February 25, 2015

Director of Research and Technical Activities  
Project No. 3-24P  
Governmental Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

Dear Director of Research and Technical Activities:

We are pleased to have the opportunity to provide our response to the Preliminary Views of the Governmental Accounting Standards Board (the Board) on Leases (the PV). We support the Board’s objective to reexamine accounting and financial reporting for leases and to consider improvements to current guidance. We do not believe current accounting and financial reporting standards are appropriate to meet user needs.

We agree with the PV’s foundational principle that all leases are financings of the right to use an underlying asset. Therefore, we support the use of a single approach to account for leases that would result in assets and liabilities from lease transactions. We also support the Board’s goal to carefully assess expected benefits and perceived costs in creating standards that address user needs.

We believe certain enhancements or changes to the concepts expressed in the PV would improve the consistency and comparability of the reporting for leases and provide better information to assess the nature and extent of a government’s leasing activities. Our comments are provided below.

Include Transfers of Ownership Within Scope

We disagree with the exclusion of leases that transfer ownership from the scope of a proposed lease standard. Consistent with views expressed by the Board in the PV, the right to use an asset is different than owning the underlying asset. The distinction between the two is based on which party holds legal title. The lessee has a right-of-use asset up to the point at which it obtains legal title to the underlying asset. We believe this difference justifies the different accounting for a lease with a future transfer of ownership versus a sale that immediately transfers ownership, as detailed in the August 2014 project staff memo Issue 1, Paper 5. Accordingly, we believe a new lease standard should address the accounting for leases that include a future transfer of ownership of the underlying leased asset.

We acknowledge that a lease with an ownership transfer conveys substantially all of the remaining risks and rewards of ownership to the lessee. However, we do not believe this justifies excluding these transactions from the scope of the lease standard because they are not substantively different from leases that cover the entire remaining economic life of the underlying asset. Such leases (i.e., with a term that cover the entire remaining economic life of the underlying asset) also transfer substantially all risks and rewards to a lessee, but these types of leases are not excluded from the scope of the lease standard. Finally, if excluded from the scope of the lease standard, it is unclear how a government would account...
for a lease with an ownership transfer if the lease is amended to remove the ownership transfer or if the lessee does not intend to take ownership at the end of the lease.

Include Bargain Purchase Options Within Scope

We disagree with the exclusion of bargain purchase options (BPO) from the scope of a proposed lease standard. In addition to our views expressed above related to transfers of ownership that are also applicable to BPOs, we believe the determination of whether a purchase option is a “bargain” would create a de facto lease classification test, in which the judgment of a bargain dictates one of two possible accounting models for the lease contract. Further, we note that some governments do not exercise BPOs based on operational needs or other non-economic considerations, so the existence of the BPO does not necessarily mean the lessee will ever take ownership of the underlying asset.

Include Non-Exchange Lease Transactions Within Scope

We disagree with the exclusion of leases that result from nonexchange transactions from the scope of the lease standard. We also disagree with the Board’s belief that the substance of these arrangements is something other than a lease. A lease that results from a nonexchange transaction represents a right-of-use asset for the lessee that we believe should be recognized as an asset in the statement of net position. The existing guidance contained in GASB Statement No. 33, Accounting and Financial Reporting for Nonexchange Transactions (GASB 33), does not discuss the potential for recognizing a right-of-use asset. We believe there is significant diversity in practice today in recording such transactions. It is our experience that these transactions, more often than not, are recorded as operating leases.

Include Periods Related to “Lessor Termination Options” Within Lease Term

Chapter 3, paragraph 3, of the PV states that if the lessor alone has an option to terminate or cancel the lease after a certain point in time, any periods following that date would be considered cancellable periods and would be excluded from the lease term. We disagree with this distinction because if the option to terminate or cancel is lessor-only, the lessor would have an enforceable obligation against the lessee during those lessor-cancellable periods. Current GAAP includes lessor-only cancellable periods in the initial lease term.

Revise Circumstances that Require Lessee Reassessment of Lease Term

We agree with the PV’s position that a lessor should reassess the lease term only when a lessee (1) elects to exercise an option to extend the lease that was initially determined as not probable, or (2) does not elect to exercise an option to terminate the lease that was initially determined as probable.

However, we do not believe these same criteria for reassessment are appropriate for lessees, because the lessee often has more insight than the lessor into the probability, and changing probability, of exercising extension or termination options.

We recommend the criteria for a lessee to reassess a lease term should require reassessment upon the occurrence of certain significant triggering events that indicate the lease term is probable to be extended or shortened from what was originally determined. Examples of significant events include the
construction of significant leasehold improvements, making significant modifications or customizations of the underlying asset, and subleasing the underlying asset for a period beyond the exercise of an option to extend the lease. Limiting the requirement to reassess lease term to these types of significant events should limit the cost and burden on financial statement preparers while providing more timely information to users on changes in lease liability. We believe the benefits of this approach outweigh the costs.

We understand that judgment may be required in determining when an event is a “significant event” triggering the need to reassess lease term, and any list of examples would not be all-inclusive. We believe, however, that even in the extreme case of certain preparers using the examples as a checklist, this would still provide more timely and accurate information about changes in lease liability than waiting until the date an extension or termination option is exercised.

Limit Circumstances that Require Remeasurement of Lease Liability and Lease Receivable

The PV states the lessees and lessors would consider remeasurement of lease liability and lease receivable, respectively, under various circumstances. Certain of these criteria, including changes in qualitative factors, external rate or index changes, and changes to the rate charged by lessor, could result in remeasurement, or at least a required analysis to determine whether remeasurement is necessary, every reporting period. We believe the cost of such frequent remeasurements or reassessments would outweigh expected benefits to financial statement users.

Accordingly, we recommend narrowing the remeasurement criteria to the following circumstances:

- Lease term changes based on a significant triggering event
- Change to probability of lessee exercising a purchase option based on a significant triggering event
- Change in amount expected to be payable under a residual value guarantee - in this situation we believe only the residual value guarantee should be remeasured

We believe these criteria for remeasurement adequately capture changes to lease liabilities that are more than inconsequential, while also reducing cost and complexity for financial statement preparers.

The PV states the lessees and lessors “would consider remeasurement” of lease liability and lease receivable. We recommend the term “would consider remeasurement” be revised to “should remeasure,” to avoid ambiguity and possible diversity in application of the requirement.

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If you have any questions or need additional information regarding our comments, please contact Mr. Jeffrey Markert at 212-909-5306 or jmarkert@kpmg.com.

Sincerely,

KPMG LLP