

Transitional Amendment to SFFAS 54

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Name: Cecilia Coates, Deputy Comptroller

Please identify your organization, if applicable.

Organization: Department of State, Bureau of the Comptroller and Global Financial Services

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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.

The U.S. Department of State (State) appreciates the opportunity to review this proposal and agrees with the proposed transitional amendment partially.

Partial with Transitional Amendment

State is fully committed to implementing the SFFAS 54 and associated standards. The additional option to extend reporting requirements for embedded leases will allow State to allocate resources to prepare for the other requirements within SFFAS 54 for our significant population of overseas real property leases, while working with our Acquisition organization to accurately quantify and prepare for reporting of embedded leases; however, we are respectfully requesting that the Board provide up to three (3) years to allow for full compliance.

Transitional Amendment Level of Effort

State estimates that the Transitional Amendment requirements around embedded leases include

- 1) identifying the population of contracts,
- 2) determining the components (lease and nonlease) in each contract, and
- 3) quantifying the lease and non-lease components to categorize whether the purpose of each contract is primarily attributable to the lease or non-lease components to determine whether the transitional amendment applies.
- 4) Documenting judgements made for the purpose of the contract
- 5) Reporting accordingly
- 6) Responding to audit inquiries regarding the judgements made

These steps will require a significant level of effort to evaluate, make, document, and respond to inquiries on judgements and could result in an immaterial balance. Even with the transitional amendment, State anticipates needing three (3) years) to implement needed changes to our acquisition systems and to establish contract language for future contracts to segregate lease and nonlease components to better identify, track, and report on the lease components. Therefore, we do not anticipate reporting any embedded leases until after the maximum allowed transition (i.e., FY 2026).

Request to Expand the Scope of the Transitional Amendment

Given the level of effort still required to identify the purpose of contracts with lease and non-lease components, as described in our response to QFR 2, State is suggesting that the Board consider expanding the transitional amendment to include a **delay in evaluating and reporting leases for any lease elements within service contracts not currently identified as a lease.**

Engagement with the Acquisition Community

State recognizes that adding language to contracts and agreements with other parties to require segregating costs for lease and nonlease components will make a significant impact on future reporting of lease components. We recommend that the FASAB Staff and/or Board engage with the Federal acquisition community, including OMB's Office of Federal Procurement Policy to understand the lead times and level of effort needed across Federal agencies to identify, quantify and apply language to service contracts to efficiently identify and quantify lease and nonlease components.

Request for Relief Regarding Intragovernmental / Reimbursable Agreements

Federal agencies frequently provide services to each other, which could include joint benefit from service contracts with vendors that contain embedded leases. The proposed transitional accommodation and proposed practical expedient discuss agreements and contracts but do not provide specific accommodations for Federal transactions.

Even with the current guidance in SFFAS 54 that categorize these leases as expenses for the lessee, the level of effort to review these arrangements will be extensive and without benefit. Would FASAB consider a permanent expedient to remove requirements for reporting embedded leases between agencies as lease expenses and only recognize the lease expense by the agency who enters into the contract with the non-Federal vendor?

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 components(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.

Expand the Transitional Amendment

As stated in QFR 1, State agrees with the 96A criteria at a minimum, but given the level of effort still required to identify the purpose of contracts with lease and non-lease components, State is suggesting that the Board consider expanding the transitional amendment to include **a delay in evaluating and reporting leases for any lease elements within service contracts not currently identified as a lease**. This would allow the State Department and other agencies to focus on proper reporting for known leases (i.e., real property and personal property), for which the Federal agency is intentionally entering into a lease transaction and over the next two years (requested above to be three (3) years) to implement processes, procedures, systems, and controls to identify the full population of leases within service contracts that likely are made up of predominantly nonlease components. State’s requested clarification would give agencies more time to make these judgements and provide the relief that the Board is seeking.

Consider the Differences between Federal Acquisitions and Contracts by Other Entities

After discussions with State’s Acquisition organization State makes note that there are significant differences in the acquisition processes and goals between federal and other industries including public companies, private companies, and state and local governments. These differences are important for the Board to recognize as they impact how effective the accommodations are. Examples include:

- Federal agencies engage in contract actions or agreements with other parties in far greater numbers than non-Federal entities.
 - State enters into approximately 50,000 service contracts domestically and overseas that could meet the criteria for evaluation as embedded leases.
 - Given the increased number of contracts to review, the initial work of identifying all contracts and determining the primary purpose of the contract is a heavy lift for Federal personnel. Paragraph 96 D does mitigate some of the lift by allowing for grouping of contracts, but agencies still must gain confidence initially around the groupings.
- Federal contracts may seek to achieve efficiencies by procuring services across a broad scope of services in one contract. Therefore, the efforts required to confirm whether a contract includes lease and nonlease components and then to determine the primary purpose of the contract may involve an extensive level of effort and significant judgements.
- Federal agencies have a significantly higher number of contracts with small businesses, who manage tight budgets and face challenges providing additional contract information unless they are able to quantify the price of providing the information. If the contract is able to separate lease components in the original acquisition, that would allow for bidding vendors to respond with proposals that include these associated costs rather than trying to separate costs at a later date.

Based on the above factors, it is critical that leases embedded in service contracts are able to be established with reporting requirements at inception. Given the long lead acquisition cycles in the Federal Government, 2 years is a minimum amount of time needed to develop contract language to segregate lease and nonlease components ahead of future Requests for Quotes, receive proposals and make awards that will apply to the FY 2026 time frame, as well as provide training to the State (and Federal) acquisition community to identify which contracts would need to include the associated lease component language. State is respectfully requesting three (3) years (i.e., FY 2027) rather than 2 years for the transitional amendment.

Request for Permanent Accommodation for Agreements between Agencies

As described in our response to QFR 1, Federal agencies frequently provide services to each other, which can include services with embedded leases. The proposed transitional accommodation and proposed practical expedient discuss agreements and contracts but does not provide specific accommodations for Federal transactions. Even with the ability to report these leases as a designated lease expense, the level of effort to review these arrangements will be extensive and without benefit. **State is suggesting that FASAB consider a permanent expedient to remove requirements for reporting embedded leases between agencies as lease expenses?**

Request for Relief in Assets not Used Directly by the Agency

We suggest that FASAB issue implementation guidance specific to embedded leases to assist agencies with making consistent judgements on what does and does not constitute control **and** what does or does not qualify as an embedded lease.

Additionally, State posits that there are two types of embedded leases: leases that a Federal agency controls and leases that the vendor controls. Leases that the agency controls. State would recommend, that the Board consider adjusting just the definition of an embedded lease from “the Agency’s right to control the asset” to “Agency’s control of the leased asset.”

This amendment would allow for a distinction between assets that are used exclusively by the vendor to accomplish the contracted service and those assets also used by the agency. The rationale for this change is that if the agency purchases the service and does not use the asset, the contract should be accounted for as a service.

This proposed addition would exclude the possibility of an agency adjusting contracting processes and policies to hide leases in other contracts to avoid reporting on the lease, while still giving relief to agencies on reporting embedded leases.

We provide two (2) examples below that show the difference between control and right to control:

Example 1a: Security contract with assets controlled by a Federal agency:

- An agency engages with a vendor to provide security during the night-time and weekend hours, while Federal employees provide security during the day. The contract includes security equipment that are used exclusively for the agency, by agency personnel and the service provider, depending on the shift.
 - In this case the agency would agree that the security equipment need to be accounted for as a lease.
 - The benefit for the agency occurs over time as the equipment allows federal employees to provide the associated security at the level of quality needed
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during their shifts. If the equipment was not included, State would need to procure similar assets.

Example 1b: Security contract with assets controlled by the vendor:

- An agency engages a third party to provide security for a facility 24/7 for 5 years. The vendor uses security equipment as part of surveillance. The equipment is used exclusively for State by the service provider.
- The agency is only invested in the service provided, the provider could substitute the specific equipment as long as the service provided was at a commensurate or higher level.
 - In this case State does not agree that the security equipment need to be accounted for as a lease. Rather State considers the equipment to be a means to an end for the contracted service.
 - The benefit for the agency is the real time security of the facility. If the equipment was not available either the vendor would need to adjust their manpower and / or equipment to provide commensurate services or the agency would need to end the services with the vendor and reassess how to achieve security needs (a much larger endeavor than leasing equipment).

Example 2a: Medical equipment contract with assets controlled by the agency

- An agency engages a third party to provide an MRI machine and maintenance of the Machine. The service provider installs, trains Department staff, and maintains the equipment which is also included in the contract.
 - In this case the agency would agree that the MRI machine needs to be accounted for as a lease.
 - The benefit for the agency occurs over time as the MRI machine allows federal staff to provide medical services to post personnel. If the MRI machine was not included, the agency would need to procure similar assets.

Example 2b: Medical equipment contract with assets controlled by the vendor

- An agency operating overseas engages a third party to provide medical services at a post. The third-party provider uses space at the embassy and provides a team of three doctors, 6 nurses, and a suite of medical equipment and supplies.
- The agency is only concerned with post personnel having access to high-quality medical care. The provider can provide any type of equipment, as long as post personnel are medically cared for.
 - In this case State does not agree that the medical equipment needs to be accounted for as a lease. Rather State considers the medical equipment to be a means to an end for the contracted service.

The benefit for the agency is the real time medical care to post personnel. If the MRI machine was not available either the vendor would need to adjust their manpower and / or equipment to provide commensurate services or the agency would need to end the services with the vendor and reassess how to achieve medical care for post personnel (a much larger endeavor than leasing an MRI machine).

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.

Agreement with Transitional Amendment

State agrees with the accommodation period with the request above to provide one (1) additional year and the prospective application of paragraph 96C, including contract modifications not affecting the primary purpose of contract in place as of election (FN 12). The delay and the prospective approach allow agencies the ability to update acquisition processes, to identify and track leases within primarily nonlease contracts, and clauses that affect the SFFAS 54 calculations. Since the federal contracting process can take over a year, the two-year delay allows State time to implement these needed changes into the process.

Clarify the Intent of “Modifications of Leases” under the Transitional Amendment

Paragraph 96B states: “unless they are subsequently modified after the end of the accommodation period.” State requests the Board clarify contract modifications, since Federal service contracts are typically modified each year to renew an option period for the same services or other administrative purposes not impacting the lease and non lease components or the purpose of the contract. State suggests that FASAB clarify that Footnote 12 applies to modifications after 9/30/25 (if the agency applied the full two year extension) and contracts would only be evaluated for lease and nonlease components and associated reporting if the contract was new or the **contract modification changed the contract scope?**

Clarify Disclosure Requirements for Leases under the Transitional Amendment

Paragraphs 54 and 67 of SFFAS 54 reference disclosure requirements for leases. State assumes the intention of the Board is that if leases do not require reporting, they do not require disclosures per paragraphs 54 and 67. State suggests that language be adjusted to reflect that these transitional amendments also apply to the SFFAS 54 requirements for disclosures in paragraphs 54 and 67 to specifically confirm that if agencies elect to take the transitional amendments, they are not required to disclose any information about these contracts except the disclosure requirements proposed in this Exposure Draft.

Clarification of Understanding around Service Contracts and Traditional Lease Agreements

A.12 states that “The Board expects that most contracts meeting paragraph 96A criteria will have lease terms that are comparatively shorter in relation to contracts with a purpose primarily attributable to lease components.” State disagrees with this statement. To identify lease and nonlease components, agencies must evaluate contract scope in addition to contract terms. Federal contracts may have a wide variety of scope elements and the level of detail provided to determine the lease elements can require an extensive level of effort to determine, especially for embedded equipment. In addition, assets embedded within these contracts may not be written into scope or contract terms and would require data calls or engagement with vendors (i.e., a cleaning contract that uses specialized assets/machines to polish floors may be brought in by the vendors, stored on site, and provide benefit only to the agency, but may not be specified in the contract language that is buying cleaning services). This would require a significantly higher level of effort than real estate lease documents (follow a standard structure like a model lease, include a deviation approval process and follow standard industry terms).

Engagement with the Acquisition Community

As stated in QFR 1, State recognizes that adding language to contracts and agreements with other parties to require segregating costs for lease and nonlease components will make a significant impact on future reporting of lease components. We recommend that the FASAB

Staff and/or Board engage with the Federal acquisition community, including OMB's Office of Federal Procurement Policy to understand the lead times and level of effort needed across Federal agencies to identify, quantify and apply language to contracts for contracts with lease and nonlease components.

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.

Request for Additional Time to take the Transitional Amendment

State requests one additional year and agrees with prospective application including contract modifications not affecting the primary purpose of contract in place as of election (FN 12).

State does consider the alternative approach, which in essence allows for a permanent expedient around embedded leases as compelling.

Intragovernmental / Reimbursable Agreements

The proposed transitional accommodation and proposed practical expedient discuss agreements and contracts but does not provide specific accommodations for Federal transactions. State would recommend a permanent accommodation for these types of agreements.

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.

Agreement with Transitional Amendment

State agrees with the 96D criteria at a minimum but would ask the Board to consider expanding the delay to include all contracts not currently identified as a lease. This would allow the State and other agencies to focus on proper reporting for known leases (i.e., real property and personal property), for which the Federal agency is intentionally entering into a lease transaction and over the time allowed in the transitional amendment to implement processes, procedures, systems, and controls to identify the full population of leases within contracts with predominantly nonlease components.

Transitional Amendment Level of Effort

If the Board chooses to consider a permanent expedient (as described in the alternate opinion), State would recommend including similar wording from paragraph 96D. This paragraph does not allow much immediate relief but would allow relief in a permanent or long-term manner.

The reason this paragraph does not allow for immediate relief is federal agencies will first have to review the contract populations, determine the primary purpose, categorize the contracts by nature, and finally determine if the nature of the arrangement correlates to the primary purpose.

Once in place, agencies can create procedures to confirm the accuracy each year and correctly identify and account for any outliers.

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.

Agreement with Transitional Amendment

State agrees with proposed paragraph 96 E, but as stated in our response to QFR 3 suggests this paragraph be expanded to include discussion around other SFFAS 54 required disclosures.

Transitional Amendment Level of Effort

State requests the disclosure the Board expand this paragraph, or paragraph 96.B, to reflect that these transitional amendments also apply to disclosures. Paragraphs 54 and 67 of SFFAS 54 reference disclosure requirements for leases. State assumes the intention of the Board is that if leases do not require reporting, they do not require disclosures.

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.

Agreement with Transitional Amendment (Alternative View)

State agrees with the intent of the alternative view. Although State does consider that additional research would be required before the language could be added to the standard, to avoid any unintended consequences. State recommends adopting the transitional amendment and applying a fully researched permanent alternative view starting FY 2026.

State would recommend considering allowing for the permanent expedient to include similar language as paragraph 96D which would allow grouping of contracts or agreements that are reasonably similar in nature. Analysis in the first year, and periodic checks to confirm the results are still reasonable, would allow for additional relief.

State agrees with the language in paragraph A21 would provide relief for embedded leases as valuation can be one of the most challenging and time-consuming parts of embedded lease reporting.
