



California
Society
Certified
Public
Accountants

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Technical Director
Financial Accounting Standards Board
407 Merritt 7
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RE: Discussion Paper *Leases: Preliminary Views*

The Accounting Principles and Auditing Standards Committee (the “AP&AS Committee”) of the California Society of Certified Public Accountants (“CalCPA”) is pleased to provide our comments to the Financial Accounting Standards Board (“FASB”) on this Discussion Paper (“DP”).

The AP&AS Committee is the senior technical committee of CalCPA. CalCPA has approximately 32,000 members. The Committee is comprised of 50 members, of whom 67 percent are from local or regional firms, 23 percent are sole practitioners in public practice, 5 percent are in industry and 5 percent are in academia.

Our comments are presented as responses to the questions posed in the DP.

Chapter 2: Scope of 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?

Yes.

If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

Question 2

Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why.

Non-core assets should not be excluded. Accounting should be based on the transaction, not the business of the entity. Short-term leases should be excluded on the basis of practicality.

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Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

Although admittedly arbitrary, we recommend that leases under one year (including options to renew) should be excluded. There is a point where the benefit of recording the rights and obligations is less than the cost and one year corresponds to a typical reporting period.

Chapter 3: Approach to Lease 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.

Yes.

Question 4

The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:

- (a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)*
- (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?

Yes. The basic recognition requirement would be a substantial improvement over current standards.

If you support an alternative approach, please describe the approach and explain why you support it.

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 recognises:

- (a) a single right-of-use asset that includes rights acquired under options*
- (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?

No.

If not, why?

The measurement of the lease obligation under the boards' tentative decision would be highly judgmental and complicated.

More importantly, we do not believe that amounts payable under options, contingent rental agreements or residual value guarantees are obligations, or liabilities, until a further event transpires that causes them to be an obligation. Until that event happens, they are nothing more than contingencies. Accordingly, the accounting approach for these payments should follow accounting for contingencies. They should be recorded as liabilities only if it is probable, as defined in Statement of Financial Accounting Standards No. 5, that they will be paid.

Circumstances where payments are probable, and these future potential obligations would be recorded are:

- Options: Lease obligations would be measured including payments of option periods when the lessee is under economic compulsion to make the future payment because of contractual factors, non-contractual financial factors, or business factors of the type cited in paragraph 6.39.
- Contingent rentals: Lease obligations would be measured with future contingent rental payments based on current performance, unless it is probable that current performance will not continue.
- Residual value guarantees: The liability would include residual value guarantees whenever the estimated future fair value of the asset is less than the guaranteed residual value.

This would avoid many of the measurement and other difficulties cited in paragraph 3.32 while reducing the ability to structure leases to reduce the liability recorded for the lessee's obligation to pay rentals.

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?

No.

If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

We believe the rate implicit in the lease should be used if it is practical to determine that rate, (absent other stated or unstated rights or privileges). This is consistent with the practice for borrowing transactions. If the lease is a form of seller financing, then it would be necessary to evaluate the interest rate in accordance with the provisions of APB Opinion No. 21. If it is not practical to determine the rate implicit in the lease, then the lessee's incremental borrowing rate should be used.

Question 7

Do you agree with the boards' tentative decision to initially measure the lessee's right of use asset at cost?

Yes

If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

Chapter 5: Subsequent Measurement

Question 8

The boards tentatively decided to adopt an amortised 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?

Yes.

If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

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.

Yes, if and only if all financial assets and liabilities are reported at fair value (i.e. remove leases from the ineligible list in SFAS No. 159.)

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.

No. We support the use of the rate implicit in the lease. Furthermore, this method is not consistent with the way other financial liabilities are subsequently measured.

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 are opposed to the revision at either period.

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?

Yes.

If you disagree, please explain why.

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 amortisation or depreciation in the income statement. Would you support this approach?

No, we do not believe the decrease in value of the right-to-use asset should be described as rental expense. Any attempt to differentiate between types of leases will result in the same problems we currently experience and will unlikely result in a mixture of subjective judgments and bright line tests.

If so, for which leases? Please explain your reasons.

We believe the classification of rental expense should be reserved for short-term leases that are not recorded as assets and liabilities.

Chapter 6: Leases with Options

Question 13

The boards tentatively decided that the lessee should recognise 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?

No.

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

See our response to Question 5 above. The option would be included in the measurement of the liability once it became probable that payments would be made under the option.

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 recognised as an adjustment to the carrying amount of the right-of-use asset. Do you support the proposed approach?

No.

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

As we noted in response to Question 5, the payments due under options would be included in the measurement of the lease liability when it is probable payment would be made. There should be a reassessment of the probability of payments due under option periods at each reporting date based on facts or circumstances at that date. Changes would be recognized as an adjustment to the carrying amount of the right-to-use asset.

Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

Yes. Leases are often very long. Assessments made several years ago may have been based on assumptions that are no longer valid in later years.

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?

No.

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Please see our response to Question 5. There should be a reassessment of the probability of exercising the purchase option at each reporting date on the basis of then existing facts and circumstances. Changes would be recognized as an adjustment to the carrying amount of the right-to-use asset.

Chapter 7: Contingent Rentals and Residual Value Guarantees

Contingent rentals

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?

No.

If you disagree with the proposed approach, what alternative approach would you recommend and why?

Please see response to Question 5, above.

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.

As stated in our response to Question 5, we would apply a different threshold to recording a liability under a contingent rental agreement. Amounts based on future increases in sales, or other factors, would generally not be recognized. Future sales levels would generally be based on sales of the most recent period, unless it could be determined that a different level of sales was probable.

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.

No. While we agree with the use of the index or rate existing at the inception of the lease, we believe that as the index changes, it may be appropriate to adjust the right-to-use asset and the lease liability.

If the contingency is based on a cost of living index, the liability should be based on the current payment level, and then remeasured at the time a change occurs in the index. For example, if lease payments are revised every two years on the anniversary of the lease, the lease liability at each reporting period would be based on the payments which would be payable computed using the CPI at that date.

If the contingency is based on an index that fluctuates up or down, such as interest, then payments should be charged to expense as incurred. Changes in interest payments would be charged as interest expenses. Other amounts charged to expense would be included in amortization.

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 would support it only for contingencies recorded as described in our response to Question 5.

Question 20

The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:

(a) recognise any change in the liability in profit or loss

(b) recognise 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.

As described in response to Questions 16 through 19 above, we favor an approach that would recognize all remeasurements of the liability as under alternative (b).

If you support neither approach, please describe any alternative approach you would prefer and why.

Residual value guarantees

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.

Our suggested approach recognizes both contingent rentals and residual value guarantees using the same approach.

If not, what alternative approach would you recommend and why?

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.

No. We do believe the separate classification of lease obligations on the face of the balance sheet accomplishes any significant purpose as long as information regarding all financial liabilities is disclosed in the notes to financial statements.

What additional information would separate presentation provide?

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.

We believe that leased assets should be presented in the statement of financial position based on the nature of the leased item, and should be disclosed separately from owned assets in the notes.

What additional disclosures (if any) do you think are necessary under each of the approaches?

The original cost and accumulated depreciation by classification of the assets held under leases should be disclosed.

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 recommend that the Boards address subleases as part of this project.

Although these matters are already described, we offer our comments as follows:

- **Date of recognition of liability (and related asset).** We believe the asset and liability should be recognized upon receipt of the asset (commencement date). If construction is required, record upon completion of construction.
- **Sale-leasebacks.** We support the approach in paragraph 9.12(b) with no gain recognition.
- **Initial direct costs.** As opposed to developing unique standards for initial direct costs of leases, the Boards need to consider a consistent approach for initial direct costs for all types of transactions.
- **Leases that include service arrangements.** We support the approach described in paragraph 9.25, the separation of lease payments from payments for services.

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.

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 support the approach in which there is derecognition of the leased item. It is conceptually more realistic and it is consistent with approach for lessees.

Question 27

Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

We believe dealers should recognize income at the inception of the lease. These transactions have two components - the sale of the merchandise and the financing of the sale. The result should be similar to a sale involving a trade note receivable.

Question 28

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

Yes. We believe it would be difficult, if not impossible, to differentiate investment properties from other property with clarity.

Question 29

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

We did not note any lessor issues that were not identified in the DP.

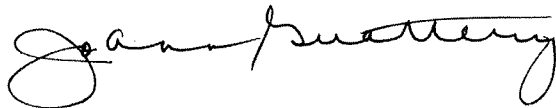
Additional Comment

We cannot anticipate the Boards future approach to addressing the issue for accounting for leases. However, we do wish to make it known to the Boards that we would oppose

the bifurcation of lessor accounting and lessee accounting issues. These matters should remain as a single project.

We thank you for the opportunity to comment on this matter. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Very truly yours,

A handwritten signature in black ink, appearing to read "JoAnn Guattery". The signature is written in a cursive style with a large initial "J" and a long, sweeping underline.

JoAnn Guattery, Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants