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Standard & Poor's Ratings Services Comments On The FASB/IASB Discussion Paper Regarding Lease Accounting

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*(**Editor's Note:** The following is the text of a response sent by Standard & Poor's Ratings Services' Chief Quality Officer and Chief Accountant Neri Bukspan to the Financial Accounting Standards and International Accounting Standards Boards regarding their joint discussion paper, "Leases: Preliminary Views," on July 17, 2009. The views expressed in this letter represent those of Standard & Poor's Ratings Services and do not address, nor do we intend them to address, the views of any other subsidiary or division of Standard & Poor's Financial Services LLC or The McGraw-Hill Companies. Further, we intend our comments to address the analytical needs and expectations of our credit analysts.)*

Standard & Poor's Ratings Services appreciates the opportunity to provide the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB and together, the Boards), our comments on the Boards' Discussion Paper, "Leases: Preliminary Views".

We previously indicated our support for the Boards' decision to comprehensively reconsider existing lease accounting standards, to ensure that financial-statement users are provided useful, transparent, and complete information about leasing transactions in the financial statements. Given the importance of leasing as a source of business financing and the extensive use of leases by many of our rated companies, we have always noted that the use of leases can meaningfully alter the financial and liquidity characteristics of an issuer. Understanding an issuer's leasing activities is essential to our credit analysis. Our article, Ratings Implications Of Proposed Joint FASB/IASB Lease Accounting Project (published Aug. 2, 2006, on RatingsDirect) presented our initial views when the project was first announced, and provides further details on key analytical considerations in our evaluation of lease arrangements entered into by corporate issuers.

We support the Boards' objective to address what we believe are certain shortcomings of the existing accounting model for leases (e.g., off-balance sheet treatment for operating leases, rules-based nature, ability to structure around bright line tests, and overall complexity of existing standards) by producing a significantly improved common standard on lease accounting. We also encourage the continued convergence of U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS) that this proposal represents.

Employ The Right-of-Use Model And On-Balance Sheet Treatment

We support the approach expressed in the Discussion Paper to account for all lease contracts as the acquisition of a right to use the leased item for the lease term, and agree with the resulting "right-of-use asset" and "obligation to pay rentals" liability that a lessee will record under this approach. We also support the Boards' decision to include rights acquired under options (e.g., term options, termination options and purchase options) as a part of a single right-of-use asset, and a single obligation to pay rentals that includes contingent rentals and residual value guarantees. (We describe our views on these and other aspects of the Discussion Paper in more detail in our responses to the Boards' specific questions in the appendix to this letter). However, information about the composition of the right-of-use asset should be available in the footnotes.

We believe the most significant impact of the new model will be to remove the accounting distinction between operating and finance leases (also referred to as capital leases), placing obligations formerly classified as operating leases on the balance sheet--a result we very much support. We have long viewed the accounting distinction between operating and finance leases as substantially artificial because, in both cases, the lessee contracts for the use of an asset, entering into a debt-like obligation to make periodic rental payments. As a result, we historically have adjusted reported amounts to eliminate the operating or financing distinction by capitalizing lease obligations accounted for as operating leases. We principally adjust by capitalizing the net present value of disclosed future minimum lease payment commitments and by adjusting other profitability and cash-flow measures used in our analysis to reflect the financing nature of this activity. (For further details on our adjustment for operating leases, please refer to the "Encyclopedia of Analytical Adjustments" section of Standard & Poor's Corporate Ratings Criteria 2008, published April 15, 2008 on RatingsDirect and www.sandp.com.) The model proposed in the Discussion Paper will capture the economics of our operating-lease-adjustment methodology. We expect the proposed model to improve the financial reporting of the underlying economics of leasing transactions, and provide better, decision-useful information to financial-statement users than current accounting standards.

Provide Comprehensive Disclosures

We have long held that a thorough and decision-useful financial reporting framework must include both an appropriate accounting framework in the basic accounting statements and comprehensive disclosures in the accompanying footnotes and supplemental disclosures. Basic financial statements alone do not include all necessary information; footnotes should provide the essential information to comprehend fully the basic financial statements. In this regard, we are pleased by the FASB's recent announcement to initiate a Disclosure Framework project intended to enhance disclosures and facilitate improved communication to financial statement users.

Comprehensive disclosure will be a critical facet in financial-statement users' ability to understand the application and consequences of the new leasing standard and leasing arrangements. Disclosures are even more important, given the complex nature of lease transactions, the options, guarantees, and contingencies that are common in lease arrangements, and the principles-based accounting framework in the proposal. Whether in conjunction with the recently announced FASB comprehensive disclosure framework project, or separately as part of this project, we believe it is imperative for the Boards to develop an accompanying comprehensive lease disclosure framework.

As detailed in our responses to the specific questions, we would like to see separate balance sheet items (or footnote presentation, including the amounts in financial statement lines) for the obligation to pay rentals and the right-of-use asset. Meaningful lease disclosure should also include:

- The nature of the assets leased and business purpose;
- Related lease term and depreciation information;
- Annual estimated future lease payments in a manner similar to the current disclosure for operating leases (including information on short-term leases);
- The incremental borrowing rates used and changes in the company's rates applied; and
- Information providing insight into management's judgments involving lease option periods, contingent rental payments, residual value guarantees, and information on changes to estimates and assumptions.

Regardless of the accounting rules in the final standard, robust disclosure of leasing activities will be important to our analysts' ability to understand the economics of the business; accounting aspects of the leasing transactions; and the assumptions and estimates management used to arrive at the reported amounts.

Address Lessor Accounting, Intangible Assets, And Other Scope Issues

We understand the Boards' rationale for tentatively deferring consideration of lessor accounting and acknowledge that many of the criticisms leveled against existing leasing standards are heavily weighted to lessee accounting. The fact that leases have not been included in the scope of recently issued key standards such as SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities, and the desire to converge the accounting treatment of leases under U.S. GAAP and IFRS are among the many reasons not to significantly delay a new lessee accounting model. Nevertheless, as our rated-issuer universe encompasses both lessees and lessors, we believe the most prudent approach would be for the Boards to continue to make all reasonable efforts to conclude on a model for both lessee and lessor accounting to assure comprehensiveness and symmetry (where appropriate), reflecting both sides of leasing transactions. To that end, we encourage the Boards to continue the discussions regarding lessor accounting issues subsequent to the issuance of the Discussion Paper, and to issue lessee and lessor accounting standards concurrently. If the Boards determine that this approach is not plausible without unduly delaying a standard for lessee accounting, then we recommend the Boards develop and promulgate lessor accounting standards as soon as practicable thereafter.

Lessor accounting aside, the Boards have decided that the scope of the proposed new lessee standard should be based on the scope of the existing standards. We support the Boards' decision to focus on the main aspects of the proposed new accounting approach, but strongly urge the Boards to consider a second phase of the project that will soon thereafter address lease issues that are not fully addressed in the final standard. This should include leases of intangible assets, further definition of the types of arrangements that meet the definition of a lease, thus addressing issues not fully resolved by Emerging Issues Task Force EITF Issue 01-8--Determining Whether an Arrangement Contains a Lease, and its international equivalent, IFRIC 4--for example, whether certain types of long-term purchase commitments are leases. It would also include issues currently covered by a scope exclusion (e.g., licensing agreements), and the significant scope differences that currently exist between IAS 17 and SFAS 13 (e.g., inclusion of some intangible assets under IAS 17, differences with regard to investment property). We support the continued convergence of leasing standards by the Boards and accordingly, urge the Boards to eliminate any current differences in their approaches (e.g., calculations of contingent rentals) in the final standard.

We also concur with the Boards' decision to provide further guidance on the accounting for leases that are "in-substance" purchases. However, we believe it is essential that this guidance become a core component of any final standard pursuant to the Discussion Paper.

The Boards have also acknowledged the need to resolve certain issues before publishing an exposure draft, including the following (for which no preliminary view has been included in the Discussion Paper): timing of initial recognition; sale and leaseback transactions; initial direct costs; leases of a component of an asset; impairments; leases that include service arrangements; and disclosure. While the Boards continue to address each of these areas, we cannot stress enough the importance of addressing analytical needs for comprehensive disclosure, whether through an overarching disclosure framework or a more limited, but nonetheless vital, comprehensive lease disclosure framework as a core part of this project.

Appendix: Responses To Specific Questions In The Discussion Paper

Chapter 2: Scope of lease accounting standard

Question 1. The Boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach? If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

As more fully described above, we prefer to see the Boards consider accounting for leases by lessees and lessors in a comprehensive manner, while not jeopardizing the issuance of a final standard on or close to the targeted mid-2011 date. This would include a best-efforts approach to issuing lessee and lessor accounting standards concurrently. However, if the Boards determine that this approach is not viable without unduly delaying a standard for lessee accounting, we urge the Boards to issue a standard for lessor accounting as soon as practicable after the issuance of the new lessee accounting standard.

Concerning lessee accounting, we agree with the Boards' approach to base the scope of the proposed new lease accounting standard on the scope of existing lease accounting standards. We recognize, however, that there is a need to address, in a reasonably acceptable amount of time, the important issues that are currently beyond the scope of the proposed new standard. These issues include leases of intangible assets, defining what other arrangements may constitute a lease, issues currently covered by a scope exclusion (e.g., licensing agreements), and the significant scope differences that currently exist between IAS 17 and SFAS 13 (e.g., inclusion of some intangible assets under IAS 17, differences with regard to investment property). We strongly urge the Boards to consider a second-phase lease project to address all remaining lease issues not fully addressed in the final standard.

We concur with the Boards' decision to provide further guidance on accounting for leases that are "in substance" purchases and believe it is essential that this guidance be addressed in the final standard resulting from this Discussion Paper. We urge the Boards to eliminate any differences in their approaches (e.g., methods of calculating contingent rentals) in the final standard.

We also recommend adopting comprehensive lease disclosure requirements, whether through the recently proposed overarching disclosure framework project or a more limited comprehensive lease disclosure framework as part of this project. We believe disclosure requirements should provide financial-statement users with information necessary to understand how the company manages leasing transactions and how leases affect the financial position, earnings, and cash flows of the company.

Question 2. Should the proposed new standard exclude noncore asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

We do not believe the proposed standard should provide exclusions for noncore assets or short-term leases. We believe the financial statements would be most informative and consistent if all material leases were subject to a single model without exception to avoid mixed-attribute accounting measures.

The fact that the lease may be for a noncore asset does not mitigate the need for consistent treatment with other leased assets; in our analysis, we do not differentiate based on whether leases are for core or noncore assets because we consider the lease obligations to be debt-like in either case. We also believe exempting short-term leases could be an invitation to structuring contracts around the new model and that varied subjective interpretations as to what constitutes short term could lead to inconsistent treatment.

If the Boards ultimately allow any such exclusions, it would be useful to see detailed disclosure of the amounts and descriptions of the leases that companies consider noncore and the rationale in making that decision so that our analysts may consider that information in our analysis. Tabular presentation of a company's lease payments should be required, similar to the current operating lease disclosure, including amounts for leases capitalized and leases excluded from capitalization. We do not object to--and in fact encourage--disclosures in the footnotes of the nature of use and deployment in the business of leased assets, including core as well as noncore assets.

Chapter 3: Approach to lessee accounting

Question 3.Do you agree with the Boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

Question 4.The Boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognize: (a) An asset representing its right to use the leased item for the lease term (the right-of-use asset), and (b) A liability for its obligation to pay rentals. Appendix C describes some possible accounting approaches that were rejected by the Boards. Do you support the proposed approach? If you support an alternative approach, please describe the approach and explain why you support it.

We agree with the Boards' overall analysis of the rights and obligations, and related assets and liabilities arising in a simple lease contract.

We support the Boards' proposed right-of-use approach, whereby the right to use a leased item for the lease term is recorded as an asset, and the obligation to pay rentals is recorded as a liability. The Boards' proposed approach is consistent with our long-held view that the accounting distinction between operating and finance (capital) leases is substantially artificial, because in both cases, the lessee contracts for the use of an asset, entering into a debt-like obligation to make periodic rental payments.

Question 5. The Boards tentatively decided not to adopt a components approach to lease contracts. Instead, the Boards tentatively decided to adopt an approach whereby the lessee recognizes: (a) a single right-of-use asset that includes rights acquired under options, and (b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees. Do you support this proposed approach? If not, why not?

We agree with the Boards' proposed approach to include rights acquired under options as part of a single right-of-use lease asset and to include contingent rental arrangements and residual value guarantees as part of a single obligation to pay rentals, as we do not view these items as having value separate from the lease. Although we are not preparers, we recognize the Boards' concerns over the difficulties preparers might have in applying a components approach and the introduction of increased subjectivity in separately valuing each portion. In our view, the single asset and single liability approach will reduce complexity for financial statement users without unduly limiting the usefulness of the financial information. In this regard, we wish to emphasize the importance of disclosures about the nature of options and similar arrangements that are included in a lease and their potential to meaningfully alter the cash flows related to a lease, information we believe is important to analysts.

Chapter 4: Initial measurement

Question 6. Do you agree with the Boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate? If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

We agree with the Boards' tentative decision to measure the lessee's rental obligation at the present value of the lease payments. The use of the net present value of the lease payments is consistent with the approach we use in our Corporate Criteria. We apply an adjustment methodology intended to eliminate the distinction between financing (capital) and operating leases by capitalizing lease obligations accounted for as operating leases using the net present value of disclosed future minimum lease payment commitments.

We further agree with the Boards' tentative decision that the present value of the lease payments be measured using the lessee's incremental borrowing rate instead of the rate implicit in the lease. Our Corporate Criteria currently states that, ideally, we use the imputed discount rate associated with the lease as the discount factor. However, the imputed rate is rarely available, and is unlikely to be available for all companies in an industry. We therefore more commonly use the average rate on the company's secured debt, or a rate imputed from the company's total interest expense and average debt. We believe the consistent use of the incremental borrowing rate at inception of a lease is appropriate in arriving at the lessee's rental obligation. We believe, however, that companies should use the borrowing rate attributable to similar assets and arrangements (e.g., secured borrowing).

We also recognize that there are companies (including some in the retail sector) that do not use debt financing, but do participate in leasing transactions. The Boards should consider guidance on how these companies should determine their incremental borrowing rate.

We recommend that the Boards require disclosure of both the estimated lease payments (e.g., similar disclosure to the current operating lease requirements) and the incremental borrowing rates used to calculate the lease obligation. This should also include information about underlying assumptions and methodologies (e.g., lease term and contingent rental features) which will aid in scenario analysis.

Question 7. Do you agree with the Boards' tentative decision to initially measure the lessee's right-of-use asset at cost? If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

We agree with the Boards' tentative decision to initially measure the lessee's right-of-use asset at cost, with cost equal to the present value of the lease payments discounted using the lessee's incremental borrowing rate. We agree that the right-of-use asset should initially be measured at the same amount as the initial obligation to pay rentals, which is the result achieved under the proposal. However, when a lease contains an extension or purchase options, its cost at inception will include the present value of the option payment, which would be amortized in future periods. Although it may be somewhat inconsistent with the accounting for option payments made on PP&E, we believe it is a practical and reasonable accommodation, which we expect to be a candidate for harmonization in future projects.

Chapter 5: Subsequent measurement

Question 8.The Boards tentatively decided to adopt an amortized cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do you agree with this proposed approach? If you disagree with the Boards' proposed approach, please describe the approach to subsequent measurement you would favor and why.

Given the current accounting framework for assets and liabilities, we agree with the Boards' tentative decision to require subsequent measurement of both the obligation to pay rentals and the right-of-use asset, and agree with the proposed approach to use the amortized cost-based approach for such subsequent measurement. We believe amortization of the right-of-use asset should be consistent with the method currently used to amortize assets, i.e., the amortized-cost approach.

Question 9. Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

We believe it best not to allow a lessee to elect to measure its obligation to pay rentals at fair value, in effect, leaving in place the scope exception for leases in SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities. If accounting standards allow companies to measure lease obligation at fair value, a change in fair value of the obligation would cause gains (and losses) in earnings and capital. We believe these are not sustainable earnings, and will commingle changes in the obligation arising from credit as well as interest rate factors. This is consistent with our analytical criteria, under which we currently eliminate the revaluation of liabilities that result from changes in a company's own creditworthiness from capital and earnings. We therefore believe applying fair value to lease obligations would only add noise through the life of the lease, without adding value to the financial-statement user under a mixed attributes accounting framework.

We are also concerned that allowing the fair-value election would hamper consistency among companies, and that any such optionality will lead to increased, mixed-attribute accounting.

Question 10. Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons. If the Boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

We agree with the FASB's tentative decision not to require reassessment of the lessee's incremental borrowing rate. We believe changing the lease obligation as interest rates change does not faithfully represent the economics underlying the lease transaction of acquiring right-of-use assets with fixed rate borrowings--again, considering the current, predominantly cost-basis, mixed-attributes accounting framework. We take this view for reasons of simplicity and, while we are not preparers, we realize it could be costly and difficult for companies to continually reassess their incremental borrowing rate for prior lease contracts.

We also do not object to the IASB's tentative decision to require subsequent revision of the incremental borrowing rate. However, we believe the revision should be made only when there is a change in the estimated cash flows. We believe that requiring adjustment only upon a change in estimated cash flows would generally be consistent with the Boards' tentative decision to adopt the catch-up approach, whereby the carrying amount of the obligation to pay rentals would be adjusted to reflect revised estimated cash flows. In any event, we believe the Boards should reach a consensus on all issues and the final standards should not differ between the FASB and IASB.

As discussed in our response to Question 6, disclosure of incremental borrowing rates used to calculate the lease obligations is necessary. If revision of the incremental rate is required, the impact of the remeasurement should also be disclosed.

Question 11. In developing their preliminary views, the Boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the Boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities. Do you agree with the proposed approach taken by the Boards? If you disagree, please explain why.

We agree with the proposed approach taken by the Boards.

Question 12. Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortization or depreciation in the income statement. Would you support this approach? If so, for which leases? Please explain your reasons.
We believe amortization or depreciation is more appropriate given the concept that a right-of-use asset is created under the new model. The terms amortization or depreciation would be more consistent with how other fixed assets and intangible assets are reduced in value over time.

Chapter 6: Leases with options
Question 13.The Boards tentatively decided that the lessee should recognize an obligation to pay rentals for a specified lease term, i.e., in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The Boards tentatively decided that the lease term should be the most likely lease term. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.
We support the Boards' tentative decision that the lessee be required to specify the appropriate lease term when a lease contains term options. We recognize that lease options can significantly extend the life of the lease. While we support the Boards' choice of the most likely lease term as the best of the three approaches considered, we are concerned that companies may too easily be able to structure lease transactions in order to achieve a desired result. The Boards indicate they will provide guidance on the contractual, noncontractual, and business factors that are to be considered in determining the most likely lease term. To avoid misuse, we believe this guidance should be clear and comprehensive to achieve consistent results among lessees. We do not agree with the Boards' preliminary views (Subsection 6.41) that the lessee's intentions and past practices should not be considered. Because management's intent is likely to be influenced by contractual as well as noncontractual factors and financial and nonfinancial factors, we believe it should equally be considered in determining the lease term. We believe management's intent is a very strong aspect to consider when determining lease terms based on the planned purpose and use of the leased asset. Entities could demonstrate intent through budgets and forecasts, and deviations from budgets and forecasts, and by conveying the business need for the asset beyond the initial lease term.

Consistent with our aforementioned comments about disclosures, a final standard should mandate disclosures of the factors and basis for the decision by management in arriving at the most likely lease term. Further, we believe that guidance on what constitutes an "in substance" purchase should be provided as part of a final standard.

Question 14. The Boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognized as an adjustment to the carrying amount of the right-of-use asset. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why. Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.
We support the Boards' proposed approach to require reassessment of the lease term at each reporting date, based on consideration of all facts and circumstances. We recognize the possibility of a material change in circumstances that will affect management's view of the most likely lease term, (e.g., as cited by the Boards, the addition of significant leasehold improvements could make it more likely that a company will extend the lease term). Such changes in circumstances should be reflected in the lease obligation, because this provides analysts and other financial statement users with a more appropriate depiction of the economic long-term liability resulting from the leasing transaction.

We further agree that the amount of the change resulting from the reassessment should be recognized as an adjustment to the right-of-use asset, and not to the income statement. We believe adjusting the right-of-use asset is most consistent with the overall approach taken by the Boards in the context of the linkage between the obligation to pay rentals and the right-of-use asset and with the lessee obtaining additional lease periods or shortened lease periods.

Detailed disclosure of the factors and circumstances that management considered in its reassessment of a lease option period should be required, to aid in the analysis in understanding the effects on the company's leased assets and liabilities resulting from changes in lease terms.

Question 15. The Boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease. Do you agree with the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.

We agree with the Boards' tentative conclusion that purchase options should be accounted for in the same way as term options. Our responses to Questions 13 and 14 on term options are equally applicable to this question.

Chapter 7: Contingent rentals and residual value guarantees

Question 16. The Boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements. Do you support the proposed approach? If you disagree with the proposed approach, what alternative approach would you recommend and why?

We support the Boards' proposed approach that the lessee's obligation to pay rentals should include contingent rental payments. Exclusion of the contingent rentals could result in significant understatement of the economic assets and liabilities under leases. Therefore, we believe measuring contingencies initially is preferable to excluding them from the calculation of estimated lease payments and then recognizing the expense when incurred, as is generally the case under existing standards.

We further note that the proposed approach is consistent with the proposed approach to include term and purchase options initially in the right-of-use asset.

Question 17. The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

We believe that consistent guidance on how companies should arrive at the obligation to pay contingent rentals needs to be decided by the Boards. Although we see the merits in both proposals, and the potential for inherent inconsistency with other measurement standards--and with that of the lease term--we prefer measurement based on a probability-weighted outcome.

We also believe that additional disclosures about the nature of contingent rentals and their estimated amounts or ranges would be essential and should be required. This should include the factors considered by management in determining the range of possible outcomes and the probability (likelihood of occurrence) in arriving at the lease obligation.

Question 18. The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Do you support the proposed approach? Please explain your reasons.

We agree with the FASB's tentative decision that the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease. However, if a forward rate on an index on which future payments are based exists at inception, we believe the forward rate should be used instead as this would provide a better depiction of the economic arrangement at inception.

Question 19. The Boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments. Do you support the proposed approach? If not, please explain why.

We support the Boards' proposed approach to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments. We recognize that there can be a material change in circumstances surrounding a contingency that will affect the estimated rental payment (e.g., where a sudden increase in retail sales due to the failure of a major competitor leads management to a new conclusion that a sales contingency that had not been likely will now be easily reached).

We believe financial-statement users will be well served if these types of changes in circumstances are reflected in the lease obligation, because this gives users a more current depiction of the long-term liability resulting from the leasing transaction. Changes in contingent payments can have a material impact on a company's future cash flows and would appropriately be reflected in the lease obligation. We believe it is appropriate given the current lease-accounting framework, even though future increases in revenue have not yet been attained. However, the right-of-use asset and lease obligation will reflect the increased carrying values. It also underscores the importance of disclosures of the drivers and rationale for the change in the contingent liability.

We believe detailed disclosure of the changes in circumstances considered in the reassessment of contingent rental payments should be required, allowing analysts and other users to understand the effects of the variability to the company's lease assets, liabilities, earnings, and cash flows resulting from changes in estimated contingent payments.

Question 20. The Boards discussed two possible approaches to recognizing all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments: (a) recognize any change in the liability in profit or loss, or (b) recognize any change in the liability as an adjustment to the carrying amount of the right-of-use asset. Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

We support the IASB's tentative approach to recognizing any change in the lease liability as an adjustment to the carrying amount of the right-of-use asset and not to the income statement. This is consistent with the Boards' tentative decision to account for changes in lease terms as an adjustment to the carrying amount of the right-of-use asset.

As in our response regarding changes in lease terms (Question 14), we believe adjusting the right-of-use asset is most consistent with the overall approach taken by the Boards in linking the obligation to pay rentals as an estimate of the cost of the right-of-use asset, and the capitalization of that cost. Entities should depreciate changes in the right-of-use asset over the remaining estimated term of the lease.

Question 21. The Boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the Boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

We agree with the Boards' proposed approach that residual value guarantees should be treated in the same manner as contingent rentals and should not be separately accounted for as derivatives. The proposal not to require separation of the residual value guarantee is consistent with the single asset and liability approach relied on throughout the Discussion Paper, and minimizes any additional complexity of separate treatment as a derivative.

We would also like to see disclosures about residual guarantees similar to that outlined above for contingent rental payments and for other types of guarantees, e.g., nature of the guarantee, the maximum amount payable under the guarantee and the likely outcome(s).

Chapter 8: Presentation

Question 22. Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons. What additional information would separate presentation provide?

Because of the significance and unique nature of the obligation to pay rentals to many companies, including its linkage to the right-of-use asset, we support the FASB's preliminary view that the lessee's obligation to pay rentals be presented separately in the statement of financial position. Separate presentation of both the obligation to pay rentals and the right-of-use asset would provide the most direct presentation of these significant assets and liabilities for our analysis.

However, we could also retrieve information for our analysis if entities disclosed the obligation separately in the footnotes. If the IASB's position is ultimately adopted, we want, at a minimum, to see separate footnote presentation. Because we view the obligation to pay rentals as debt-like, we believe it would be appropriate to present the obligation as a separate component of debt in the debt footnote.

Question 23. This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position. How should the right-of-use asset be presented in the statement of financial position? Please explain your reasons. What additional disclosures (if any) do you think are necessary under each of the approaches?

We agree with the Boards' preliminary view that the right-of-use asset should be presented in the statement of financial position based on the nature of the leased asset, and the leased assets should be presented separately from owned assets. We could also retrieve amounts for right-of-use assets if entities disclose the information separately in the footnotes.

We believe that, aside from separate presentation in the statement of financial position, additional footnote disclosure similar to that required for other fixed assets and intangible assets should be required. This should include a comprehensive description as to the nature of the lease transactions, a breakdown of leased assets by type of asset, and the depreciable lives and lease term for each type.

Chapter 9: Other lessee issues

Question 24. Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

We urge the Boards to continue to resolve the open issues discussed in Chapter 9 that had not yet been addressed in sufficient detail at the time of the release of the Discussion Paper: timing of initial recognition; sale and leaseback transactions; initial direct costs; leases that include service arrangements; and disclosure. In addition, it would be useful to see "in substance purchases," leases of a component of an asset and impairment considerations addressed. We also want to urge the Boards to address lessor accounting, as discussed in our response to Question 1.

Chapter 10: Lessor accounting

Question 25. Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

Yes. We believe a lessor's right to receive rentals under a lease meets the same definition of an asset that the Boards considered in determining whether the lessee's right to use a leased item is an asset. The lessor controls the right to receive rentals during the lease term by virtue of the lease contract, the control results from past events (the signing of the lease contract and the delivery of the leased item) and future economic benefits will flow to the lessor in the form of cash payments.

Because the Boards concluded that the lessee has incurred a liability for the obligation to pay rentals, it is logical that the lessor would recognize an asset on the same transaction for the right to receive those same rentals.

Question 26. This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor, or (b) recognition of a performance obligation by the lessor. Which of these two approaches do you support? Please explain your reasons.

We understand that, subsequent to the issuance of the Discussion Paper in May 2009, the Boards have tentatively concluded that the recognition of a performance obligation model is the preferred method. We do not support this model and believe that grossing up assets and liabilities does not add value for our analysts and other users. We believe the lease contract converts a portion of the ownership rights to a receivable (or the right to receive future cash payments). The Boards may also want to consider a "linked-type" presentation that will show the leased asset net of amounts attributable to "rights transferred," which in most cases will equal the residual value, and a lease receivable.

Question 27. Should the Boards explore when it would be appropriate for a lessor to recognize income at the inception of the lease? Please explain your reasons.

We understand that, subsequent to the issuance of the Discussion Paper, the FASB has tentatively concluded that a lessor would not recognize any revenue at the inception of a lease contract.

We do not believe a lessor should recognize income at the inception of the lease. Because a lease is considered a transfer of the right to use an asset, we do not believe that such a transaction can or should generate immediate income. For example, we believe a manufacturer of equipment that leases their product has not completed an earnings process simply by entering an agreement to rent their product. However, consistent with our views related to accounting for "in-substance" purchase leases by lessees, we believe a symmetric recognition of sales and corresponding revenues for lessors may be appropriate. While perhaps the tests should not be identical, there may be circumstances where "in-substance" purchase leases are purchases and should be accounted for as such.

Question 28. Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

We believe that accounting for investment properties should ideally be included within the scope of any new standard on lessor accounting.

Question 29. Are there any lessor accounting issues not described in this discussion paper that the Boards should consider? Please describe those issues.

We believe the Boards should consider transfers of other rights and obligations (e.g., tax benefits).