
Proposed Lease Accounting Standard Could Raise Costs, AICPA Says.

A proposed accounting standard on leases fails to resolve concerns for current lease accounting standards and may impose additional costs on financial statement preparers, the American Institute of Certified Public Accountants said in an October 14 letter to the Financial Accounting Standards Board.

October 14, 2013

Ms. Susan M. Cosper

Technical Director

Financial Accounting Standards Board

401 Merritt 7

P.O. Box 5116

Norwalk, CT 06856-5116

File Reference No. 2013-270

Dear Ms. Cosper:

The Financial Reporting Executive Committee (FinREC) of the American Institute of Certified Public Accountants (AICPA) is pleased to offer its comments on the FASB's May 16, 2013, Exposure Draft (ED) of a proposed Accounting Standards Update (ASU) Leases (Topic 842).

We appreciate the significant efforts made to address the concerns raised by constituents on the previous exposure draft issued in 2010.

Leasing is pervasive. The depth and breadth of the market, the desire to achieve symmetry between lessees and lessors, as well as the variety of terms and economics inherent in leasing arrangements makes the task of reaching consensus on revisions to leasing guidance a real challenge.

FinREC has been supportive of the board's project to revise lease accounting and the issues identified in the March 19, 2009, Discussion Paper Leases: Preliminary Views. The FASB and IASB identified three criticisms of current lease accounting requirements:

a. Many leases are off-balance sheet despite the fact that financial statement users believe that they give rise to assets and liabilities that should be recognized in the financial statements of lessees. This forces users to adjust the reported amounts in the financial statements in connection with those transactions.

b. The existence of two very different accounting models for leases means that similar transactions can be accounted for very differently, which reduces comparability for users.

c. Existing lease accounting standards provide transaction structuring opportunities that make the financial statements less transparent for users.

Cost benefit

A cornerstone of the response to these criticisms is that a lessee should recognize the assets and liabilities arising from a lease. We agree with this core principle and with the notion that many leases inherently include a financing component that justifies the recognition of a liability by the lessee, and the conceptual merit of recognizing the associated rights conveyed in exchange for assuming the liability. However, FinREC is concerned that other important objectives have not been met and that the overall standard is not a sufficient improvement over today's guidance to support adoption of the proposals in the ED. We are also concerned that adoption of the provisions of the ED will impose significant costs on financial statement preparers — both on transition and on an ongoing basis. Some costs represent the investment in new accounting systems and associated controls that may ease financial reporting burdens once implemented. However, the complexity inherent in the construct of the dual model, specifically the distinction based on whether the leased item is property, and the ongoing required judgments, represent a permanent increased level of effort. A lease accounting model that is general enough to consider all the various types of leasing arrangements and provides a single recognition and measurement approach has proven to be a challenge. As such, we understand why the ED proposes a dual model; however, the dual model as currently proposed is not sufficiently operational and does not incrementally improve financial reporting in a cost-effective manner.

We believe that, in formulating a final standard, the board should give robust consideration to cost/benefit. That could include performing additional field testing of the standard and evaluate how to strike a better balance between the technical and practical/operational aspects of any proposed changes to leasing. FinREC believes that any transition to a model with most leases on balance sheet will by necessity involve a significant level of effort. However, it would appear that additional accommodations with respect to classification, transition and remeasurement, some of which we will discuss later in this letter, would reduce the cost without sacrificing transparency objectives of this project.

Impact on Lessors

FinREC believes that the emphasis on recognition of the liability by the lessee, and the desire for symmetry, creates significant challenges for lessors — notably the notion that recognition of the right to use a small portion of a nonproperty asset represents a sale on the part of the lessor of a corresponding portion of the leased asset. FinREC understands the desire for symmetry between lessors and lessees, but we believe this has complicated efforts to achieve consensus on a new standard that meets the key objectives laid out in the discussion paper while providing users with improved relevant and representationally faithful information. While symmetry is a desirable goal it is not a requirement, particularly when it could result in financial reporting that is less relevant to financial statement users than that provided today. Even under today's model, leasing often results in asymmetrical results (e.g., built-to-suit leasing, real estate sale-leaseback transactions, sales type leases of real estate). Nor is this confined to leasing. Asymmetrical accounting between the parties involved in a transaction is pervasive.

The introduction of the dual model goes some way toward mitigating concerns expressed by property lessors, but does not go far enough for certain lessors of other long-lived assets that they believe share many economic characteristics of property leases. We also have concerns that a model requiring classification based on the nature of the leased asset, rather than the economics inherent in the contract, may not provide users with the most decision-useful information — particularly with respect to lessors.

Lease classification

While the proposals in the ED represent an improvement relative to the initial ED in 2010, the ED's proposals do not resolve the second and third criticisms of current lease accounting standards identified by the boards. Further, it appears that the proposed disclosure requirements reflect a clear expectation that financial statement users will continue to find it necessary to make adjustments to the reported amounts in the financial statements in connection with leasing transactions, and may even need to do so for more transactions than under current lease accounting standards because users currently do not differentiate between leases on the basis of consumption.

Further, retaining a requirement to classify leases retains significant complexity inherent in today's GAAP, but with a dividing line that may not properly reflect the economics of the underlying arrangement, which adds unnecessary complexity — particularly in terms of how components are identified and classified. This is particularly apparent in leases of power plants and other assets likely to be seen as a single component but that contain aspects of both property and nonproperty. This will add to the already challenging task of splitting multiple-element arrangements into their components.

FinREC supports an approach for lessee accounting in which all leases other than short-term leases are recognized on-balance sheet by lessees. However, FinREC believes that the board should reconsider the proposed lease classification tests for income statement purposes. The ED's proposed classification tests do not appear to be responsive to the needs of financial statement users or provide benefits that outweigh the related costs. As an alternative to the current proposals, and in an effort to identify a solution that results in converged lease standards, FinREC recommends a dual recognition method in which the pattern of recognition would depend on whether the economic arrangement is more consistent with an in-substance financed purchase or motivated more by a desire for finite usage of a given asset. We believe this classification test should be based on clearly articulated principles and field tested to ensure that it is operational. Leases consistent with in-substance financed purchases would be accounted for as Type A leases and other leases as Type B leases, both as contemplated in the ED.

If consensus resulted in classification on the basis of the guidance contained in International Accounting Standard (IAS) 17 Leases, we would not object to this split, particularly since it is similar to current proposals for property and to current lease classification guidance under U.S. GAAP but without the much criticized bright lines. This would not alter some of the conceptual and other concerns discussed above. But if a dual model is included in the standard, it may be preferable to use one that is well understood in practice and familiar to financial statement users. Such an approach would —

- Be responsive to constituents who believe there is more than one type of lease arrangement (e.g., some leases are more akin to financing of an asset and others are obtaining the right to use an asset for a finite period).
- Retain a lease classification test that is well understood in practice and familiar to certain financial statement users. This alternative does not eliminate the complexity in today's accounting guidance but would be less complex than the ED as it benefits from experience of those applying IFRS.
- Still address a key objective of bringing lease-related assets and liabilities on balance sheet.

We are aware that some have called for removing lessor accounting from the proposed guidance. This would retain many of the bright line tests inherent in U.S. GAAP today and carry forward lessor accounting. As such, we also recommend addressing lease classification for lessors in a manner consistent with the preceding paragraph, a solution that would address the above concerns but is likely to otherwise be similar to today's lessor model.

Other matters

In addition to the concerns we express with respect to the dual model, there are a number of areas in which the concepts contained in the ED could be more clearly articulated, in which current proposals might be challenging to apply, or in which guidance does not appear to produce benefits that are justified in relation to their expected costs.

The primary areas of concern include:

We welcome revisions made to the identification of embedded leases. However, we believe that the guidance as currently proposed may be difficult to apply in practice and could be improved to highlight the key factors that drove the accounting conclusion. This would enhance consistency in application for transactions with similar circumstances. We expect that this issue will be particularly significant in circumstances in which a lease is embedded in a multiple-element service contract.

How preparers should determine whether assets that are functionally interdependent represent one or more than one unit of account. In the ED, the board has provided examples of a power plant and manufacturing facility. The examples concluded that the former has one component and the latter two. This determination has a potentially significant impact on income statement presentation, but the examples are unclear as to whether this conclusion is based on the nature of the asset, the perceived relative costs of separating the property from nonproperty, or some other factor.

How the guidance in the ED will be applied to services contracts where an underlying asset is not the primary motivation for executing the arrangement. A good example of this is naming rights for a sports facility. The primary economic motivation for such an arrangement is marketing, but the arrangement constitutes a right not dissimilar to the use of a billboard.

Irrespective of the decision the board makes, implementing a standard on such a pervasive topic will be a challenge. FinREC recommends that the board establish a post-issuance lease implementation process to ensure consistent application of the final principles across different asset classes and industries.

We provide further information and commentary on these and other areas in our responses to the board's questions in the ED in the appendix to this letter.

Representatives of FinREC and the FinREC Leases Task Force are available to discuss our comments with board members or staff at their convenience.

Sincerely,

Richard Paul

Chairman

FinREC

Chad Soares

Chairman

FinREC Leases Task Force

American Institute of CPAs

New York, NY

CC:

Hans Hoogervorst, Chairman

International Accounting Standards Board

Attachment

Question 1: Identifying a Lease

Do you agree with the definition of a lease and the proposed requirements for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease?Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

We believe that it is appropriate to evaluate whether an agreement contains a lease based on whether it contains (1) an identified asset and (2) whether the lessee obtains the right to control the use of the asset for a particular period. However, we believe that the guidance and related examples, as currently proposed, may be difficult to apply in practice and could be improved to highlight the key factors that drove the accounting conclusion. This would enhance consistency in application for transactions with similar circumstances. We expect that this issue will be particularly significant in circumstances in which a lease is embedded in a multiple-element service contract.

FinREC believes that control is inherent in a lease relationship and that the focus should be on principles rather than bright lines. However, we believe additional guidance is needed on how to weight factors that seemingly indicate control against factors that would seemingly indicate an absence of control. We are concerned that the examples included in the ED do not clearly illustrate how to evaluate involvement in different phases of the arrangement (relative weight for design versus operation of the asset) or how to identify significant decisions — particularly those made in connection with the delivery of nonlease services contracted for under the arrangement. Some FinREC members also suggested that, in cases in which the asset has no utility without services provided by the lessor, the entire arrangement is better reflected as a service contract. One potential example of this would be cable television boxes, which have little stand-alone value without the associated subscription. It is one simple example of the complexity inherent in applying the control model.

FinREC believes the final standard will benefit from more detailed examples, especially on how to weight conflicting indicators when making “close calls” — this would enhance consistency in application and aid financial statement users in evaluating reported results.

In addition, we are not clear on to how to apply the phrase “throughout the term of the contract” in evaluating whether the customer has the ability to direct the activities that most significantly affect the economic benefits to be derived from use of an asset or can derive substantially all of the potential economic benefits from its use. Is it the Board’s intent to apply a model similar to ASC 810-

10/IFRS 10, or does this control model attempt to assign decisions (including those agreed to in the contract) to each of the involved parties?

We also believe it would be helpful to address how decision making inherent in nonlease elements ties into the assessment of control and associated benefits. Is this based solely on output, or must it consider the lessee's own circumstances and other assets to be used in concert with the leased asset?

FinREC also believes it is important to reconcile the guidance on control in the ED to that for sale-leaseback transactions, which appears to consider control based on risks and rewards (e.g., lease term and present value of lease payments).

FinREC is not seeking bright lines but rather is trying to ensure that the guidance can be applied consistently considering the impact that these judgments could have on preparers' financial statements.

In addition to seeking clarity regarding control, we believe that the guidance with respect to substitution rights could be improved. Specifically, we believe that the ED's examples appear to downplay the economic and operational costs of substitution. FinREC believes that when substantive substitution rights are present, they often represent the end of a lease of one asset and the start of the lease of a different asset and substitution is more relevant in considering the lease term than the presence of a lease. Notwithstanding our view, FinREC recognizes that there are contracts in certain industries (e.g., IT outsourcing arrangements) for which substitution rights and attendant costs reinforce the view that the overall arrangement is a service contract more appropriately reflected as an executory contract. This may be especially true when equipment is replaced without the customer's knowledge and/or control.

Finally, we are also concerned that the board's proposal to consider not only assets available to the lessor, but also those that could be acquired, assumes insight the lessee likely will lack as well as the availability of additional assets and the willingness of a lessor to acquire or deploy additional assets in support of a contract. FinREC believes it would be better to consider changes in assets available to the lessor as a trigger for reassessing whether the contract is in scope, rather than rely on assumptions that could be highly subjective. Should the board elect to retain the guidance proposed in the ED, we believe that it would be necessary to provide additional guidance on how to evaluate the costs of substitution. Are such costs considered relative to a given asset or to the aggregate value of lease elements in a multiple-element arrangement? Should the analysis factor in lessor incentives with respect to substitution? Under existing GAAP, if utility was an important consideration in determining when an arrangement contained a lease, substitution rights were arguably more relevant considering that a lessee may have little or no control over the asset. With control at the heart of the leasing analysis in the ED, its utility to identifying embedded leases has lessened.

Question 2: Lessee Accounting

Do you agree that the recognition, measurement, and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If no, what alternative approach would you propose and why?

As discussed in the forepart of this letter, FinREC recommends a dual-model approach for lessee and lessor accounting in which all leases other than short-term leases are recognized on-balance sheet by lessees. However, FinREC believes that the board should reconsider the proposed lease classification tests. The ED's proposed classification tests do not appear to be responsive to the needs of financial statement users or provide benefits that outweigh the related costs. FinREC recommends a dual recognition method in which the pattern of recognition would depend on whether the economic arrangement is more consistent with an in-substance financed purchase or motivated more by a desire for finite usage of a given asset. We believe this classification test should be based on clearly articulated principles and field tested to ensure that it is operational. Leases consistent with in-substance financed purchases would be accounted for as Type A leases and other leases as Type B leases, both as contemplated in the ED.

If consensus resulted in classification on the basis of the guidance contained in International Accounting Standard (IAS) 17 Leases, we would not object to this split, particularly since it is similar to current proposals for property and to current lease classification guidance under U.S. GAAP but without the much criticized bright lines. FinREC believes that, if a dual model is included in the standard, it may be preferable to use one that is well understood in practice and familiar to financial statement users.

Question 3: Lessor Accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

FinREC believes that the emphasis on recognition of the liability by the lessee, and the desire for symmetry, creates significant challenges for lessors — notably the notion that recognition of the right to use a small portion of a nonproperty asset represents a sale on the part of the lessor of a corresponding portion of the leased asset. FinREC understands the desire for symmetry between lessors and lessees, but we believe this has complicated efforts to achieve consensus on a new standard that meets the key objectives of this project while providing users with improved relevant and representationally faithful information. While symmetry is a desirable goal, leasing today often results in asymmetrical results (e.g., built to suit leasing, real estate sale-leaseback transactions, sales type leases of real estate), and this is not confined only to leasing. It has been our experience that symmetry is often the exception rather than the rule.

The introduction of the dual model goes some way toward mitigating concerns expressed by property lessors, but does not go far enough for certain lessors of other long-lived assets that they believe share many economic characteristics of property leases. We also have concerns that a model requiring classification based on the nature of the leased asset, rather than the economics inherent in the contract, may not provide users with the most decision-useful information — particularly with respect to lessors.

FinREC believes that the concerns expressed above can be addressed without dropping lessor accounting from the project and by incorporating income statement classification on the basis of

IAS 17. This would leave lessor accounting largely unchanged (with the exception of removing bright line tests and leveraged lease accounting) and symmetrical with proposals for the lessee.

If FinREC's proposal for revised lease classification guidance is not accepted, we strongly recommend that the board consider dropping proposed changes to lessor accounting until the issues raised by stakeholders can be addressed. If such a path is chosen by the board, FinREC supports a very narrow change to lessor accounting to remove the guidance for leverage leases.

Question 4: Classification of Leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the [ED] requirements, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

FinREC does not support an income statement classification model based on the nature of the leased asset. This classification approach introduces significant complexity with a dividing line that may not properly reflect the economics of the underlying arrangement and may reduce the utility of information to financial statement users. This unnecessary complexity is likely to only increase the complexity of ongoing compliance with the proposed model — particularly to the already challenging task of splitting multiple-element arrangements into their components.

As discussed in our response to Question 2, FinREC recommends a dual recognition method in which the pattern of recognition would depend on whether the economic arrangement is more consistent with an in-substance financed purchase or motivated more by a desire for finite usage of a given asset. Leases consistent with in-substance financed purchases would be accounted for as Type A leases and other leases as Type B leases, both as contemplated in the ED.

If consensus resulted in classification on the basis of the guidance contained in IAS 17 Leases, we would not object to this split, particularly since it is similar to current proposals for property and to current lease classification guidance under U.S. GAAP but without the much criticized bright lines. We believe the principles-based guidance inherent in IAS 17 is a superior approach to the consumption model, without sacrificing its benefits, and that the concerns about today's classification approach are largely grounded in the off-balance-sheet nature of operating leases and the associated bright lines, rather than concerns with classification based on risks and rewards.

Question 5: Lease Term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

FinREC supports the board's view that lease term should be reassessed to reflect changes in relevant circumstances. This will not only limit potential structuring opportunities, but it will also provide more timely information to financial statement users. We also support the board's proposals that renewals be included only when economic incentives suggest renewal is likely. However, in light of the guidance in the basis for conclusions, we believe that the standard should consider renewals that are "reasonably assured" to avoid confusion as to the possible difference between this concept and that of significant economic incentive.

FinREC believes the proposal should provide explicit examples of indicators that may indicate a change in assumptions. Of the indicators provided in 842-10-55-4, only one, the addition of significant leasehold improvements, is likely to be clear to constituents. The remaining examples cited in the guidance all seem to be market-based indicators, which ASC 842-10-55-5 indicates will not, in isolation, trigger a reassessment. Many preparers have substantial lease portfolios and have expressed concern over the cost of having to consider incentives on what is a highly subjective basis to ensure there has been no change at each balance sheet date. Reassessment is desirable to minimize structuring opportunities and to provide for more decision-useful information for users, but it must be balanced against the cost of compliance. Further clarity is needed on the non-marke- -based factors a preparer may need to consider when applying this guidance over the life of the lease.

FinREC believes that there should be clarity with regard to how management's intent is factored into the reassessment model. Many would consider management's stated intent to be a fairly compelling data point in determining the lease term, but it is not apparent how intent factors into the market-, contract-, asset- and entity-based factors cited in ASC 842-10-55-4.

We believe that the guidance in the ED should be clarified with respect to determination of short-term leases. Specifically, we believe the board should specifically address how lessees and lessors should evaluate month-to-month leases and those that contain one-party termination provisions.

Question 6: Variable Lease Payments

Do you agree with the proposals on the measurement of variable lease payments, including the reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

We understand why the board would seek to remeasure the asset and liability for changes to an index subsequent to initial recognition — particularly in jurisdictions where adjustments are significant either annually or over the life of the arrangement. However, there is significant confusion as to the frequency of such adjustments. Some FinREC members believe the lease liability should not be remeasured for changes to the index subsequent to the initial measurement. This would be consistent with how other liabilities (e.g., variable rate debt) would be treated.

FinREC recognizes that, unlike typical variable rate debt, some lease indexation (e.g., based on changes to the Consumer Price Index (CPI)) typically has an upward ratchet only and that the concepts in the ED regarding variable lease payments are reasonable. However, we believe that remeasurement should not be required as this adds an additional layer of complexity to lease accounting for which there may be no significant economic benefit to financial statement users. We instead recommend an update to the future minimum lease commitment disclosure so that when a CPI adjustment is factored into rent payments, the disclosure is updated to reflect the future cash outflows based on the current amount of rent the lessee is paying (which would include increases in CPI). This is information that preparers will have readily available once the index resets, and it will provide users with timely notice of the changes in lease payments. Presenting this on an undiscounted basis is unlikely to hamper its utility but it will reduce the cost of compliance.

If the board moves forward with the requirement to reassess the lease obligation, FinREC recommends that remeasurement be required only when the cash flows related to the lease change. For example, if the lease payments are adjusted annually by reference to the CPI, the lease liability should not be adjusted for interim changes in the CPI but only at the point that cash payments reset for a given lease. Since changes to CPI today trigger updates to lease payments, reassessment at this time is likely to impose less of a burden than the guidance as currently proposed. FinREC believes that remeasurements more frequently than the reset provisions stipulated in a given lease would reflect a false precision and that the cost would exceed the benefits.

Question 7: Transition

The ED states that a lessee and a lessor would recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the Boards should consider? If yes, what are they and why?

FinREC is supportive of the board's proposed transition provisions overall, but believes that additional improvement is possible. Specifically, we believe that the board should consider additional practical expedients to ease the transition burden for nonpublic entities and to address differences in transition under the revenue recognition standard and those in the ED. Lessors in particular may have to evaluate the same contract twice — once in connection with the adoption of the revenue recognition standard and again with respect to leasing. Depending on the board's response to our recommendation with respect to the income statement, we believe that the board should consider whether lessees and lessors should be permitted to adopt the proposals in the leases ED using a simplified approach as defined in paragraph 133 of the Proposed Accounting Standards Update on Revenue Recognition and the "modified approach that was decided on in February 2013.

Under the "modified approach" an entity would recognize "the cumulative effect of initially applying the revenue standard as an adjustment to the opening balance of retained earnings in the year of initial application (that is, comparative years would not be restated)." The standard would apply to new contracts created on or after the effective date and to existing contracts as of the effective date but would not apply to contracts that were completed before the effective date.

In the year of adoption, entities would also be required to disclose the financial statement line items that have been directly affected by the standard's application.

FinREC believes a similar model would mitigate some of the concerns expressed by lessors and likely reduce the population of leases that a preparer must consider. We believe that the simplified approach should be an option, and that the full and modified retrospective approach should also be retained. Whichever method is chosen, focus should be around good disclosure around noncomparable transactions (e.g., real estate sale-leaseback arrangements).

In addition, with respect to current transition options, we believe that the board should clarify certain aspects of transition. For example, although the board has indicated that hindsight can be used in evaluating lease arrangements, it is unclear whether this will be applied by asset class, to all arrangements, or to specific subsets (e.g., to all leases where the preparer is a lessor). Companies have a variety of assets under lease and are often a lessor even when this is not their core activity. Providing greater insight into how to apply these practical expedients would be helpful.

The ED contains very limited guidance with respect to certain aspects of leasing (e.g., leveraged lease accounting, how to transition capital leases arising solely as a result of problematic default provisions). This gap in guidance is likely to create diversity in practice — particularly when considered along with other gaps such as the issue with hindsight mentioned above. In addition, we would ask to board to consider whether to —

- Stipulate that previous sale conclusions for all sale-leaseback transactions need not be reconsidered;
- Stipulate, solely for transition purposes with respect to sale-leaseback transactions, that ownership by an entity may be deemed to occur when title transfers, not when the entity has executed a purchase order or assigned a purchase order to another party in an agreement that contains provisions exposing the entity to constructive risks of asset ownership (e.g., an indemnification of the assignee);
- Permit lessees and lessors to apply the discount rate used to classify and account for a lease under existing GAAP (i.e., the discount rate determined at lease inception) except in cases where incentives would affect the lease term;
- Permit or require lessors applying the discount rate determined at lease inception under existing

GAAP to measure the residual asset for leases classified as Type A leases at the present value of the estimated future residual value at lease inception under existing GAAP accreted to the date of initial application;
- Permit lessors to apply a discount rate determined using information at the beginning of the earliest comparative period presented when the residual asset is measured using information as of that date;
- Clarify whether any of the specified transition reliefs are available to entities that elect full retrospective application; and
- Clarify how an entity applying the modified retrospective transition approach would determine the classification of a preexisting lease upon adoption of the proposed requirements.

We would also like the board to consider whether additional guidance should be provided with respect to —

- How a lessor should reflect assets it acquired in a sale-leaseback that contains a lessee purchase option.
- Whether the transition rate should be set at the effective date rather than the implementation date.
- How to evaluate arrangements in which a leased asset is under construction and the lessee is considered the owner of that asset at the transition date. Is derecognition in transition appropriate? Will this require consideration of sale-leaseback accounting? In cases where the lessee has a purchase option, does the application of sale-leaseback accounting affect presentation of the arrangement by the lessor?

Question 8: Disclosure

The ED sets out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments, reconciliations of amounts recognized in the statement of financial position, and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

FinREC believes the board’s proposals with respect to disclosure would impose a significant burden for both public and nonpublic entities and contain elements that affect the utility for financial statement users. Although additional information may aid users, the depth and scale is significant, and the associated costs must be considered as well. It is also important to consider whether the scale of disclosure is consistent with the notion that the recognition of an asset and liability is of paramount importance to users.

The proposed disclosure requirements appear to be excessive in many respects given the extra visibility lease assets and obligations are proposed to have in the basic financial statements, but appear to be inadequate in relation to variable lease payments (see last point below).

Although the proposals would allow entities to consider the extent of detail provided, the board has not provided sufficient guidance about how to determine the appropriate level of aggregation in the disclosures.

Finally, we believe that the board should consider whether to require disclosure by lessees and lessors of aggregate undiscounted estimated variable lease payments (other than those based on an index or rate) on an annual basis for a minimum period of five years from the balance sheet date, and a comparison of actual variable lease payments with estimated variable lease payments for each comparative period presented. The board should not require discounting or require disclosure beyond a reasonable estimate to avoid the false precision such disclosures may suggest. This, along with the limit to the periods required to be disclosed, should ease preparers' concerns with respect to the cost and effort of preparing these disclosures while providing users with valuable incremental information. Under proposals in the ED, the only data provided on variable payments will be historical, and that limits its utility to users.

Question 9: Nonpublic Entities

Will the specified reliefs [in the ED] for nonpublic entities help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements? If not, what changes do you propose and why?

FinREC is supportive of including relief for nonpublic entities to help reduce the cost of implementing the proposals in the ED. However, we do not support the proposal to permit a policy election to use a risk-free discount rate to measure the lease liability. We observe that a risk-free rate would almost certainly not be the rate that the lessor charges the lessee and, therefore, would almost certainly result in an inaccurate measurement. We would favor proposals to allow the lessee to apply a best estimates approach to determining the incremental borrowing rate when the implicit rate is not known.

We also noted the board's proposal for an exception to the requirement that a lessee provide a reconciliation of the opening and closing balances of the liabilities to make lease payments. The basis for this exemption is the fact that users of nonpublic entities' financial statements generally have greater ability to directly access management and to obtain additional information beyond what is included in financial statements; as a result, the benefits of preparing this information do not outweigh the cost. FinREC does not object to this exemption, but requests that the board consider whether it should be extended to entities that sublease property as an ancillary activity.

We recommend that the board allow private companies the option of deferring the effective date for one or two years after the effective date for public companies. We believe it is appropriate to allow private companies more time to put in place the necessary systems and processes to apply the guidance and also capitalize on the experience of public companies.

Question 10: Related Party Leases

Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases? If not, what different recognition and measurement requirements do you propose and why?

Transactions between related parties carry with them the inherent risk that contractual terms are not consistent with those that would be available between unrelated parties operating on an arm's-length basis and may result in lease payments or other contractual terms geared to achieve financial reporting objectives or to permit use of property or nonproperty without an explicit contractual arrangement. However, this risk is not unique to leasing transactions and FinREC agrees with the board that the costs associated with adjusting contractual arrangements to reflect their economic substance does exceed the expected benefit. FinREC believes the appropriate response to this risk is disclosure of the relevant terms and conditions. Such disclosure permits financial statement users to evaluate the arrangement and determine what adjustments, if any, may be appropriate.

Question 11: Related Party Leases

Do you agree that it is not necessary to provide additional disclosures for related party leases? If not, what additional disclosure requirements would you propose and why?

As discussed on our response to question 10, we do not believe that it is appropriate to provide different recognition and measurement requirements for related party leases. However, we believe that the board should consider what additional disclosures may be relevant to financial statement users. FinREC believes that it may be helpful to specifically require management to explain the basis for establishing the terms of its related party leases and, in cases in which the asset is leased from a third party, disclose the terms of the associated head lease.