

Transitional Amendment to SFFAS 54

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Name: April Pratt, Director, PBS Financial Operations Division, OCFO

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This [proposal](#) would amend the implementation section of Statement of Federal Financial Accounting Standards (SFFAS) 54, *Leases*, by providing transitional accommodations to reporting entities in the area of “embedded leases” (a common industry term which generally describes contracts or agreements that contain lease component[s] and nonlease component[s], such as service components, and serve a primary purpose attributable to the nonlease component[s] as well as the related requirements of SFFAS 54, par. 72-77).

QFR 1 Do you generally agree, partially agree, or disagree with the proposed transitional amendment to SFFAS 54 as a whole? Please provide reasons for your views.

We generally agree with the proposed transitional amendment as a whole. We greatly appreciate the Board providing additional time for agencies to research our contracts/agreements to properly account for embedded leases. We fully support the Board's prompt issuance of this proposed transitional accommodation, especially given the limited amount of time remaining before SFFAS 54 becomes effective. Additional time for research will also allow agencies to provide more meaningful data to the Board on this topic and on related issues that the Board may wish to consider in the future.

We support the analysis of a contract's primary purpose as the factor for determining when the transitional accommodation may apply.

Additional comments on specific issues are provided in the QFRs below.

QFR 2 Proposed paragraph 96A provides that the transitional accommodation, if elected by the reporting entity, would apply to contracts or agreements that meet both of the following criteria: (a) the contracts or agreements contain nonlease component(s) and may contain lease component(s), and (b) the purpose of the contracts or agreements is primarily attributable to the nonlease component(s), such as service components.

Please provide feedback on paragraphs 3-4 and paragraph 5 (96A criteria), which are intended to provide criteria for the scope of the transitional accommodation for “embedded leases.” Respondents are encouraged to refer to the basis for conclusions and provide feedback on the design of these proposals and the extent to which they effectively scope in “embedded leases,” and the level of effort for applying such criteria.

As a transitional accommodation, we consider paragraphs 3-5 to be reasonable and sufficient to greatly reduce implementation burdens for embedded leases that are within contracts with a primary purpose being services in nature. Inclusion of the language that the determinations are to be made, “based on management’s assessment...and professional judgment” and that the primary purpose attribution “should not appear to be unreasonable” are particularly valuable to support agency flexibility in using the accommodation. We foresee a significantly reduced level of effort in applying this criteria and believe this is a reasonable approach that will still capture all material lease balances.

In the future, if the transitional accommodation is made permanent, we would recommend the Board (or AAPC) provide more criteria or guidance on reasonable approaches to the management assessment process. We recommend such additional guidance for permanent changes, to support consistency across reporting entities, and address likely complexities contracts may have. Reporting entities each determining the criteria for assessing the primary purpose attribution could lead to differences and inconsistencies. We believe such additional guidance is not a necessary requirement for the proposed transitional accommodation, as it is temporary in nature, but would be helpful if a permanent accommodation is adopted.

QFR 3 Please provide feedback on the proposed transitional accommodation provisions under paragraphs 96B-96C, which are intended to allow practitioners to reduce implementation time by not reporting certain “embedded leases” during the accommodation period. Please describe any alternative views or approaches, suggestions for improvements, and the reasons for your views. Respondents are encouraged to refer to the basis for conclusions and provide feedback on (1) the design of these proposals, (2) the expected effectiveness

of the transitional accommodation, and (3) and the expected level of effort for applying the accommodation.

We believe the language in paragraphs 96B - 96C could be simplified to add clarity and potentially remove additional burden.

In paragraph 96B, the FN12 indicates that contract modifications impacting the primary purpose attribute are an exception to use of the accommodation. We believe this exception should be contained in the body of a paragraph rather than a footnote and prescribe accounting treatment reporting entities should use when contract modifications change the primary purpose from non-lease to lease. FN12 is unclear whether reporting entities would apply requirements of SFFAS 54 paragraphs 80-86 for such modifications made during or after the accommodation period, or what other guidance may apply to modifications.

Also in paragraph 96B, we recommend the sentence enabling entities to elect shorter accommodation periods be further simplified. Given the latitude reporting entities will have in applying the accommodation (including potential unique application for each reporting entity, as well as by groups of contracts provided in paragraph 96D), there could be significant inconsistency in reporting methods within a reporting entity, even greater potential for inconsistency across consolidated reporting entities (i.e. Department or Agency level), and most pronounced at the government-wide level. With such potential for variability by reporting entities, we suggest rewriting the third sentence of paragraph 96B as follows: "The entity may discontinue use of the transitional accommodation at any time during the accommodation period."

In paragraphs 96B and 96C, the exercising of options after the period of accommodation is not addressed. Since contractually, exercising options is not the same as making contract modifications, we recommend addressing this as well within these paragraphs.

In paragraph 96C, the reference to new contracts commencing after the accommodation period is not necessary as paragraphs 96 A-E would no longer apply.

To provide greater clarity to paragraph 96C, we suggest the following alternative language, which also incorporates FN13 and FN14 into the body of 96C:

"For contracts where the transitional accommodation is used, if contract modifications are made subsequent to the accommodation period (or after the entity discontinues use of accommodation), entities should prospectively apply the provisions of SFFAS 54 paragraph 73. If the subsequent modifications create a lease component, for purposes of initial recognition and measurement, the start of the lease term for that component would be the effective date of the modification. For such modifications, the lease liability and lease asset (for lessees) or lease receivable and unearned revenue (for lessors) should initially be measured based on the remaining lease term and associated lease payments. Alternatively, if a component of the subsequent modification meets requirements for reporting as a separate lease in accordance with SFFAS 54, paragraph 84, that component should be recognized as a new lease, while the original contract may continue to be accounted for as a non lease contract under the accommodation, without prospective application of par. 73."

As an alternative approach for contracts for which this transitional accommodation is applied, we strongly recommend eliminating the need to review modifications and the exercising of

options during or after the transitional accommodation period. This would eliminate the need for paragraph 96C and FN 12 in 96B and further reduce implementation burden, as there would be no need for reporting entities to continuously monitor these contracts or agreements. As noted in the BFC, paragraph A12, these contracts or agreements are shorter-term in nature and the financial statement impact of removing 96C requirements would likely not be material.

As discussed in our response to QFR 1, GSA supports the Board's prompt issuance of this proposed transitional accommodation, especially given the limited amount of time remaining before SFFAS 54 becomes effective. We offer the following additional suggestions for longer-term/permanent consideration. These could be reviewed and discussed at a later time as a future accommodation.

1. We suggest the Board revisit the practical application of some of the language in SFFAS 54 paragraph 2 that leads into paragraphs 3 and 4, especially from the perspective of embedded leases and asset control. Paragraph 2 of SFFAS 54 indicates that assets should generally be explicitly identified in contracts but allows for assets to be "implicitly specified." For contracts with the primary purpose to provide services, financial terms are less likely to clearly distinguish the elements of payments related to underlying assets used. As an example, cloud computing service pricing rarely affixes elements specific to any particular pieces of equipment used. Considering these types of contracts as multi-component arrangements in accordance with SFFAS 54 paragraphs 72-77 is especially challenging and adds burden that is likely not warranted. If such contracts or arrangements without clear or estimable payment/pricing requirements for underlying assets were to follow the guidance of paragraph 76, with treatment of the whole contract as a lease, the impact on financial reporting could create significant unwanted distortions. Lease accounting for right-to-use assets brings the higher near-term recognition of expenses and lower later-year cost recognition, most noted in periods of higher interest rates, given the treatment that a lease contract is effectively treated as an asset financing arrangement, with its front-loaded interest costs produced by the interest method and its amortization of the liability balance.

While paragraph 4 of SFFAS 54 somewhat removes primarily service contracts from consideration as leases, the requirements of this paragraph would be further clarified if language similar to the proposed 96A and 96B were included.

2. We recommend changes to paragraphs 76 (edits proposed below) and elimination of 77 of SFFAS 54. This would alleviate burden for reporting entities by allowing non-lease accounting for components that are unable to be separated and eliminating the need to estimate the allocation of costs between components. However, if the alternative view is adopted by the Board, we would recommend changing this to assess the primary purpose and then account for the component based on that determination.

76. If a contract or agreement does not include prices for individual components or if any of those prices appear to be unreasonable as provided in paragraph 75, lessors and lessees should use professional judgment to determine their best estimate for allocating the contract or agreement price to those components;

~~maximizing the use of observable information. If it is not practicable to determine a best estimate for price allocation for some or all components in a contract or agreement, a federal entity should~~ account for those components as a single non-lease unit.

With these changes to paragraph 76 of SFFAS 54, paragraph 77 is no longer needed.

QFR 4 Proposed paragraph 96B provides that reporting entities may elect an accommodation period for up to two years prior to the prospective application requirements described in paragraph 96C. Please also refer to paragraphs A1-A13 of the basis for conclusions, including paragraph A10, which discusses the Board's intent that this proposal would provide additional time to prepare for prospective implementation of paragraph 73 for new or modified "embedded leases."

Please provide your views on the length and sufficiency of the proposed accommodation period and any views with respect to making the accommodation permanent. Please describe the reasons for your views and relevant considerations to facilitate the Board's analysis of your comments.

We recommend the Board consider changing the accommodation period to 4 years, to provide agencies with additional time to apply more resources and perform analysis necessary to fully apply SFFAS 54 to embedded leases. Most agencies will likely need at least one year of additional resources dedicated to the implementation of traditional leases required by SFFAS 54 and ensure proper reporting. It is expected to require significant additional resources to adequately delve into the analysis of embedded leases and develop processes and procedures to unbundle contracts. Further, accounting for contracts with embedded leases may require additional changes to financial management or acquisition systems, beyond those used for lease contracts. Any further significant systems changes would likely cause delays for agencies to comply with SFFAS 54 for embedded leases after the accommodation period.

As noted in our response to QRF 2, if in the future, the Board considers significantly extending or making the accommodation period permanent, we believe such a change should be accompanied by further guidance for entities to apply in determining the primary purpose of contracts. We can envision various contractual scenarios that add complexities to making the determinations and believe sufficient guidance (such as from the AAPC) should be provided to promote consistency among Federal reporting entities. Permanent accommodation likely requires amendment to both the multi-component contracts section (paragraphs 72-77) of SFFAS 54 as well as the contract modification section (paragraphs 80-86).

QFR 5 Proposed paragraph 96D provides that reporting entities may apply the provisions of paragraphs 96A-96C to groups of contracts or agreements that are reasonably similar in nature. A reporting entity may select different accommodation periods under paragraph 96B for different groupings of contracts or agreements.

Please provide feedback on the proposed criteria. Please describe any alternative views or approaches, suggestions for improvements, and the reasons for your views.

We strongly support the provision for reporting entities to group contracts or agreements that are reasonably similar in nature. This will greatly reduce burden by allowing management to assess the nature of a group of contracts or agreements rather than assessing each contract or agreement individually.

As noted in our response to QFR 2, if the transitional accommodation is made permanent, we would recommend the Board (or AAPC) provide more criteria or guidance on determining when contracts or agreements are “reasonably similar in nature”. Additional guidance would promote consistency among reporting entities. We believe such additional guidance is not a necessary requirement for the proposed transitional accommodation, as it is temporary in nature, but would be helpful if a permanent accommodation is adopted.

QFR 6 Proposed paragraph 96E provides that reporting entities electing the transitional accommodation would disclose the election of the transitional accommodation during the reporting period(s) covered by the accommodation period and the reporting period immediately following the accommodation period. The disclosure would not need to be repeated during subsequent reporting periods.

Please provide feedback on the proposed disclosure requirement. Please describe any alternative views or approaches, suggestions for improvements, and the reasons for your views.

We support the disclosure requirement but would recommend a minor change to the wording to avoid confusion. The way it is currently written, it could be interpreted that a reporting entity only needs to disclose the election of the transitional accommodation in FY24 and one year beyond; however, if the reporting entity intends to continue using the transitional accommodation throughout its period of availability, we believe the disclosure should be repeated each year that the reporting entity continues to use the accommodation and one year thereafter. We believe that is the intent of paragraph 96E now, but we think that a slight change to the wording would improve understanding. We suggest the edit below for consideration.

96E. A reporting entity electing the above transitional accommodation should disclose the ~~use or the discontinuance of use election~~ of the transitional accommodation during ~~the all~~ reporting period(s) ~~presented in the financial statements covered by the accommodation period and the reporting period immediately following the accommodation period. The disclosure need not be repeated during subsequent reporting periods.~~

Also, we would suggest that the disclosure requirement include the nature of the portfolio of contracts or agreements for which the transitional accommodation was used or discontinued and for what portion of the fiscal year the election was in effect, if discontinued during a fiscal year.

QFR 7 Four Board members provided an alternative view, which is documented under the basis for conclusions (appendix A), paragraphs A15-A26. Please refer to these paragraphs to review the alternative view as presented.

Do you agree, partially agree, or disagree with the alternative view? Please provide the rationale for your answer.

We disagree with the alternative view as presented, particularly the impacts of paragraph A21.a. We appreciate that the alternative view is looking for a permanent accommodation and believe there are other avenues that could be explored to achieve that. We would prefer additional data analysis to be completed before a permanent accommodation is approved in order to understand the financial impacts and materiality of different approaches for consideration.

We have the most concern with the proposal in A17 and A21.a for reporting entities with a material lease portfolio. For GSA, bundling the non-lease components with the lease components for our real property leases would greatly increase the lease liabilities and right-to-use lease assets on our balance sheet as annual operating costs would be grossed up in these values. This would greatly distort our liabilities and assets, and impact the timing of expense recognition, given the asset amortization and interest accumulating on liability balances. We do not believe that the bundled non-lease contracts or agreements would offset this distortion. While we understand that this is optional under the alternative view presented, we are concerned about the consistency across the federal government and the usability of the financial statements, particularly in consolidated reports. We have further concerns with the significant flexibility each reporting entity has, that decisions to apply such methods may be overly focused on cost savings within the financial management function, with insufficient regard to the impact on financial reports and impacts on users of the

financial statements. We would only view paragraph A21.a to be appropriate when the non-lease components included are de minimis.

We disagree with the proposal in paragraph A22 to allow a reporting entity to choose not to apply the requirements of paragraphs 85-86 of SFFAS 54 to a contract or agreement for which it has elected the practical expedient described in paragraph A21.a when any modification to such contract or agreement relates only to its nonlease components. While we appreciate that the alternative view is trying to minimize the burden required to remeasure the lease liability and asset annually because of changes to operating costs, we are concerned that this would cause even greater distortion to the financial statements by overstating interest expense when there is no relationship to carrying balances of the liability.

Further, the alternative view does not address complications, such as when contract modifications change the primary nature of the contract or when options are exercised.

We are generally in agreement with the alternative view for contracts or agreements where the primary purpose is non lease in paragraph A21.b as it is more in line with the proposed transitional accommodation.