



July 14, 2009

The Financial Accounting Standards Board
401 Merritt Seven
PO Box 5116
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Attn: Technical Director
(File Reference 1680-100)

Thank you for the opportunity to comment on the Discussion Paper entitled “Leases: Preliminary Views” (file reference 1680-100, March 19, 2009).

While we generally are supportive of the “right-of-use” model described in the Discussion Paper, we do have some concerns regarding a few of the preliminary conclusions reached by the Financial Accounting Standards Board and the International Accounting Standards Board (collectively, the “Boards”). We also feel that further clarification on several operational aspects of the model set out in the Discussion Paper would be beneficial when a more formal Exposure Draft is issued.

We would be pleased to discuss any aspect of our letter in more detail. If you have any questions, feel free to contact Scott Ehrlich, President and Managing Director of Mind the GAAP, LLC, at (773) 732-0654 or by e-mail at sehrlich@mindthegaap.com.

Executive Summary

As part of their deliberations and due process, Mind the GAAP, LLC encourages the Boards to consider the following comments, each of which is discussed in more detail in this letter.

- The Boards should choose between a “bundled model” and a “components model” for lease accounting, instead of the hybrid model that is outlined in the Discussion Paper. *(See Item 1 below)*
- The proposed new standard should not exclude non-core asset leases or short term leases. *(See Item 2)*
- Lessees should not be required to measure lease obligations at fair value. *(See Item 3)*

Making the complex understandable



- Lessees should not be required to remeasure their lease obligations for changes in incremental borrowing rates. *(See Item 4)*
- We do not agree that lease terms and purchase options should be accounted for under a “most likely outcome” approach. *(See Item 5)*
- We support the proposed measurement approach in relation to lessees’ obligations for contingent rentals. However, we have some reservations about the proposed subsequent accounting for such contingent obligations. *(See Item 6)*
- The Exposure Draft should provide further guidance on the current versus noncurrent classification for right-of-use assets. *(See Item 7)*

Note: Item 8 below contains a few other less significant concerns regarding materials presented in the Discussion Paper.

- 1. The Boards appear to have retained some aspects of a components approach to lease accounting, despite stating otherwise in the Discussion Paper. In our view, the Boards should choose either a “bundled model” (single asset and liability) or a “components model” (requiring separation of the multiple elements within a lease contract) instead of the hybrid approach that is outlined in the Discussion Paper.**

Chapter 3 of the Discussion Paper indicates that the Boards considered whether to require the lessee to recognize and measure each of the rights and obligations in a complex lease separately (a components approach).

A complex lease contract may contain many individual rights/obligations, such as:

- Options to extend the lease on payment of additional rentals
- Options to terminate the lease early
- Options to purchase the leased asset on payment of an additional amount
- Obligations to pay variable rentals or contingent rentals
- Obligations to compensate the lessor if the value of the leased asset declines below a specified value (residual value guarantees)



Ultimately, the Boards tentatively concluded to not require a components approach (paragraph 3.33), opting instead for what seems to be a “bundled model” – that is, recognizing a single right-of-use asset and a single obligation to pay rentals.

However, the bundled approach endorsed in paragraph 3.33 is seemingly contradicted by other aspects of the Discussion Paper:

- Lessees would be required to separate and apply derivative accounting for contingent rental obligations that are embedded derivatives (paragraph 7.4).
- Lessees also would be required to separate payments for services from other lease payments (paragraphs 9.23 – 9.25).

We do not have a strong view either way as to whether a lease contract should be accounted for as a bundle, or whether it would be more beneficial to take a components approach and separate the multiple elements within a lease contract.

However, our key recommendation is that the model – once chosen – should be applied consistently:

- If the Boards retain the single asset and liability model – as proposed in the Discussion Paper – none of the individual elements within a lease contract should be bifurcated, including elements that would otherwise qualify as embedded derivatives. This accounting treatment would be consistent with the tentative conclusions reached by the International Accounting Standards Board in regards to the accounting for financial instruments that are classified as being measured at amortized cost.
- If a components approach is adopted, however, it is imperative that the Boards provide more guidance on separating the individual elements within lease contracts – particularly service elements. In this regard, we suggest that the Boards consider the potentially analogous approach outlined in the forthcoming EITF Issue No. 08-1, “Revenue Arrangements with Multiple Deliverables”.

Lastly, we note that the Boards’ tentative conclusions not to require a components approach appears to contradict with the Boards’ conclusions set out in the Discussion Paper on Revenue Recognition, in which all performance obligations (no matter how insignificant or nonsubstantive) must be accounted for separately.



2. The proposed new standard should not exclude non-core asset leases or short term leases.

Excluding non-core assets from the new standard will produce inconsistent accounting for similar lease arrangements, as different companies may form disparate views of which assets are core versus non-core to their respective businesses. For example, some companies may believe that their leased fleet of automobiles – used by the sales force for customer calls – is non-core to the operating activities of the company, while other companies in the same industry may take the exact opposite view.

Moreover, excluding short-term leases from the new standard will provide opportunities for structuring leases to avoid applying the “right-of-use” model set out in the Discussion Paper. In fact, we would expect to see a proliferation of “month-to-month” leases if the scope exception around short-term leases is retained in a final standard on lease accounting. If this were to occur, it may be difficult for auditors to ascertain whether there is commercial substance for the reporting entity’s decision to enter into a month-to-month lease or whether the entity was simply structuring a lease arrangement to take advantage of a possible scope exception in the accounting literature. In our view, the potential benefits of including this scope exception do not outweigh the costs of doing so (such as the increased judgment placed on the auditors in assessing management’s intent for entering into a transaction).

3. A new lease accounting standard should not require lessees to measure lease obligations at fair value.

At present, there are no markets that we are aware of in which lessees transfer their lease obligations; therefore, a fair value measurement for most if not all lease obligations would need to be derived from Level 3 inputs.

In our view, the measurement of a lease obligation using Level 3 inputs is no more reliable than a measurement based on the present value of the lease payments.

Moreover, requiring fair value measurement would increase the compliance cost for preparers, without any discernible benefit to the users of the financial statements.



4. Lessees should not be required to revise lease obligations for changes in incremental borrowing rates.

Changes in the lessee's incremental borrowing rate do not affect the remaining cash outflows to be paid by the lessee. Therefore, the cost and effort involved in remeasuring a lease obligation for changes in the lessee's incremental borrowing rate is not commensurate with the usefulness of additional information users will receive.

We would, however, support a requirement that the lessee should disclose any significant changes in its incremental borrowing rate. For the avoidance of doubt, this disclosure would in no way trigger a remeasurement event under any circumstances.

5. We do not agree with the Boards' tentative decision to measure lease obligations using the "most likely" lease term.

In our view, renewals and extensions should not be incorporated into the measurement of the lease obligation unless the lessee is *economically compelled* to renew or extend the lease term, as assessed at the inception of the lease. For example:

- The lessee would have to pay a very large penalty if it elected not to renew the lease, or
- The property subject to the lease is critical to the operations of the lessee and is of a specialized nature, making it difficult for the lessee to find comparable property at the end of the initial lease term.

Note: The above examples are intended to be representative, and not an exhaustive list of instances in which a lessee would be economically compelled to extend or renew the lease term.

Instead, at the inception of a lease, a liability typically should be established only for payments due under the initial term of the lease. As and when the lease term is extended or renewed, a new lease obligation and corresponding right-of-use asset would be recognized. Likewise, purchase options should only be accounted for when the lessee exercises the purchase option.

We feel that our proposed approach more appropriately accounts for the substance of the agreement between the lessee and lessor, since the lessee does not typically have an obligation to renew the lease until the moment that it agrees to do so.



Furthermore, we do not agree with the Board's proposal to periodically reassess the "most likely" lease term, which would require a huge effort on the part of lessees – particularly those companies that literally have tens of thousands of leases for small value items such as computers, copiers, automobiles, etc.

6. We support the proposed measurement approach in relation to lessees' obligations for contingent rentals. However, we have some reservations about the proposed subsequent accounting for such contingent obligations.

We support the use of the "most likely" approach for measuring the lessee's obligation for contingent rentals (i.e., measuring the amount of the contingent rental at its most likely payment amount). In our view, the alternative "probability-weighted" approach may result in an impossible outcome and is no more reliable than the "most likely" approach.

We also agree that estimated future rental payments should be periodically reassessed for changes in projected contingent rentals, but that an annual reassessment for estimated changes generally would suffice. The Boards may want consider analogizing to the timing requirements of goodwill impairment testing model, in which the assessment is performed once a year unless triggering events warrant an earlier re-assessment.

7. The Exposure Draft should provide further guidance on the current versus noncurrent classification for right-of-use assets.

We agree with the proposal in paragraph 8.16 of the Discussion Paper that right-of-use assets should be presented based on the nature of the leased item, adjacent to but separately from owned assets. In our view, this presentation approach provides the most useful information on the types and values of assets controlled under leasing arrangements.

However, as illustrated in the following example, more guidance is required in order to classify the right-of-use assets as current versus noncurrent:



Example. On December 31, 20X8, a lessee leases equipment under an arrangement that expires in six months' time. The lessee has the option to extend the lease arrangement for further term of three years. The lessee may exercise this extension option at any time up until the current lease arrangement expires on June 30, 20X9. At the financial reporting date, it is probable that the lessee will elect to extend the lease but has not formally committed to the lessor to do so.

We are uncertain whether the lessee would be required to classify the right-of-use asset as a current or noncurrent asset as of December 31, 20X8. As noted above, we request that the Boards provide further guidance in making this classification.

8. We have other, somewhat less significant, comments regarding the Discussion Paper bulleted below.

- We do not encourage the use of the term “cost” to describe the initial measurement of the lessee’s right-of-use asset. The term “cost” carries connotations of purchase price, initial direct costs, etc., and thus has potential for confusing the reader. It would be clearer if the proposed standard simply stated something like the following: “... *the lessee should initially measure its right-of-use asset at the same amount as the corresponding lease obligation (i.e., the present value of the lease payments discounted using the lessee's incremental borrowing rate).*”
- The term “rental expense” should no longer be used throughout the leasing literature, as this term is synonymous with the operating lease model which is being eliminated. The terms “amortization” or “depreciation” more accurately characterize the cost recognized in profit and loss related to the consumption of right-of-use assets.
- We believe that it would be sufficient for lessees to disclose their obligations to pay rentals within the notes to the financial statements, consistent with the view of the International Accounting Standards Board set out in paragraph 8.7 of the Discussion Paper. It is not necessary for the lessee to separately present its obligation for rental payments in the statement of financial position as discussed in paragraph 8.8 of the Discussion Paper. In practice, users of financial statements are familiar with obtaining this information from the note disclosures; thus it is not necessary to add another line item to the statement of financial position that would merely add more clutter to that statement.



- Lessor accounting matters:
 - o We strongly recommend that the Boards provide further guidance on when and how any income should be recognized by a lessor at the inception of a lease. Such guidance is necessary, as many leasing arrangements include elements other than financing (e.g., manufacturer or dealer profit).
 - o We believe that lessors should derecognize the property subject to a lease – that is, we are proponents of the views set out in paragraph 10.7 through 10.16 of the Discussion Paper.
 - A lessor's right to receive rentals only arises when the lessor has given up the right-of-use over the leased asset to the lessee. In addition, the lessor's obligations under the lease are fulfilled when the lessee receives right-of-use over the leased asset. From that point forward, we do not view the lessor as having any further “performance obligation” in respect of the leased asset.
 - Moreover, we believe that the lease accounting model for lessors should be analogous to the financial reporting model used by lending institutions: When a bank extends finance to a customer under a loan arrangement, the bank does not record a “performance obligation” under the loan arrangement. For this reason, we strongly object to the proposed model described in paragraphs 10.17 through 10.22.
 - o We are firmly of the view that the lessor's right to receive rentals continues to meet the definition of an asset.
 - o Both IFRS and US GAAP should have a common approach to investment properties. Therefore, we recommend that the accounting for investment properties be included in the scope of any proposed standard on lessor accounting.