

Heads Up

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Although it looks like the requirement for lessees to record an asset and a liability for most leasing transactions is here to stay, the boards are reconsidering many of the most controversial aspects of the ED, including the treatment of contingent rentals and renewal options.

More Likely Than Not to Change? Boards Consider Feedback on Leases ED

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The comment letters are in, the roundtables are over, and the FASB and IASB (the “boards”) have already held several board meetings to discuss comments received on the [exposure draft on leases](#) (“the ED” or “the leases ED”). Although it looks like the requirement for lessees to record an asset and a liability for most leasing transactions is here to stay, the boards are reconsidering many of the most controversial aspects of the ED, including the treatment of contingent rentals and renewal options. In addition, the boards are considering a straight-line expense recognition pattern for many leases rather than the front-end loaded expense recognition pattern required by the ED.

The boards now begin the work of making changes to the ED with the hope of issuing a final standard in June 2011. This *Heads Up* summarizes the main themes and concerns raised in the comment letters and roundtable discussions. It also includes our observations from the recent joint board meetings on the leases project and insights into areas of the ED that are likely to change.

In addition to the main themes, the *Heads Up* addresses some other significant issues that were identified at the roundtables and in comment letters, including transition methods, the treatment of lease incentives, and guidance on build-to-suit leases. These are discussed in [Appendix A](#). Although much of the feedback was similar among industries, some concerns were specific to certain sectors. Those industry-specific concerns are highlighted in [Appendix B](#).

Background

Since issuing the ED on August 17, 2010, the boards have conducted extensive outreach. The comment period, which ended December 15, 2010, produced over 750 letters, and afterwards the boards hosted roundtable sessions in London, Hong Kong, Chicago, and Norwalk. The roundtables included participants from all constituencies, including preparers, users, and auditors, from a wide cross section of industries. The boards also used questionnaires and workshops with lessees and lessors to obtain feedback.

Editor's Note: The ED proposes new accounting models for lessees and lessors and eliminates the concept of operating leases. See Deloitte's August 17, 2010, [Heads Up](#) on the ED.

Comment Letters and Roundtables — the Main Themes

Although most respondents supported the basic concept of a lessee's recording of an asset and a liability for most leasing transactions, their views were mixed, and some voiced strong objections to several critical aspects of the proposed guidance. The roundtable discussions and January board meetings focused on five main topics that have received the most attention: (1) the definition of a lease (distinguishing lease contracts from service contracts), (2) expense recognition pattern for lessees, (3) lease term and the treatment of renewal options, (4) variable lease payments, and (5) the lessor accounting model. We anticipate that the boards will focus on these areas over the next couple of months before moving on to their redeliberations of other aspects of the ED.

Definition of a Lease (Distinguishing Lease Contracts From Service Contracts)

The ED lists conditions for use in determining whether an arrangement contains a lease. The conditions are similar to those currently in ASC 840¹ (and previously in Issue 01-8²) and they are used under current U.S. GAAP to distinguish a lease contract from a service contract. However, respondents to the ED noted that this distinction has been less critical under current U.S. GAAP because the accounting treatment for operating leases does not differ significantly from the accounting for service contracts (i.e., executory contracts). Several examples were discussed at the roundtables, including fleet leases for rail cars and trucks, rights to use portions of assets including communication cables, data warehousing arrangements, power purchase agreements, time charter arrangements in the shipping industry, professional seat licenses for sporting events, oil and natural gas drilling services, wet leases in the aircraft industry, satellite service, and cable television services.

The primary concern expressed at the roundtables and in comment letters is that the definition of a lease is too broad and would include contracts that are essentially service contracts. Respondents also noted that there are several practice issues with current U.S. GAAP that should be addressed, such as clarification of the terms "output" and "contractually fixed per unit of output."

In a related issue, many respondents expressed concern about determining whether items such as common-area maintenance, insurance, and property taxes would represent "distinct" services that should be accounted for separately from the lease arrangement.

Editor's Note: At their joint meetings in January 2011, the boards began discussing this issue; however, no decisions were made. The boards are considering whether lease accounting should be required in situations in which an asset is an incidental part of providing an underlying service to a customer or when the customer is indifferent to the underlying asset that is used to provide the service. The boards are also considering clarifying the concepts of identifying a specified asset, the lessor's right of substitution, a fixed price per unit of output, and identifying outputs when physical and intangible outputs exist.

Expense Recognition Pattern for Lessees

Most respondents did not agree on how a lease should be reflected in a lessee's income statement (or a lessor's income statement under the performance obligation approach). Several respondents disagreed with the income statement recognition pattern proposed in the ED because it would result in (1) higher expenses in earlier periods of the lease and (2) further divergence from the cash payments made in lease contracts. In addition, for leases previously accounted for as operating leases, some financial statement users indicated they would prefer to see lease payments treated as rental expense (rather than

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¹ For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

² EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease."

interest expense and amortization expense as the ED proposes) on the income statement and as an operating cash flow in the statement of cash flows (as opposed to a financing cash outflow as proposed in the ED).

Editor’s Note: At the January 2011 joint meetings, some board members raised the possibility of retaining the current operating/capital lease distinction (or a similar distinction) for income statement purposes only. In other words, all leases would be recognized on the balance sheet, but leases more akin to operating leases would continue to record expense on a straight-line basis while leases more akin to capital leases would record amortization expense and interest expense on the liability to make lease payments.

Lease Term and Treatment of Renewal Options

The ED defines the lease term as the “longest possible term that is more likely than not to occur.” The comment letters overwhelmingly disagreed with this proposal. The most common objection was that rentals in renewal periods do not represent a liability until the lessee has actually exercised the renewal option. Most respondents indicated that the provisions in current accounting guidance to determine lease term are the most appropriate. That is, if exercise of a renewal option is reasonably assured, then the renewal period would be included in the initial measurement of the asset and liability. Other respondents suggested that renewal options should only be included if they are virtually certain to be exercised.

Editor’s Note: We think it is “virtually certain” that the FASB and IASB will change the threshold for including renewals to one that is higher than the threshold proposed in the ED (e.g., renewal options that are reasonably assured of being exercised would be included in the initial lease term). The boards will also need to reconfirm whether they want to continue to require a continuous assessment of the lease term (as the ED requires).

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Variable Lease Payments

The ED requires the use of a probability-weighted expected outcome approach to estimate lease payments (including contingent rentals), term option penalties, and residual value guarantees. Many respondents to the ED objected to this proposal, noting that the approach could add significant earnings volatility and would cost a significant amount to implement. Some respondents had differing views depending on the type of variable lease payments. For example, some respondents felt that lease payments that are contingent on indexes (such as the consumer price index (CPI)) or rates represent an unavoidable obligation that should be included in the lease liability. However, many respondents felt that rents that are within the control of the lessee (e.g., usage-based rents or rents based on a percentage of sales) were avoidable and should not be part of the initial liability. Several respondents expressed concerns about the reliability of estimates for long-term leases.

If contingent rentals are required to be estimated, many respondents oppose the use of a probability-weighted approach to determine the lease payments. There was significant concern regarding the complexity of this model as well as the subjective judgments to determine probabilities. Many respondents suggested the use of a best-estimate approach to determine the lease payments, or a higher threshold for including contingent rents (such as reasonably assured or probable).

Editor’s Note: Because the feedback on variable lease payments was not as consistent as the feedback on renewal options and lease term, it is less clear how the boards will decide to address contingent rentals in the final standard. If the boards do not require an estimate of contingent rentals, it is likely that additional disclosures related to contingent rentals would be required.

Several roundtable participants questioned the need to change the current lessor accounting model under U.S. GAAP and IFRSs.

Lessor Accounting Model

Several roundtable participants questioned the need to change the current lessor accounting model under U.S. GAAP and IFRSs, noting that the two approaches suggested in the ED (the performance obligation approach and the derecognition approach) do not represent an improvement over the current model. Many financial statement users also commented that they do not currently make adjustments to lessors' financial statements (unlike lessee accounting). Many respondents stated that the lessor accounting proposals need significant further development and refinement and that additional application guidance would be needed for lessors to determine which approach to apply. There was no consensus on how to move forward on lessor accounting. Some suggested leaving the current accounting model in place and providing application guidance for subleases and sale-leaseback transactions; others suggested one model based on the derecognition approach; still others suggested a model that is consistent with the [ED on revenue recognition](#) ("the revenue ED").

Editor's Note: At their January 2011 meetings, the boards decided to first consider issues that need to be addressed for both lessors and lessees (such as the treatment of renewal options, variable lease payments, and the definition of a lease). After making those decisions, the boards would then decide what changes, if any, are needed to the current lessor accounting model under U.S. GAAP and IFRSs. In other words, it is unclear at this time whether the final standard will substantively change lessors' current accounting. On the basis of the feedback, it seems that most respondents prefer that the FASB and IASB retain guidance that produces financial reporting results for lessors that are similar to the results currently obtained under ASC 840 and IAS 17.³ It seems particularly unlikely that the performance obligation approach will remain in the final standard given the overall lack of support for it.

Cost/Benefit Considerations

Many respondents questioned whether the benefits of the ED outweigh the potential implementation costs. Preparers cited potentially significant administrative costs, including the need for new systems and modifications of debt covenants. However, measuring the benefits of the ED is difficult for the boards because feedback from users was limited and often contradictory. Many users commented that they typically do make adjustments to financial statements to recognize a liability for operating leases and that they support the ED. However, some noted that they did not expect that recognizing these arrangements on the balance sheet would significantly affect their analysis because they use information currently provided in the footnotes to perform such analysis. At one of the roundtables, a participant from a ratings agency noted that if recognizing leases on the balance sheet caused a debt covenant violation, then its analysis of a company could be affected.

Several respondents commented that the measurement provisions, lease term, and lease payments, in particular, would create complexity and a lack of comparability. Furthermore, some users noted that under the ED they may still have to make adjustments to the financial statements for their analysis. In addition, many preparers commented that they may have to make additional non-GAAP disclosures to provide the information users require.

Editor's Note: It is likely that the boards will perform further outreach with financial statement users. Simplification of the proposed ED (particularly of the lease term and variable lease payment guidance) and additional disclosures could help reduce the expected costs of implementation and address many users' concerns about increased complexity and a lack of comparability.

³ IAS 17, *Leases*.

The comment letters and roundtables indicate that a significant amount of work still remains before the ED is ready to become final.

What's Next?

The boards will hold meetings and conduct additional outreach over the next several months as they redeliberate the proposals in the ED and work to finalize the standard.

The FASB and IASB continue to state that their target date to complete the ED is June 2011. However, the comment letters and roundtables indicate that a significant amount of work still remains before the ED is ready to become final, and the FASB staff has indicated that it has additional field testing to conduct over the next several months.

In a webcast on January 25, 2011, FASB Chairman Leslie Seidman stated that the June 2011 target is subject to the nature and extent of the feedback received and that the FASB will take extra time if needed to complete the leases project. The boards have not yet discussed an effective date for the proposed guidance. The FASB will discuss effective dates for the leases project, as well as other major projects, collectively as part of its discussion paper on effective dates and transition.

Editor's Note: The ability of the boards to finalize the leases standard in 2011 could be affected by whether the boards decide to reexpose any aspects of the proposals as well as the extent of the staff's additional field testing. Some of the FASB's and IASB's constituents indicated that the revised proposals should be reexposed before they are finalized because (1) extensive practice and conceptual issues were identified in the proposed guidance and (2) consequential amendments to other IFRSs and the *FASB Accounting Standards Codification* were not exposed. Regardless of whether the leases project is finalized by June 2011, we believe it is unlikely that the effective date of any final standard would be earlier than fiscal years beginning after December 15, 2013.

Appendix A — Other Significant Issues Noted in Comment Letters

The following additional issues were identified during the comment letter process. These issues were communicated to the boards during their January 2011 meetings; however, the boards' staffs are still assessing which of these matters will be the subject of further reconsideration and which matters will not be addressed.

Scope

IFRIC 12

Several respondents noted that IFRIC 4⁴ currently scopes out public-to-private service concession arrangements within the scope of IFRIC 12.⁵ However, this scope exception was not carried forward to the ED.

Inventory

Some respondents noted that leases of inventory were not explicitly excluded from the scope of the standard. We do not believe this result was intended by the boards and anticipate this will be clarified in the final standard.

Lessee Right-of-Use Model

Lease Incentives

Several respondents noted that the ED does not include guidance on how to account for lease incentives.

Key Money and Deposits

Some respondents requested additional guidance on the accounting for key money payments as well as deposits to a landlord.

Build-to-Suit Leases and Changes Between Lease Inception and Lease Commencement

Most U.S. respondents observed that the ED does not include guidance on build-to-suit lease arrangements and other arrangements in which the lessee is involved with the leased asset during the construction period. Although many respondents asked for additional guidance on this topic, we noted that almost none requested a carry forward of the existing guidance under U.S. GAAP (i.e., the guidance in ASC 840 that was previously included in Issue 97-10⁶).

Other respondents requested clarification of how to account for changes in lease payments or estimates between lease inception and lease commencement.

Rate the Lessor Charges the Lessee

The boards received several comments on the "rate the lessor charges the lessee." Some questioned how to address promotional rates (such as 0 percent financing) when determining the rate the lessor charges the lessee. Others questioned how to determine the "yield on property" for real estate leases because interpretations differ on how such a rate would be calculated.

Incremental Borrowing Rate

Various application issues were raised related to the "incremental borrowing rate" definition, including situations in which a parent guarantees a subsidiary's borrowings, or there is a global lease arrangement negotiated by a parent that provides international subsidiaries a different rate from that which would be obtained if the lease was locally financed. Other respondents questioned what rate a lessee would use if it could not obtain financing to purchase the underlying asset.

Impairment of the Right-of-Use Asset

Some respondents requested additional guidance on how to assess the lessee's right-of-use asset for impairment. They also inquired about determining fair value for a right-of-use asset in the measurement of an impairment loss and how nondistinct services included in the right-of-use asset would affect the fair value. In addition, they questioned which balances would be included in the asset group in the performance of the impairment test.

Leasehold Improvements

Some respondents noted that useful lives of leasehold improvements are often tied to the lease term for accounting purposes. If lease terms are revised on the basis of the new guidance, it is unclear whether useful-life assumptions for leasehold improvements also need to be revised under the ED (both on an ongoing basis and at transition under the simplified retrospective approach).

⁴ IFRIC 4, *Determining Whether an Arrangement Contains a Lease*.

⁵ IFRIC 12, *Service Concession Arrangements*.

⁶ EITF Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction."

Lease Term — Implicit Renewal Options

Some respondents noted that paragraph B16 of the ED could imply that a renewal option exists even when there is no explicit contractual right to renew (e.g., an expectation of negotiating a renewal option in the future).

Leases Cancellable by the Lessor

Some respondents commented that the ED does not address how a lessor's right to terminate a lease should be addressed. The ED is not clear as to whether the lease term should include options from the lessee's perspective or the lessor's perspective, or both.

Variable Lease Payments — CPI Based Contingent Rentals

Paragraph BC131 of the ED implies that a forward rate or index is readily available for the CPI. Some respondents questioned whether such a forward rate or index exists and requested that the boards clarify this statement. Others requested that rents based on an index or rate should be determined on the basis of the current spot rate (in a manner similar to how they are treated under current U.S. GAAP).

Transition

General

Many respondents observed that the ED does not provide transition guidance for sale-leaseback transactions or for transactions that are in-substance purchases or sales under the ED. In addition, although many respondents were supportive of the simplified retrospective transition method in the ED, some requested the option to adopt the standard on a fully retrospective basis. Some cited cost-benefit concerns and argued for a prospective adoption approach. Others requested clarification of whether companies should use the most current information they have (i.e., hindsight) when booking estimated amounts such as contingent rent for prior periods rather than determining an estimate as if they did not know what their actual results had been.

Lessors

Many respondents noted that the ED is not clear about when lessors should determine which model to apply on transition (i.e., inception of the lease or date of initial application).

Other

Lease Modifications

The ED does not address how to account for changes or modifications to lease contracts after lease commencement. For example, if one year after the beginning of a lease there is an amendment to add several renewal options, it is not clear whether the arrangement should be treated as a new lease, or as an adjustment of the existing lease balances.

Short-Term Leases

Although most respondents supported simplifications for short-term leases, many requested additional relief for lessees (i.e., treat as operating leases or on a cash basis rather than the simplified accounting proposed in the ED).

Consequential Amendments to Other Areas of GAAP

Several respondents noted that the boards did not expose consequential amendments to other IFRSs and the *FASB Accounting Standards Codification*. Some areas of concern included:

- Asset retirement obligations.
- Capitalization of interest expense.
- Accounting for exit costs for leases and the interaction with ASC 420.
- Leases acquired in a business combination.
- Software license arrangements — the guidance in ASC 350-40-25-16 directs issuers to ASC 840 (which will be superseded by the final standard) to determine whether the present value of license installment payments should be capitalized as an asset.

Foreign Currency

Some respondents requested additional guidance on leases denominated in a foreign currency, noting that neither existing standards nor the ED addresses translation measurements for leases.

Leases of Land and Buildings

Some respondents requested guidance on combined leases of land and buildings, noting that the lessor may have to use the derecognition approach for the building and the performance obligation approach for the land. Respondents requested application guidance for this example.

Income Taxes

Several respondents noted that the ED will create additional book-versus-tax differences as a result of the difference between cash payments for tax purposes and the recognition of interest and amortization for book purposes.

Sale-Leasebacks and In-Substance Purchase/Sales

Many respondents objected to the “in-substance purchase and sales” exclusion in the ED. Others noted that the criteria to achieve a sale were not consistent with the guidance in the revenue ED. It was also noted that the leases ED did not indicate the guidance under which “in-substance purchases” should be accounted for. Some respondents also noted that a contract could meet the sale-leaseback criteria in the leases ED, but fail to qualify as a sale under the revenue ED (e.g., a sale-leaseback that includes a fair value purchase option).

Payments for Excess Wear and Tear

Guidance under U.S. GAAP currently states that a lease provision requiring the lessee to make up the residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to a contingent rental. The ED does not indicate treatment of such arrangements.

Consolidation Considerations

ASC 810-10-55-39 indicates that certain operating leases are not variable interests in the lessor entity. It was noted that the FASB will need to reconsider whether there should continue to be exceptions to the consolidation analysis related to lease arrangements.

Appendix B — Industry-Specific Feedback

For most industries, the feedback was consistent with that noted in the [Comment Letters and Roundtables — the Main Themes](#) section of this *Heads Up*. The discussion below highlights some feedback about the ED that was unique to specific industries.

Retail

As one of the industries that is most significantly affected by a new lease accounting standard, retail was represented at the roundtables and submitted a large number of comment letters. In addition to the main themes discussed [above](#), because of the extensive use of leasing in the industry, comments addressed the costs of implementation and other issues noted below.

Comparability

Many respondents thought that the subjective nature of estimates related to lease terms and contingent rentals might lead to lack of comparability among retailers with identical contractual commitments. These concerns result from what would be the need to estimate lease terms and contingent rentals over long periods (often up to 30 years).

Measurement Uncertainty

Many retailers indicated that a potential consequence of adopting the ED's proposals would be that long-term forecasts of potential store-level revenues would be required. Many respondents believed that such estimates would be prone to error and would not be reliable.

Reaction to Overall Model

The basic premise that leases of real estate should be on the balance sheet was not shared by all retailers. Many respondents argued that in many instances, a lease of property is not akin to a financing. For many retailers, such as those in a mall, an option to purchase is not available; therefore, no buy-lease decision is made by the retailer and the current operating lease accounting treatment is appropriate. In contrast, others argued that recording the lease arrangement on the balance sheet is appropriate. Many also noted that the front-end loaded expense pattern of the lessee right-of-use model is further magnified for longer-term leases, which are common for some retailers.

Lease Incentives

Because lease incentives (e.g., up-front payments from lessors) are common in the retail industry, several respondents noted that the ED does not provide guidance on how to account for them. In addition, some respondents requested additional guidance on the accounting for "key money" and deposits paid to a landlord.

Editor's Note: Views differ on how lease incentives should be treated under the new guidance. Some believe that a cash incentive from a lessor represents an adjustment of the right-of-use asset. In other words, it should be treated as a reduction in the cost of the asset. Others believe that an incentive represents an adjustment of the lease liability and that it should be reflected through reduced interest expense over the lease term. Because the ED does not specifically address the accounting for lease incentives, we expect that its treatment will be clarified in the final standard.

Financial Services

Financial services companies are significantly affected by the proposed accounting. Such companies commonly act as a lessor, a lessee, and a user of financial statements, and therefore the boards received a significant number of comment letters from the industry. In addition to commenting on the main themes outlined [above](#), some respondents expressed concern about the impact on regulatory capital and leveraged leases.

Impact on Regulatory Capital

Some respondents expressed concern about the impact of the ED on the regulatory capital requirements of regulated banks and financial institutions. They noted that if the right-of-use asset is considered an intangible, then regulators may treat such assets as a deduction of capital. The comment letter from the five federal regulatory agencies responsible for supervising the safety and soundness of U.S. financial institutions⁷ also requested that the FASB clarify in its final standard that the right-of-use asset is not an intangible asset.

⁷ The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Leveraged Leases

Several respondents from the financial services industry favored the retention of the current leveraged lease accounting model. Many respondents from other industries recommended that the specialized accounting for leveraged leases should be eliminated, noting that there is no guidance under IFRSs on leveraged lease accounting. Those in favor of retaining the guidance indicated that the existing accounting is a better reflection of the economics of the transaction and that incorporation of the tax benefits is appropriate because it is such a significant component of the pricing in the agreement. During the roundtables, some suggested that a compromise approach would be to allow grandfathering of past transactions (i.e., allow leveraged lease accounting to continue for transactions entered into before the effective date or an earlier date) and that a grandfathering approach would also avoid transition issues (such as whether the nonrecourse debt should be recorded at fair value, the treatment of deferred taxes, as well as associated consolidation conclusions for existing trusts and other legal entities). Some respondents also acknowledged that under IFRSs there is no “special” accounting for leveraged leases. They noted, however, that leveraged leases are used much more extensively in the United States and that the accounting approach for them is a domestic issue.

Editor’s Note: Many respondents questioned the criteria that would be used to determine which lessor accounting model to apply. For example, some believe that the tax benefits of a leveraged lease would need to be considered in the determination of whether to apply the performance obligation approach or the derecognition approach (because taxes are an important part of the economic benefits of a leveraged lease), while others believe taxes should be disregarded because the ED is a pretax model.

Technology, Media, and Telecommunications

Many comment letters were submitted by technology, media, and telecommunications (TMT) companies. Respondents’ comments reflected the main themes outlined [above](#); however the most significant concerns were about the definition of a lease and the distinction between a service contract and a lease contract.

Determining Whether an Arrangement Contains a Lease

TMT industry respondents identified numerous arrangements in which the use of an asset is required for delivery of the contracted service, e.g., the provision of television or satellite services or IT outsourcing services. In these arrangements, equipment is often dedicated to the customer and is located at its site. However, many respondents stated that in the past such arrangements have either not been thought of as leases or, if they were considered leases, were viewed as operating leases and therefore accounted for like service contracts.

Most respondents in the industry believe that these types of arrangements should not be accounted for as leases. However, many are concerned that these arrangements would be within the ED’s scope under its definition of a lease. Respondents noted that in many such arrangements, although the asset may be specified, the customer is indifferent to the asset used to provide the service — i.e., the customer’s primary concern is the service provided. The service provider can often substitute one asset for another; however, there was concern with the provision in the ED that states that the ability to substitute is disregarded if the lessor “rarely does so in practice.” Some companies stated that this provision would result in a different conclusion than had previously been obtained under the current lease guidance. Many respondents indicated that the cost of the asset can be relatively insignificant relative to the entire arrangement; however, if the services are not distinct and cannot be separated, then under the ED the entire arrangement would be treated as a lease, even if the majority of the contract is related to a service.

Respondents also requested clarification for arrangements that provide the right to use portions of assets. Examples cited included the provision of a “wavelength” of capacity on a cable.

Several industry respondents and roundtable participants suggested ways to help provide more guidance in distinguishing between a service and a lease arrangement. One recommendation was to limit a lease to only transactions in which a lessee takes on significant risks and rewards of the underlying asset. Another was that an asset that (1) is primarily used to deliver a service, (2) has no other utility, and (3) does not represent a significant component of the entire arrangement should be outside the scope of the leasing standard. Another suggestion was to include in the scope only whole assets that can be purchased (thus excluding items such as rights of way, capacity agreements, and telephone pole space).

Many responded that if the guidance is not clarified, significantly more arrangements might be within the scope of lease accounting. This would result in (1) a significant increase in costs and (2) accounting that financial statement users would not find useful.

Editor’s Note: The FASB and IASB have indicated that the guidance on distinguishing or identifying a lease is one of their most significant priorities for redeliberation. They are considering several alternatives that could significantly affect which arrangements will fall within the scope of the new guidance. The TMT industry in particular should closely follow these developments because the conclusions could significantly impact industry participants’ accounting treatment as well as that of their customers.

Leases of Intangible Assets

Some respondents noted that lease arrangements in the technology industry may include both tangible and intangible assets. These respondents indicated that because intangible assets are not included in the ED's scope, a lease of the intangible asset may be recognized differently under the revenue ED than a lease of the tangible asset would be recognized under the leases ED. Given that the two leases are economically similar, many respondents questioned this reporting result and encouraged the boards to either include intangibles in the scope of the leases ED or ensure that revenue recognition under the leases ED is consistent with that under the revenue ED.

Manufacturing

Constituents in the manufacturing industries provided a significant number of comment letters on the ED. Many were consistent with the main themes discussed [above](#); however respondents also noted concerns about consistency with current guidance for U.S. government contractors.

U.S. Government Contractors — Scope and Allowable Expenses

Several respondents representing U.S. government contractors noted the unique statutory and regulatory requirements for entities within that industry. Pricing and costing for contracts with the U.S. government must follow the principles within the cost accounting standards that are applied through the Federal Acquisition Regulation (FAR). This guidance contradicts certain of the ED's proposals.

Respondents specifically noted that under the FAR, interest expense is not an allowable and recoverable cost. For lessees, the proposed model in the ED would classify a portion of the expense as interest expense, whereas under current guidance this expense would be included as rent expense. This change would make costs that were previously recoverable no longer recoverable.

Respondents also noted that entities that are U.S. government contractors are often required to enter into leases under certain contracts. As part of the performance of the contract, the utility of the leased asset is consumed. Respondents expressed concern about the requirement for contractors to record a right-of-use asset and liability in these arrangements. They requested that the boards consider removing such arrangements from the final standard's scope.

U.S. Government Contractors — Leases Cancelable by a Governmental Entity

In certain leases in which the lessor is a governmental entity, it is common for the government to have a unilateral termination right. Under U.S. GAAP, leases in which the lessor is a governmental entity are currently addressed in ASC 840-10-25-25. However, this guidance was not carried forward into the ED. Some respondents noted that the ED does not address how a lessor's right to terminate a lease should be addressed.

Editor's Note: The ED is not clear about whether the lease term should include options from the lessee's perspective, the lessor's perspective, or both.

Energy and Utilities

Over 30 comment letters were received from entities in the energy and utilities industry. In addition to the main themes outlined [above](#), many addressed the guidance on whether an arrangement contains a lease. Concerns about specific scope exclusions were also raised by entities within the oil and gas industry.

Power Purchase Arrangements

Many respondents questioned the application of the proposed guidance to power purchase arrangements (PPAs), indicating that the accounting for these arrangements is currently diverse. In addition, many believe that the proposals in the ED will lead to further diversity as a result of differing interpretations of the terms "output" and "contractually fixed per unit of output." Some also requested clarification about whether an "insignificant amount of output" implies a bright-line threshold of 10 percent. In addition, some requested clarification about whether a pro rata portion of the output of an asset can be the subject of a lease. See Deloitte's⁸ [comment letter](#) on the ED for additional examples and commentary on this topic. Respondents noted that diversity in accounting for these arrangements under current lease guidance has not been a significant issue for PPAs that meet the criteria for operating lease classification. Because the proposals in the ED eliminate operating lease treatment, determining whether PPAs represent a lease becomes more critical. Respondents requested that the boards reconsider the guidance on determining whether arrangements qualify as leases to mitigate the different interpretations that may exist. Respondents also requested additional guidance on how to allocate total contract consideration in a PPA between lease and nonlease elements because practice is currently diverse on such allocations in the industry. Some also requested clarification on whether input costs (such as fuel) should be excluded from the right-of-use asset and lease obligation.

⁸ Deloitte Touche Tohmatsu Limited.

Solar PPAs

Some respondents commented on the impact of the ED on solar energy PPAs in situations when a roof or ground mounted solar system is located on a customer's premises. They raised the same practice issues regarding interpretations of the term "output" and "contractually fixed per unit of output," and they questioned whether a potential lessee "controls" the underlying asset. In addition, they observed that accounting for the variable payments under these contracts would be unduly burdensome.

Secondary Property Use

Some respondents expressed concern that arrangements such as easements or right-of-way agreements would be considered leases under the ED. Examples cited were agreements under which a utility is allowed to place its transmission lines across private property and those under which a cellular service company attaches an antenna to a utility's poles or towers.

Lease Accounting by Regulated Entities

ASC 980-840 addresses lease accounting for regulated entities. Industry respondents expressed concern that this guidance would be eliminated by the new standard (which does not include similar guidance for regulated entities). ASC 980-840 states that regulated entities should record expense for a lease equal to the amount allowed for rate-making purposes rather than the amounts that would otherwise be recorded for interest and amortization expense for a capitalized lease. Several respondents requested that this guidance be retained.

Grandfathering Provisions in Issue 01-8

It was further noted by respondents that Issue 01-8 contains a scope exception for contracts entered into or acquired before May 2003. The proposals in the ED do not include the same scope exception. Respondents expressed concern about the time and effort they would need to assess such contracts during transition and requested that the boards consider providing a similar exception in the final standard.

Consolidation Considerations

ASC 810-10-55-39 indicates that certain operating leases are not variable interests in the lessor entity. It was noted that the FASB will need to reconsider whether there should continue to be exceptions to the consolidation analysis related to lease arrangements.

Scope Exclusions — Oil and Gas

Many respondents expressed concern about whether the guidance in the ED would indicate that drilling rig service arrangements contain a lease. This issue was discussed at the leasing roundtables and may be further considered during the boards' redeliberations (see additional discussion in the [Equipment Lessors](#) section). Other respondents expressed concerns about the scope exclusion related to exploring or using "minerals, oil, natural gas and similar non-regenerative resources." Those respondents stated that the ED is unclear about whether this exclusion applies only to leases for mineral rights or whether it extends to other services, such as drilling rig service arrangements.

Private Companies and Not-for-Profits

Several companies and accounting groups commented on the impact of the ED on private companies and not-for-profits. Although many of the concerns were similar to those expressed by public companies (discussed [above](#)), the following additional issues were noted by comment letter respondents and roundtable participants.

Effective Date

Many respondents noted that private companies often benefit from the implementation experience of public companies, and thus they recommended a delayed effective date for nonpublic companies.

Editor's Note: On Wednesday, January 26, 2011, a blue-ribbon panel submitted a report to the Financial Accounting Foundation (the FASB's parent organization) recommending significant changes to the future of accounting standard setting for private companies, including a separate board. The panel also made a short-term recommendation that the FASB should consider a delay for private companies in the effective date of major new standards (such as the leasing standard), especially those issued in connection with the FASB's and IASB's Memorandum of Understanding (MoU) projects, that is longer than the now-routine one-year delay. The delay would be with respect to the effective date for public companies. For example, if the effective date for a particular MoU project is 2014 for public companies, this recommendation would contemplate an effective date of 2016 or later, rather than 2015, for private companies.

Distinct Services

A requirement in the determination of whether a service component can be accounted for separately from the lease arrangement is that the service must have a distinct profit margin. Several respondents noted that although not-for-profit and public sector entities provide goods and services that are subject to distinct risks and for which they can separately identify the resources needed to provide them, there may not be a profit margin on such transactions because of the nature of the entity.

Donated Space

The ED does not address the accounting for donated space. In her webcast on January 25, 2011, FASB Chairman Leslie Seidman mentioned that this is an area that will be reconsidered during redeliberations. Other not-for-profits stated that the accounting under the ED would imply that they had “acquired” a large amount of fixed assets, which some of their donors may believe is contrary to the best use of charitable funds.

Small and Medium-Sized Entities (SMEs)

Some respondents requested that the revised lease accounting guidance not be incorporated into the IASB’s *IFRS for SMEs*.

Equipment Lessors

Over 100 comment letters were received from entities that are equipment lessors. In addition to the main themes outlined [above](#), lessors identified potential issues with the ED’s definition of a lease (specifically as it relates to distinguishing leases from service contracts).

Shipping Industry

Respondents from the shipping industry noted that the lack of precision in the ED regarding the definition of a lease could lead to confusion about whether certain transportation contracts fall within the definition. For example, they noted uncertainties about whether a voyage (or time) charter (i.e., one in which the ship owner maintains control of the ship and pays all trip-related costs and is paid on the basis of volume and ports) would meet the definition of a lease or if it would be considered a transportation service contract. Respondents believe that these contracts would be more accurately classified as transportation service contracts; however, they requested that the boards provide additional clarification. In addition, respondents noted that if the time charter arrangement does meet the definition of a lease, it would be difficult to apply the “distinct service” criteria in the ED to determine which services should be accounted for separately from the lease.

Drilling Industry

Comment letters received from constituents in the drilling industry also noted concerns about the definition of a lease in the ED. Entities in this industry usually contract their drilling units, equipment, and work crews on a day-rate basis to drill oil and gas wells for customers. The day rate is market-driven, and the contract usually specifies the drilling unit to be used in performance of the services. Respondents requested that the boards provide clarifications or modifications so these arrangements are not within the scope of the lease guidance. Other respondents requested a broader scope exception for this industry.

Railroad Industry

Respondents in the railroad industry expressed concerns about the definition of a lease as it relates to car hire arrangements. The examples in their comment letters noted that these contracts more appropriately represent rights to access the freight car as opposed to rights to use the asset. The respondents asked that the boards provide additional clarification on such contracts and on whether they meet the definition of a lease or should be accounted for as a service contract. Also, lessees in the railroad industry noted many of their leases are short-term in nature and that a more extensive exception for such leases should be provided in the final standard.

Real Estate Lessors

Several real estate lessors responded to the ED. The general consensus of the feedback received was that the proposed lessor model is not an improvement over the current accounting for leasing real estate. In addition, many supported and encouraged the FASB to continue its ongoing investment property project if the boards do proceed with the changes to the current lessor accounting model, which would require fair value reporting for investment property real estate (and such properties would be outside the scope of the new leasing standard).

Reaction to Overall Model

The proposed lessor model was rejected by respondents for a number of reasons. Most of the real estate lessors presented the view that real estate leases are fundamentally different from equipment leases. Some reasons given were that lessors of property are heavily involved in the active management of the asset, the asset is typically not a depreciating asset, rental rates are market driven rather than a financing of the asset, and the lease only covers a small percentage of the useful life of the asset.

The fundamental reason respondents gave for not supporting the proposed lessor model was their belief that the economics of the lease arrangement will become obscured in lessors' financial statements. Some noted that even the current accounting of straight-lining rental income obscures the economics of a lease arrangement since lease payments typically escalate over time. However, respondents believed that the proposed lessor model would take the recognition in the income statement even further away from the actual cash payments by front-end loading income even as payments may be escalating.

Investment Property Project

Many respondents discussed the FASB's ongoing investment property project. The proposed ED removes investment properties, measured at fair value, from the lease standard. Currently, under U.S. GAAP, entities are unable to measure investment property at fair value unless the entity qualifies as an investment company. However, under IFRSs, IAS 40⁹ provides an option for investment properties to be measured at fair value through earnings. The FASB is currently working on a project to require the use of fair value for investment properties. Most respondents supported this project, particularly if the boards proceed with the proposed lessor accounting model.

Editor's Note: The FASB continues to deliberate the investment property project and has recently stated its commitment to it. The board intends to issue an exposure draft in the first quarter of 2011, with a final standard being effective concurrently with the leasing standard.

Several respondents raised concerns about the scope of the investment property project. Current deliberations have focused on limiting the definition of an investment property to when the entity's substantive activities relate to investing in real estate properties for capital appreciation. Some commented that the definition should be broader and should also include reporting income-producing properties at fair value.

Respondents also requested that guidance be provided on how to recognize lease income related to investment property measured at fair value — that is, on a straight line basis or a cash basis. The investment property would be measured at fair value through earnings; however, it is unclear what accounting guidance (the revenue recognition standard or the lease standard) would govern how the lease income should be recognized.

Health Care

Constituents in the health care industry provided a significant number of comment letters on the ED. In particular, respondents noted concerns about short-term leases, the impact on the reimbursement for patient care, and the impact on debt covenants for not-for-profit organizations.

Short-Term Leases

Industry respondents noted that short-term leases are prevalent in the health care industry because (1) demand for medical equipment can be for a short duration during peak patient periods, (2) equipment can be specialized in nature for a specific patient diagnosis, and (3) medical equipment often requires frequent technological updates that make outright ownership economically unwise. Respondents requested additional simplifications for short-term leases (i.e., treat them as operating leases or on a cash basis rather than use the simplified accounting proposed in the ED). Some lessor respondents indicated that the short-term lease simplifications do not address certain "month-to-month" leases in which the lessee can continuously renew the lease. Those respondents stated that the boards should retain the current approach to lessor accounting in U.S. GAAP.

Impact on Reimbursement for Patient Care

Some respondents expressed concern that the ED would cause an unfavorable impact on patient care reimbursement. They noted that some health care providers are compensated under cost-based reimbursement models (i.e., Medicare program) and that some states provide a percentage of Medicaid reimbursement on the basis of costs. In some cases, operating expenses are reimbursed differently from capital expenditures. Respondents noted concern that the proposed guidance would require further revisions and complications in the way health care providers are reimbursed.

⁹ IAS 40, *Investment Property*.

Impact on Debt Covenants of Not-for-Profit Organizations

Some respondents and roundtable participants indicated that increases in debt and debt service as a result of the new standard could cause organizations to default on debt covenants. They noted this could present a unique challenge for not-for-profit health care organizations because of the difficulty of amending a master trust indenture, which defines the debt covenants and related calculations that apply to the entity. These respondents noted that obligations issued under master trust indentures frequently secure publicly-sold bond issues.

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