FASAB Exposure Draft: Questions for Respondents due January 6, 2017

Leases: *An Amendment of SFFAS 5, Accounting for Liabilities of the Federal Government and SFFAS 6, Accounting for Property, Plant, and Equipment*

Please select the type(s) of organization responding to this exposure draft. If you are not responding on behalf of an organization, please select “individual.”

Accounting Firm			
Federal Entity (user)			
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Association/Industry Organization			
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Please provide your name.

Name: William Fleming

Please identify your organization, if applicable.

Organization: U.S. Securities and Exchange Commission

Q1. The Board is proposing to define a **lease** as a contract or agreement that conveys the right to use a nonfinancial asset (the underlying asset) for a period of time in an exchange transaction. The current lease standards, Statement of Federal Financial Accounting Standards (SFFAS) 5, *Accounting for Liabilities of the Federal Government* and SFFAS 6*, Accounting for Property, Plant, and Equipment*, do not specifically define a lease. SFFAS 5 and SFFAS 6 only define a capital lease as a “lease that transfers substantially all the benefits and risks of ownership to the lessee.” The Board believes that the more concise definition being proposed is broad enough to capture the diversity of federal leasing activities. The proposed lease definition is presented in paragraph 9 and further explained in paragraph A15.

Do you agree or disagree with the proposed definition of lease presented in paragraph 9 and further explained in paragraph A15? Please provide the rationale for your answer.

SEC Response: Agree. The proposed definition is concise and reasonable.

Q2. The Board is proposing that the **lease term** be determined as the period during which a lessee has a noncancelable right to use an underlying asset (referred to as the noncancelable period) plus each option period if it is probable, based on all relevant factors, that the lessee will exercise that option to extend the lease. The lease term proposal also provides guidance on the noncancelable period and on how specific provisions (such as fiscal funding/cancellation clauses and month-to-month lease holdovers) should be applied. The proposed lease term requirements are presented in paragraphs 14 – 18 and further explained in paragraphs A16 – A18.

Do you agree or disagree with the proposed guidance on determining the lease term as presented in paragraphs 14 - 18 and further explained in A16 – A18? Please provide the rationale for your answer.

SEC Response: the lease term should not include option periods, for the following reasons:

a. For option periods, a proposed lease liability does not appear to meet the definition and characteristics of a liability. SFFAC 5 defines a liability as "A liability is a present obligation of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand,"[1] and states that, "A present obligation is incurred **when the government takes a specific action or an event occurs that commits or binds the government."[2]** Even a contingent liability depends upon events that are not under the control of the reporting entity. An option to renew a lease is not a binding agreement is completely under the control of the reporting entity and so does not create a liability, as defined in SFFAC 5.

b. The private sector standards upon which the proposed standards are based were intended to prevent known abuses in the private sector, such as leases that were deliberately structured in order to qualify for a desired accounting treatment. These abuses did not occur in the federal government, in part because the reasons for the abuses relate to conditions that do not exist in the federal government. The federal government is fundamentally different from the private sector. The federal government does not pay taxes or persuade stockholders to buy stock. It has an ability to impose mandatory taxes as its primary source of revenue. For this reason, the federal government should have a compelling reason to parallel private sector accounting principles. For example, the principles of accrual accounting clearly do have a compelling advantage for departure from federal budgetary accounting, because of the advantage of the matching principle for representational faithfulness in recognizing expenses when they are incurred and revenues when they are earned. However, the ED has provided no compelling reason why proprietary accounting should depart from budgetary obligations regarding the length of the lease term. In addition, longer lease terms that include option years greatly increase the level of uncertainty in estimating the lease asset and liability and make it more likely that the estimated asset and liability will be misstated.

c. The likelihood of exercising option periods is uncertain and subjective. Over long periods of time, such as lease option periods, lease terms are often highly unpredictable, because they are subject to major changes in financial priorities and mission goals that can occur when federal administrations change. For example, downsizing, upsizing, or changes in geographical location may occur, and often have occurred, as directed by

[1] SFFAC 5, par. 39

[2] SFFAC 5, par. 42 (bold added)

Congress and the President, to reflect changing priorities as expressed by the voting public. Predicting whether an agency will exercise option periods for long-term leases implies a degree of certainty greater than actually exists, which may be misleading for readers of the financial statements.

d. The subjective nature of guessing whether option periods will be exercised is likely to create disagreements between agencies and their auditors, which would require the use of personnel resources for accountants and auditors to resolve, with no clear value added. This is important regarding the increasing emphasis on the federal government "doing more with less" and/or reducing the size, scope, and cost of the federal government.

Q3. The Board is proposing that at the beginning of the lease term, a lessee should recognize a lease liability and a property, plant, and equipment right-to-use lease asset (the lease asset), except for intragovernmental and short-term leases. The proposed lease recognition requirements are presented in paragraph 19.

Do you agree or disagree with the proposed lessee recognition of a lease at the beginning of the lease term as presented in paragraph 19? Please provide the rationale for your answer.

SEC Response: Agree, provided that there are exceptions for both intragovernmental leases and short-term leases, with the definition of short-term leases broadened to include five years at the beginning of a new lease or remaining on existing leases at the initial implementation date.

Q4. The Board is proposing that a lessee should measure the **lease liability** initially at the present value of payments to be made for the lease term. In addition, the measurement of the lease liability should include the several types of payments that might be required by a lease. The proposed lease liability measurement and recognition requirements are presented in paragraphs 21– 29 and further explained in paragraphs A20 – A21.

Do you agree or disagree with the proposed lessee measurement and recognition of the lease liability as presented in paragraphs 21 - 29 and further explained in paragraphs A20 – A21? Please provide the rationale for your answer.

SEC Response: Disagree. Paragraph 21g is too broad a category for inclusion in the calculation of the lease liability. The requirements for calculating the liability should have explicit exclusions for payments for routine operating costs, such as utilities and maintenance, even in cases where the payments will be made to the lessor. When, for example, a lessee may be required to make utility payments to the lessor instead of to a utility company, this does not change the substance of the transaction; it is an operating expense that should be charged to the reporting period, and not be included in the lease asset/lease obligation calculation. The explicit exclusions would also serve to make reporting more uniform within each agency and throughout the federal government, because there is likely little or no consistency in how these operating expenses are paid by lessees.

Q5. The Board is proposing that the future lease payments should be discounted using the rate the lessor charges the lessee, which may be the interest rate implicit in the lease. If the rate cannot be reasonably estimated by the lessee, the lessee's incremental borrowing rate (the estimated rate that would be charged for borrowing the lease payment amounts for the lease term) should be used. The specific proposed requirement is presented in paragraph 23.

a. Do you agree or disagree that the rate the lessor charges the lessee, which may be the interest rate implicit in the lease, should be used to measure the future lease payments as presented in paragraph 23? Please provide the rationale for your answers.

SEC Response: Disagree. The lessor's interest rate often is not identified in the lease and cannot be readily determined. Because the alternative is to use the lessee's interest rate, which will always be considerably lower, there would be a huge variation in the interest rates used for this calculation. Accordingly, there are two reasonable options for uniform and comparable reporting: (a) the Treasury rate for bonds of a similar period, or (b) some other readily determinable rate, such as the published market rate for AAA bonds of similar length. The Board should select only one of these options for the sake of uniformity, because option (a) would be a much lower rate than option (b).

b. Do you agree or disagree that the lessee's incremental borrowing rate should be used to measure the future lease payments when the lessor rate cannot be reasonably estimated by the lessee as presented in paragraph 23? Please provide the rationale for your answers.

SEC Response: Partially agree. There are two reasonable options for uniform and comparable reporting: (a) the Treasury rate for a similar period, or (b) some other readily determinable rate such as published market rates for AAA bonds of similar length. Disagree that these options should only be used if the lessor's rate cannot be determined. The Board should select only one of these options for the sake of uniformity, because option (a) would be a much lower rate than option (b).

Q6. The Board is proposing that the lessee should remeasure the lease liability at subsequent financial reporting dates if certain changes have occurred and are expected to significantly affect the amount of the lease liability. The Board is also proposing that the lease asset should generally be adjusted by the same amount when the corresponding lease liability is remeasured based on those changes. Additionally, if the change reduces the carrying value of the lease asset to zero, any remaining amount should be reported in the flows statement as a gain. The proposed lessee requirements for remeasurement are presented in paragraphs 25 – 29, 33, and further explained in paragraph A19.

a. Do you agree or disagree with the circumstances when the lessee must remeasure the lease liability as presented in paragraph 25? Please provide the rationale for your answer.

SEC Response: Disagree. Remeasurement should only be required when clearly unavoidable, such as lease termination or major modification. Regarding the requirement in paragraph 25e, as explained in the response to Q5a above, the lessor's interest rate should not be used in discounting to present value, because the lessor's interest rate is often unknown; as a result, the resulting calculations would be inconsistent among different leases even within the same federal agency. The ED does not provide a compelling rationale for why agency resources should be used for remeasurement except when remeasurement is unavoidable.

b. Would the requirements triggering remeasurement cause undue costs? Please provide the rationale for your answer.

SEC Response: Yes, the requirements triggering remeasurement would cause undue costs, especially for high-volume lessees such as GSA. This would be particularly true for requirement 25a if agencies are required to include option years in the lease term. See Q2 for SEC comments on including option years in the lease term. The ED does not provide a compelling rationale for why agency resources should be used for remeasurement except when remeasurement is unavoidable.

c. Do you agree or disagree with the effect of the remeasurement on the carrying value of the lease asset as presented in paragraph 33 and further explained in paragraph A19? Please provide the rationale for your answer.

SEC Response: Agree. The recognition of a lease asset and liability should not impact net position. A lease asset should never be valued at less than zero.

Q7. The Board is proposing that a lessee should measure the lease asset initially as the sum of (1) the amount of the initial measurement of the lease liability, (2) lease payments made to the lessor at or before the beginning of the lease, less any lease incentives received from the lessor, and (3) initial direct costs that are ancillary charges necessary to place the lease asset into service. The proposed lessee lease asset measurement and recognition requirements are presented in paragraphs 30 – 34 and further explained in paragraph A22.

Do you agree or disagree with the proposed lessee measurement and recognition of the lease asset as presented in paragraphs 30 - 34 and further explained in paragraph A22? Please provide the rationale for your answer.

SEC Response: Conditionally agree, if SEC recommendations on (a) explicit exclusions (Q4) and interest rate (Q5) in the calculations are incorporated in the revised requirements.

Q8. The Board is proposing that at the beginning of the lease term, a lessor should recognize a lease receivable and deferred revenue, except for intragovernmental and short-term leases. The proposed requirements for the measurement and recognition of the lessor lease receivable and deferred revenue are presented in paragraphs 36 – 48 and further explained in paragraphs A23 - A24.

Do you agree or disagree with the proposed lessor measurement and recognition of the lease receivable and deferred revenue as presented in paragraphs 36 - 48

and further explained in paragraphs A23 - A24? Please provide the rationale for your answer.

SEC Response: Partially agree. Lessor reporting should parallel lessee reporting, including the SEC recommendations in Q1-Q7.

Q9. The Board is proposing to define a short-term lease as a lease that, at the beginning of the lease, has a maximum possible term under the contract/agreement of 24 months or less, including any options to extend, regardless of its probability of being exercised. The proposed requirements for the measurement and recognition of a short-term lease are presented in paragraphs 59 – 61 and further explained in paragraph A25.

Do you agree or disagree with the proposed definition and measurement and recognition of a short-term lease as presented in paragraphs 59 - 61 and further explained in paragraph A25? Please provide the rationale for your answer.

SEC Response: Disagree. A short-term lease should be defined as a lease with a non-cancelable period of five years or longer. Reason: the implementation of the lease asset/lease liability requirements will be considerably labor-intensive, and should not be required for relatively short-term leases.

Q10. The Board is proposing to establish distinct standards for intragovernmental leases. An intragovernmental lease is a contract or agreement that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration occurring within a consolidation entity or between two or more consolidation entities as defined under SFFAS 47, Reporting Entity. The proposed requirements for the measurement, recognition, and disclosure of intragovernmental leases are presented in paragraphs 75 – 95 and further explained in paragraphs A26 - A29.

Do you agree or disagree with the proposed definition, measurement, recognition, and disclosures of intragovernmental leases as presented in paragraphs 75 - 95 and further explained in paragraphs A26 - A29? Please provide the rationale for your answer.

SEC Response: Agree. The lease assets, liabilities, revenues, and expenses for intragovernmental leases would be eliminated for the consolidated government-wide financial report. There is no compelling rationale for expending agency resources on increasing agencies' reporting burden with complex reporting requirements for intragovernmental amounts that are eliminated in the consolidation process.

Q11. The Board is proposing that leases unexpired at the beginning of the reporting period in which the standard is implemented be recognized and measured using the facts and circumstances that exist at the beginning of the reporting period. The proposed implementation requirements are presented in paragraphs 99 -100.

Do you agree or disagree with the proposed prospective implementation approach as presented in paragraphs 99 - 100? Please provide the rationale for your answer.

SEC Response: Agree.

Q12. The Board is proposing that the requirements of this Statement be effective for reporting periods beginning after September 30, 2018. The proposed effective date is presented in paragraph 101.

Do you agree or disagree with the proposed effective date as presented in paragraph 101? Please provide the rationale for your answer.'

SEC Response: Disagree. The proposed effective date should accommodate the need for additional systems and staffing needed by large-volume non-intragovernmental lessee agencies such as GSA to implement the new requirements.

Additional comments: Impact on the Statement of Net Cost.

The ED focuses entirely upon the balance sheet and the notes, with detailed requirements for calculating the asset and liability and a detailed list of disclosures. In contrast, for the Statement of Net Cost, there is no detailed guidance for how to calculate and recognize expenses. Paragraph 31 states that agencies should amortize the lease asset in a "systematic and rational" manner. Would that include amortizing the lease asset so that the amortization plus the interest would result in as total lease expense that is equally distributed throughout the lease term, which effectively would parallel current reporting of expenses for an operating lease? That would qualify as "systematic and rational," because the right to use the leased asset, and the benefit of using the leased asset, is identical in each period throughout the lease term. Paragraph 35 requires agencies to calculate and report the principal and interest implicit in the calculation of the present value of the lease asset and lease liability. If this means that agencies will be required to distort period lease expenses, by front-loading them, and reporting a larger total lease expense early in the lease and a smaller expense in later lease periods, the ED has provided no justification for this distortion of expenses from one period to another. If the standard would permit allocating the expense on a straight-line basis, it would appear that the calculation and disclosure of principal and interest would impose a reporting burden that would serve no clear purpose. The ED appears to allow either method of calculating expenses (S/L or skewed), which would result in a lack of consistent accounting principles used for, and reporting of, lease expenses throughout the federal government for long-term non-intragovernmental leases. The Board should issue a revised ED that would include a discussion and rationale for expense calculation and recognition in the Basis for Conclusions. The revised ED should also include an illustrative example, showing period expenses and an illustrative disclosure.