the right to receive lease payments). More specifically, it would be very useful if the standard would include an example that would go beyond the current example in paragraph B17 to show how a lessee would come up with an estimate of the present value of a lease obligation using the probability-weighted average cash flows and the lease term alternatives already presented in paragraph B17.

Some contingent rents should also be excluded from the measurement model

For the same reasons we object to the inclusion of lease renewal options in the lease term, we do not support including some contingent rentals in the measurement of the right-of-use asset. Our view here again is supportive of that of Mr. Cooper, who is concerned about the ED's requirement of including all forecasted contingent rentals in the calculation of the expected lease payments and hence the measurement of the lessee's liability. The ED applies a similar approach to the lessor, except that lessor only needs to include lease payments that can be reliably estimated.

First, we question the logic of allowing the lessor to exclude estimates of contingent rentals that cannot be reliably measured, but requiring a lessee who is similarly unable to reliably measure

contingent rents to include such rents in the measurement; we ask that the Boards conform the treatment for contingent rents by both the lessor and lessee, and only require inclusion of those contingent rentals that can be reliably measured.

Further, we agree with Mr. Cooper's position that contingent rentals based on an index or rate (we assume this would mean an index like CPI or a rate like LIBOR) should be included, while contingent rentals that vary based on asset's usage or performance should be excluded from the measurement because of the following:

- Any lease payments which a lessee has no contractual or constructive obligation to pay do not meet the definition of a liability.
- As with optional lease periods, such contingent rental arrangements provide the lessee with additional flexibility and contribute to reduced business risk (whereas for the lessor they increase exposure to asset risk).
- Reflecting all expected contingent rentals in the measure of the lessee's liability and the lessor's receivable does not provide relevant information about the economics of such leasing arrangements.
- The reliability of measures that include estimates of contingent rentals based upon subjective management forecasts of business performance over many years is highly questionable. In addition to reliability, the subjectivity involved in estimating contingent rentals (as well as lease renewal periods) many years in the future would lead to a loss of comparability in the financial statements.
- The concern over structuring opportunities should not outweigh the requirement for the information provided in the final statement to be relevant.
- It is possible to avoid structuring opportunities by establishing principles for identifying where optional lease periods and contingent rental arrangements lack economic substance and represent disguised minimum rental payments and through appropriate disclosure.

In addition, some real estate leases contain rent step-up clauses to fair market value during the base lease term. We think that similar to contingent rentals that vary based on asset's usage, lessees (and lessors) should not be required to include the estimated payments reflecting such lease payment step-ups during the base lease term in the present value of the lease obligation (and lease payment receivable) at lease inception. The lessees and lessors would not be able to produce an objective future market rent estimate since there are no rates or indexes available that they could rely on for coming up with such an estimate.

In summary, we are asking the Boards to clarify that contingent rentals should only be included in the measurement of lease assets and liabilities if they can be reliably estimated. Contingent rentals would be reliably estimated if they depend on an index or a rate, and such forward rates or indices are readily available.

Should lease payments related to currency exchange rate changes be considered contingent rent?

The ED is silent about the treatment of lease payments denominated in non-functional currency under leases that qualify as operating leases today. For example, assume that a company that reports under U.S. GAAP has a subsidiary in Poland. The subsidiary with Polish Zloty (PLN) as its functional currency has an operating lease with payments made in USD. Today under U.S. GAAP, the lease payments would be considered to have embedded derivatives that require bifurcation. Under the proposed ED, it is not clear whether the bifurcation of the embedded derivative is still required. Even if bifurcation is no longer required, it is not clear what the appropriate accounting treatment is for these types of leases.

If bifurcation is not required, we think that one of the alternatives would be to measure the lessee's lease liability at inception by discounting the USD lease payments using the lessee's incremental borrowing rate. There is no need to consider forward USD/PLN forward rate directly. Subsequent to initial measurement, the lease liability will change based on changes in the USD/PLN spot exchange rate. The change in the liability due to USD/PLN rate changes would be recorded through income. However, the right-of-use asset would be denominated in functional currency (PLN) and initially measured at an amount equal to the initial measurement of the liability. Therefore, subsequent to initial measurement, there will be a balance sheet mismatch between the lease asset and liability due to currency rate changes on the liability side.

An alternative accounting treatment would be to consider the portion of the lease payment related to the currency exchange rate change to be contingent rent. Under the ED, the lessee, in determining the present value of lease payments payable, must include an estimate of contingent rentals payable that depend on an index or a rate, using readily available forward rates or indices. Therefore, the lease liability should be recorded in functional currency by present valuing the future lease payments estimated based on USD/PLN forward rates. Reassessment of the liability is required in subsequent periods as the exchange rates change. To the extent that changes in rates relate to future lease payments, the lessee should record an offsetting adjustment to the right-of-use asset.

We ask the Boards to clarify whether bifurcation is required and if not, which treatment is appropriate for lease payments denominated in a non-functional currency under the proposed ED.

Reassessment of lease assets and liabilities

We agree that lessees and lessors should remeasure assets and liabilities arising under a lease only when changes in facts or circumstances indicate that there is a significant change in the liability to pay or in the right to receive lease payments. However, we note that even such requirement to reassess and remeasure leases will be very burdensome for preparers because of

the ongoing monitoring of all relevant facts and circumstances for each individual lease to determine whether changes in facts and circumstances would result in significant changes.

The lessee asset and liability should be amortized on the same basis

For the lessee, the proposed approach in the ED will lead to a reduction in income recognition at lease inception and increased income recognition in subsequent periods as the lease matures. The opposite effect would occur for lessors. This higher aggregate expense in the early part of a lease term compared with recognizing rent as a straight-line expense today would occur as a consequence of amortizing the right-of-use asset on a straight-line basis, whereas the lease payment liability is amortized using a level-yield method. Since the right-of-use asset and the lease obligation are linked (i.e., the asset would not exist without the liability and vice versa), we are concerned that the proposed model would cause confusion for investors because this linkage is not apparent in the income statement in the way the right-of-use asset and obligation to pay rent are measured subsequent to lease inception. Accordingly, we propose that the right-of-use asset be amortized on the same basis as the lease payment liability. Tying the amortization of the right-of-use asset to the periodic reduction of the lease liability would provide for greater operational simplicity as well as better transparency for users of financial statements, as the sum of the amortization of the asset and the interest expense on the liability would result in a better proxy for cash rental payments than the proposed accounting.

We note that the Boards considered, and rejected, this approach, as described in the Basis for Conclusions. However, we agree with the view that the right-of-use asset and the lease payment obligation are inextricably linked, both at inception as well as on an ongoing basis, as the right-of-use asset cannot exist in isolation without the lease payment obligation. Therefore, we ask the Boards to reconsider this alternative in its redeliberations.

The Proposed ASU should allow non-core leases to be accounted for as operating leases

The proposed ASU would pose tremendous operational challenges in accounting for leases of small-ticket items like computer equipment and copiers. While obligations for these relatively small items even in the aggregate would be unlikely to add up to a material amount on our balance sheet, we would have to inventory thousands of contracts and then, for each lease, categorize, and remeasure them subsequently. Since most of these leases qualify as operating leases today, none of this activity is required under current GAAP and gathering and analyzing the information will take considerable time and effort. Furthermore, the requirement to reassess estimates when facts and circumstances change will entail significant incremental effort without any material change or benefit to the financial statement users as compared to the current approach.⁴ This data-gathering and accounting would apply to all these small leases, most of which are clearly unrelated to our core business operations. To ease the significant operational burden of the Proposed ASU, we strongly recommend that non-core leasing activities continue

⁴ We note that the Boards' decision to exclude certain term renewal options and contingent payments as recommended in this letter would significantly simplify this effort.

to be accounted for as operating leases using the current accounting by both lessees and lessors. In order to ensure a principles-based approach, non-core activities could be defined generally as those leases that are not essential to an entity's operations. Companies would then be required to identify core versus non-core activities for their particular business and fully disclose what is included in each category in the footnotes to the financial statements.

If the Boards do not wish to adopt the principles-based core vs. non-core asset approach, which we note the Boards have already once rejected, we believe that there should be at least a more expansive scope exception for short-term leases. By short-term leases, we would propose leases with a term of up to three years, rather than the one-year term proposed in the ED. The scope exception proposed in the ED provides little relief for preparers as there are virtually no leases that exist today with a term up to one year. Also, the proposed exception for short-term leases would not ease the operational burden for lessees, since the lessee would still be required to record and reassess periodically the lease liability and the right-of-use asset. We believe that the current accounting model is deficient only for longer-term leases, where the distinction between a lease versus outright ownership may sometimes be unclear. Also, the one-year scope exception in the ED only provides some relief for lessors who would be allowed to apply the current operating lease accounting for those short-term leases (we agree that this simplified accounting is appropriate). However, the lessees still need to record a right-of-use asset and lease obligation on their balance sheet for those short-term-leases, which seems inconsistent with the lessor accounting and provides no real benefit for lessees. Therefore, the current operating lease accounting model should continue to be appropriate for short-term leases (with a term of up to three years) of both lessees and lessors and should not be abandoned. For leases subject to the scope exception for recording on the balance sheet, additional qualitative and quantitative disclosures should be required to provide additional transparency to users of financial statements about the types of leases and the total amount of remaining lease payments.

Interest relating to non-core leases should not be included in net interest revenue for lessees or lessors

The Proposed ASU would eliminate the income statement caption "rent expense" for lessees and replace it with amortization expense relating to the right-of-use asset and interest expense on the lease payment obligation. We note that for commercial banks, net interest revenue is a key metric used by investors to assess the profitability of the bank's core business activities of accepting deposits, investing and making loans. Accordingly, we are strongly opposed to including interest expense on the lease payment obligation or interest revenue on the rent receivable relating to non-core leasing activities in net interest revenue. We believe that including interest related to ancillary activities in this key performance metric would reduce the usefulness of the financial statements for investors. We recommend instead that financial institutions be permitted to present lease-related interest below net interest revenue on the income statement as it relates to non-core leasing activities. If, on the other hand, leasing is

identified as a core activity for a financial institution, we agree that it should be included in net interest revenue.

Lease incentives

We note that the Proposed ASU does not address the impact of lease incentives (i.e., payments a lessor makes to a lessee as an incentive for the lessee to enter into the lease) on the measurement of the right-of-use asset and lease liability. Lease incentives may include funding allowances provided by a lessor to a lessee for tenant improvements which would result in the lessor's making payments to lessee at the inception or usually at the early part of the lease. As these arrangements are fairly common, we believe that they should be addressed by the Boards.

Netting for subleases

The ED requires a lessee that is an intermediate lessor (sub-lessor) to present the right-of-use asset, right to receive lease payments in a sublease, and sublease lease liability together in the statement of financial position, before presenting a total for the net lease asset or liability for those three items. While we agree with this presentation, we ask the Boards to consider allowing only the net lease asset or liability to be recorded on the balance sheet. This net amount would be presented after the assessment of the right-of-use asset for impairment. We recommend that the sub-lessor would instead be required to disclose the gross amounts, like the presentation in paragraph B29, in the notes to financial statements.

Accounting for premises costs associated with exit activities

Under current U.S. GAAP, a lessee who vacates a space rented under an operating lease but is not terminating the lease and continues to make lease payments over the remaining lease term, recognizes a liability (we refer to this liability as a "sublease loss reserve") at fair value on the cease-use date, which is the date the lessee discontinues its use of the leased asset. The fair value of the liability is based on the remaining lease rentals reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the lessee does not intend to enter into a sublease as a sub-lessor. Since the ED provides no guidance, we are asking the Boards to clarify the accounting for sublease loss reserves in the final ASU. We are suggesting that lessees/sub-lessors would have to perform an impairment analysis for the right-of-use asset at the cease-use date, and if the cash flows based on estimated sublease rentals are insufficient to fully recover the right-of-use asset, an impairment loss would be recognized for the asset.

Financial statement presentation and impairment for the lessee's right-of-use asset

We believe that the right-of-use asset is in substance similar to property, plant and equipment and therefore agree that it should be presented as such in the statement of financial position. We ask this to be made clear in the final standard. A lack of clarity on this point could potentially lead to a dollar-for-dollar deduction from Tier 1 capital of banks. Also, we believe that the right-of-use asset should be tested for impairment as property, plant and equipment, and not as an intangible asset. Therefore, we ask that paragraph 24 in the ED be revised to say that a lessee

should apply Topic 360 instead of Topic 350 at each reporting date to determine whether the right-of-use asset is impaired and to recognize any impairment loss.

The proposed accounting models for lessors have been insufficiently deliberated and have some conceptual flaws

Although we do not think that the lessor accounting is an area that is considered problematic by users or investors, we acknowledge that a change is needed to make lessor accounting symmetrical with the changes in lessee accounting. However, we believe that the two lessor models proposed by the Boards have been insufficiently deliberated and both have some conceptual flaws, particularly the Performance Obligation model

We believe that the proposed Performance Obligation approach is inconsistent with the Lessee right-of-use model. It is not clear why the lessor still has a performance obligation if the lessee has recorded an unconditional obligation to pay.

Furthermore, the Performance Obligation approach results in the lessor's recognition of two distinct assets on its balance sheet: a receivable for the expected amounts due under the lease contract, as well as the underlying asset. Assets are bundles of rights – in the case of property, plant, and equipment, the right to own the asset and the right to lease it. We do not believe that the act of leasing an asset should result in the recognition of an additional asset without derecognizing at least a portion of the underlying asset. Conceptually, if the new asset represents cash flows collected from the lessee, which pays for the right to use the underlying asset, then the lessor's underlying asset must become "impaired" when the lessor gives up rights to a portion of the asset in exchange for lease payments. In other words, by recognizing an additional asset, the result of the Performance Obligation approach is that the total assets recognized by the lessor would ultimately exceed the cash inflows expected from those assets.

Regarding the proposed Derecognition approach, the ED is silent about the accounting for the residual asset. We ask that additional guidance be provided to clarify the accounting for the residual asset during as well as after the lease term. For example, would the residual asset be allowed to be discounted at the lease inception and then accreted to its future value by the end of the lease term? Given that with some leases (for example, long-term real estate leases), the time before the lessor would be able to realize the residual asset could be lengthy, the residual asset may have to be discounted and then accreted to its future value, to give the users of the financial statements the best information about its value.

If the Boards decide to change the lessor accounting, we think there should be a single model that would result in the derecognition of at least a portion of the underlying leased asset. However, we support the scope exception for non-core leases. Similar to non-core leases for a lessee, lessors should continue to account for non-core leases as operating leases are today.

Transition

The proposed “simplified” retrospective transition approach is not simple and poses a significant operational burden. For example, if we were to adopt the standard on January 1, 2014, as an SEC registrant, we would be required to apply the provisions of the standard beginning January 1, 2010 to all leases that existed at that date even if they expired or were replaced by January 2014. It would be very difficult for us to recreate the past for all leases and determine what our estimates of lease terms and contingent rentals would have been at the time assuming no knowledge of the future even when the future has actually occurred. Also, gathering data for some of the leases in order to be able to apply the standard would be a very onerous exercise, since the current accounting requirements do not require us to have the systems in place to track such data. Therefore, we strongly recommend that the Boards adopt a prospective transition approach for all existing leases at the adoption date, with a cumulative effect adjustment, if any, recorded in retained earnings at that time. While adopting the lease standard would still be a significant undertaking, doing it under the prospective transition would ease some of that burden. Also, the prospective transition would be consistent with the transition approaches taken for other complex accounting standards which had the potential impact of bringing significant additional assets and liabilities onto the balance sheet, such as FASB Interpretation No. 46, “Consolidation of Variable Interest Entities” and Statement of Accounting Standards No. 167, “Consolidation of Variable Interest Entities, an Amendment to FIN 46(R).” Neither of these pronouncements required a retrospective approach.

In light of the complexities of implementing the requirements of the Proposed ASU, the Boards should allow for a sufficiently lengthy amount of time to ensure that entities can implement the new requirements in a safe and sound manner. If the Boards require retrospective adoption at transition, the lead time from the issuance of the final standard would need to be longer than under the prospective approach to allow us to put in place the required systems to start tracking the information. With prospective approach, we should be able to apply the standard in a shorter timeframe after the issuance of the final standard, since the tracking needs to start when the standard becomes effective.

Also, we note that the transition provisions do not specifically address how any deferred gains from sale-leaseback transactions from prior periods would be evaluated as of the date of the initial application. Would these gains, even though they were realized at the time of sale but required to be deferred under the current U.S. GAAP because of the leaseback provisions, be recognized through income at the time of initial application? Under the sale-leaseback provisions of the Proposed ASU, we believe that most of these gains would qualify for immediate recognition through income at the time of sale.

If the recognition of deferred gains occurs through retained earnings, we note that under a retrospective transition, the deferred gains already recognized through income during the

periods for which comparative financial statements are required to be presented at the time of adoption, would need to be pulled out of earnings and rerecorded through an adjustment to beginning retained earnings. This result is very strange considering that both the current as well as the new proposed ED would allow the recognition of gains through earnings, even though the timing of the recognition would differ under the current and new proposed ED. We note that a prospective transition approach would eliminate re-recognizing such gains in retained earnings that may have already been recognized in income during prior periods.

Finally, we ask for clarification regarding the treatment of sublease loss reserves upon transition. Please see the discussion on sublease loss reserves in the section entitled “Accounting for premises costs associated with exit activities” above. Since the proposed standard does not specifically address sublease loss reserves, we ask that the final standard address whether the existing sublease loss reserves need to be reversed and rerecorded upon transition to the new lease standard. If so, we ask the Boards to provide guidance regarding how that reversal should be recorded upon transition.

Other Comments

Scope

We agree with the scope exclusions, including the exclusion of leases of investment property carried at fair value under IFRS and potentially under U.S. GAAP in the future if the FASB finalizes its project on fair value option for investment properties.

See our comments above on excluding non-core or short-term leases from the scope.

Accounting for service in a contract where the lease component and the service component are not distinct

Regarding the accounting for service components in a contract where the lease component and the service component are not distinct, should the Boards proceed with the changes to lessor accounting, we strongly recommend that the FASB and IASB adopt a single approach.

Clarification of lessor models for sublessors

If the Boards decide to retain the proposed models for lessors, the guidance regarding the models as they apply to sublessors needs to be clarified.

According to paragraph B24 as currently written:

A lessor shall consider the following factors when determining whether it retains exposure to significant risks or benefits associated with the underlying asset after the expected term of the current lease:

- (a) whether the duration of the lease term is not significant in relation to the remaining useful life of the underlying asset.

We suggest that the wording in paragraph B24 be changed to clarify that, if the lessor is a sublessor, bullet (a) should read as follows:

(a) whether the duration of the lease term is not significant in relation to the remaining ~~useful life~~ term of the ~~underlying asset~~ head lease.”

Also, according to the ED, a lessor would apply either the performance obligation or derecognition approach depending on whether it retains exposure to significant risks or benefits associated with the underlying asset. However, when the lessor is a sublessor and needs to apply the derecognition approach (because, for example, the duration of the sublease term is not significant in relation to the remaining term of the head lease), it is not clear under the proposed guidance which asset the sublessor should derecognize. Since the sublessor does not own the underlying leased asset, the derecognition has to be applied to the right-of-use asset, which is the only asset related to the lease recorded in the sublessor's books. We ask the Boards to clarify this in the final standard, since there is no mention of this in the current proposed ED.

Furthermore, we note that the balance sheet presentation for intermediate lessors is only discussed in the section of presentation for performance obligation approach (in paragraph 43 of the ED) and there is no guidance provided for intermediate lessors in the derecognition approach section. We ask the Boards to clarify whether they believe that intermediate lessors should always apply the performance obligation approach. If so, we disagree with that conclusion since under the guidance provided in the ED for determining when to apply the performance obligation or derecognition approach, intermediate lessors seem to be required to apply performance obligation approach to some subleases and derecognition approach to others (see an example of a sublease that would be subject to the derecognition approach in the paragraph above).