NACUBO

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Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1850-100

Dear Technical Director:

On behalf of the National Association of College and University Business Officers (NACUBO), we submit the following comments on the proposed Accounting Standards Update, "Leases (Topic 840)" (the ASU). NACUBO's comments on the proposal were developed with input from our member institutions and our Accounting Principles Council (APC). The APC consists of experienced business officers from various types of institutions who, collectively, possess a thorough knowledge of higher education accounting and reporting issues and practices.

NACUBO is a nonprofit professional organization representing chief financial and administrative officers at more than 2,100 colleges and universities. In its capacity as a professional association, NACUBO educates over 2,000 higher education professionals annually on accounting and reporting issues and practices. Where appropriate, NACUBO also issues industry specific accounting and reporting guidance.

Overall Observations of the ASU

In general, we agree that there should be consistent treatment of leasing transactions. We are concerned, however, about some of the measurement requirements within the ASU which are detailed in our responses to selected questions posed by the Boards.

Institutions of higher education enter into lease transactions as both lessees and lessors. As a lessee, the institution may lease research and scientific equipment, office equipment, fitness equipment, vehicles, real estate, etc. Transactions as a lessor include: the leasing of dorm rooms to students, student computers, bookstores, long-term land leases and real estate investment property. In addition, institutions, especially those in urban areas where housing space is at a premium, are often sublessors of apartments to faculty and students. The breadth of these transactions causes us trepidation with respect to the initial implementation of the ASU and the ongoing accounting for leases.

Another concern is that while many leases may be immaterial individually, under the proposed guidance it may be necessary to aggregate them for audit or financial statement presentation. We say this because the proposed guidance seeks to clarify and quantify the leveraged position of reporting entities; consequently, auditors will want to evaluate the materiality of all leases. This evaluation could require the aggregation of hundreds of immaterial leases. Recognition of these leases that had previously been excluded from the statement of financial position will impact financial ratios and covenants and require extensive preparer time and effort.

Finally, we did not find the examples in the ASU to be broad enough or relevant to circumstances faced by not-for profit organizations (NFPs). Due to the lack of NFP-relevant examples, we spent a significant number of hours creating our own in an effort to fully understand the ramifications of the proposals to our industry's financial statements. We request that the Board significantly expand the examples in the final standard.

Question 1: Lessees

(a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We agree that lessees should recognize a liability for the discounted present value of non-cancellable lease payments and the related asset to the extent that the asset would be capitalized if purchased outright by the organization in accordance with their capitalization policy. There is a conceptual difference between the lease of an asset that will be renovated or refurbished in the future and one, such as that for a photocopier, which is essentially a consumable item that will be disposed of after its relatively short life. Were an entity to purchase these consumable items, they would not capitalize them as the relatively low cost and short life span would result in depreciation expense roughly equal to the monthly payments. In addition, the administrative burden and cost to the organization of accounting for such assets would far outweigh any value that showing these amounts on the face of the financial statements would provide.

Under the proposed guidance, entities would likely have to aggregate like items that have been leased and capitalize them. We are aware of one university that has 310 photocopier leases. Each of the leases is immaterial to the overall financial position of the university and, were the university to purchase these photocopiers, they would not be capitalized. The future payments required to be made under these leases is disclosed in the notes to the university's financial statements providing readers with information related to claims on future cash flows of the institution. Aggregating the "right-to-use" 310 photocopiers into one asset would likely cause the auditors to consider it material for audit testing and presentation, despite the fact that each individual photocopier is not material enough to warrant capitalization.

Continuing with this example, significant effort would be required to review each of the lease agreements in order to determine the estimated life of the lease. The resulting liabilities and assets would require detailed tracking to generate the general ledger entries. Since the assets and liabilities are derecognized in different ways, this would require 620 separate calculations each reporting period – for the photocopier leases only.

Add to this the other leases of consumable goods (such as cell phones, computers, fitness equipment, etc.) and it is easy to conclude that the University would need to add more staff and undertake system modifications to meet the requirements of the ASU.

While we do not believe that it is the intention of the Boards to create an onerous administrative burden, the fact that the ASU does not clearly articulate the unit of measure to be used when determining materiality is likely to create unintended consequences for preparers. We urge the Boards to define the unit of measure as the individual underlying asset being leased in order to determine materiality. For assets that are immaterial, the organization would record the payments as rent expenses and disclose the anticipated annual payments in the notes.

(b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Recharacterizing what, historically, was recorded as rent expense to amortization and interest expense has the potential to create confusion for financial statement users. The current classification of payments on operating leases as rent expense allows users to quickly determine the amount, and to some extent the magnitude, of the entity's leasing activity. Showing those expenses as amortization and interest expense obfuscates the substance of the transactions. While it is true that there is an implied interest component of the lease, we believe that separately presenting that component adds little, if any, value. We recommend that the expense be labeled as lease expense or rent expense in the financial statements with the amortization and interest expense components disclosed in the notes.

Question 3: Short-term leases

This exposure draft proposes that a lessee or a lessor may apply simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less.
Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

We appreciate the Boards' desire to simplify the accounting for what would typically be immaterial short-term obligations. Unfortunately, the reality is that nearly all leases contain renewal options that would push the estimated term of the lease over the 12-month threshold for the simplified treatment. As such, the simplified approach offers little relief in the practical application of the ASU.

In addition, there is no requirement for the lessor to account for these short-term leases, but the lessee must still book them and derecognize them over their short term. Under the proposed guidance, a lessee would gross up assets and liabilities and the change in net assets recorded in the statement of activities would be no different than under current guidance for operating leases.

We are concerned that due to the relatively small number of leases that would qualify as short-term, the effort to account for what could easily be hundreds of leases using the discounted present-value approach would far exceed the benefits. As such, we propose that the Board allow the simplified treatment for all leases with a non-cancellable term of 12 months or less, regardless of the presence or absence of renewal options.

Question 5: Scope exclusions

This exposure draft proposes that a lessee or a lessor should apply the proposed guidance to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33−BC46).

Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

We believe that the exclusions should also include real estate held for investment purposes. This is especially important for higher education institutions that often have properties held in their endowments that are leased for the purpose of earning endowment income. Under the proposed guidance, the institution would apply the performance obligation approach to these types of properties. That approach would require that the income earned be characterized as interest and lease income rather than endowment income. As colleges and universities closely track their endowment returns and benchmark them against their peers, recharacterization of endowment income for these types of transactions would be inappropriate.

Question 6: Contracts that contain service components and lease components

This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, Revenue Recognition (Topic 605): Revenue from Contracts with Customers, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5−B8 and BC47−BC54). If the service component in a contract that contains service components and lease components is not distinct the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

Do you agree with the approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

When leases contain both service and lease components, we agree with the approach proposed by FASB, and prefer applying the lease accounting requirements to the combined contract. For example, universities lease dormitory space to students. Services provided under the lease, but typically not separately priced, may include utilities, resident advisor services, security, etc. We believe that transactions such as these should be accounted for as a single unit.

In addition, the Boards should identify services associated with real estate that need not be considered for separation. For example, utilities, maintenance and security are “services” often included with the rental of apartments and houses. These additional services are part of the bundle of services that a renter receives and, unless separately billed for, should not require breaking a lease agreement into services versus leased assets.

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

We do not agree. The inclusion of conditional rentals or renewal options does not meet the criteria of a liability. Concept Statement No. 6 states that an item is a liability if "the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice." We also note that the Boards' current Conceptual Framework – Elements and Recognition Project defines a liability as a "present economic obligation for which the entity is the obligor." The term "present" means that the obligation exists at the date of the financial statements and the term "economic obligation" is defined as an "unconditional promise to provide or forgo economic resources…" Conditional rentals or renewals are neither obligations that exist at the balance sheet date nor are they unconditional promises to forgo or provide economic resources. Conditional rentals and renewals by their very nature provide the ability to avoid a future sacrifice of assets. The "more likely than not" criterion should be replaced with a much higher threshold that would be in keeping with the criteria described in Concept Statement No. 6 and the Conceptual Framework project. We suggest that the Boards use the non-cancelable term of the lease.

Using a lease term that is longer than the non-cancelable contractual obligation at inception of the lease (i.e. including optional renewal periods in the lease term) could result in amounts being recorded in the statement of financial position that are not actual obligations of the organization. Thus, the balance sheet would not reflect the current economic condition of an organization. In addition, use of an estimated term could result in significant swings in income/expense and assets/liabilities if the estimate is wrong. This would be especially true when a lease is not renewed as anticipated and that decision is not made until it is time to renew the lease. A review of several scenarios demonstrates that for a lessor, using a shorter lease term (and later changing to a longer term) will always be superior to picking the longer possible lease term and later changing it to a shorter term. In addition, using an estimated term could potentially result in significant differences between the amounts recorded in the income statement and the economic reality of the transaction. In fact, if a lease has escalating rents, cash payments would be inversely related to the amounts recorded as expense in the income statement – low in early years, high in later years.

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do

you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?
Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured? Why or why not?

As previously noted, using an expected outcome technique creates a significant administrative burden and an analysis of various scenarios shows that even major errors in the original estimate do not result in a significant difference and would very rarely warrant "fixing" the lease payments. A "best estimate" approach would be just as accurate or reliable and take less time to prepare. Additionally, we do not think that contingent rentals and term options create a present obligation unless they are virtually certain to occur.

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

When significant uncertainty is added to the initial measurement, it becomes necessary to remeasure assets and liabilities. As noted above, reducing the level of uncertainty in the initial calculation eliminates the need for frequent remeasurement. Again, we believe that the lease term should be based on the non-cancellable lease term, unless the likelihood of renewal is probable (for example, if a bargain purchase renewal option exists).

Furthermore, even a significant change in contingent rentals is unlikely to have much effect on the bottom-line for remeasurement adjustments made annually. Changes in contingent rents would have to be very material before a remeasurement of the entire lease would be justified. As such, we do not believe that contingent rental estimates should be included in the initial measurement and, therefore, would not require remeasurement.

Question 12: Statement of financial position

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease (paragraphs 25 and BC143−BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

To the extent that a right-of-use asset and liability must be recorded in the statement of financial position, separate presentation may be useful if the amounts are relevant and material to the organization's overall financial position. Otherwise, detailed disclosure in the notes would be preferable as it would provide users with information about leasing transactions in one discrete location of the statements and would not clutter the face of the statements. Also, gross reporting of the assets and liabilities under lease transactions may create confusion for readers. This is especially true for lessors who will be required to carry a lease liability – a concept that is not intuitive given the substance of the transaction.

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

Current accounting standards require income from subleases to be reported in the notes to the financial statements. We see no reason to change this practice as it is of interest to only a few financial statement users. We believe such disclosure is adequate to inform readers of subleasing activities.

In addition, we recommend the Boards add an example footnote disclosure in the final ASU related to leases that would incorporate lease and sublease disclosures in a concise, useful format.

Question 13: Income statement

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

We agree with the discussion in paragraph BC146 that amounts related to amortization expense of the right-of-use asset and interest expense on the liability could be sufficiently disclosed in the notes. For NFPs that present natural expenses on the face of the statement of activities, the amounts should be shown as rent or lease expense to the extent that they are material and relevant to understanding the entity's financial performance. For NFPs that present functional expenses on the face of the statement of activities, reporting lease expense separately would render each of the functional expense categories incomplete and would not present the cost of programs, administration, or fundraising expenses. In general, presentation of this information in the notes would actually make the information more useful to readers as it would be aggregated in one discrete location within the financial statements.

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:
(a) identifies and explains the amounts recognized in the financial statements arising from leases; and
(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows? (paragraphs 70−86 and BC168−BC183)? Why or why not? If not, how would you amend the objectives and why?

The business decision to lease equipment or buildings is not any more risky than to buy them with financing, yet the Boards are requiring significantly more disclosure for the lease transaction. All business decisions carry uncertainty. The required disclosures will be burdensome for the entity to produce and for the user of the financial statements to read. Paragraph 71 does not help entities or their auditors determine when disclosures can be reasonably omitted or the level of detail that is required.

While we appreciate the Boards' attempt to prevent lengthy and obscure disclosure as noted in paragraph 71, we nevertheless believe that the typical leasing activities of large, complex organizations such as colleges and universities will require significant amounts of disclosure to comply with the ASU. The proposed disclosures are not scalable for an entity that has hundreds of leases. While the disclosures may be appropriate for entities with one or two applicable transactions or a number of homogeneous transactions, this is not the case for most organizations.

For example, the requirement to provide a narrative disclosure about the options that were recognized as part of the right-of-use asset and those that were not would require a sophisticated system to capture and catalog the relevant data necessary to present this information in the notes. It is unclear how an entity would report this information in a meaningful manner. Boilerplate sentences are often the result, such as, "Many of the entity's leases contain options to renew or terminate the lease. The entity has included these options in the right-to-use asset to the extent it expects to exercise the option." Those boilerplate sentences are not useful.

In addition, we continue to disagree with the Boards' penchant for reconciliation-type disclosures. Disclosures of this type reproduce, albeit on a highly aggregated basis, the entity's general ledger. That level of detail is inappropriate in financial statements and causes the reader to wade through so much detail that the value of the information is significantly diminished. More importantly, we believe that the roll-forward reconciliation disclosure will provide largely redundant information. For example, lease payments and total interest related to leases are proposed in other required disclosures (i.e., paragraphs 26 and 27 and current requirements for disclosure of noncash financing and investing activities). A similar redundancy exists for lessors using the performance obligation method.

We believe that the "maturity disclosures" required by paragraphs 85 and 86, if prepared in a format similar to that generally used for capital and operating leases by lessees today, are more useful than the lease liability reconciliation. As long as the maturity analysis goes beyond ten years to include all future lease payments and then subtracts interest, it should tie to the reported liability accounts. The right-to-use asset will generally be little different than the liability for lease payment, except for very long leases. Initially, the amount reported for a new lease liability will differ from the new right-to-use asset only by any initial direct costs incurred by the lessee. More importantly, it is unclear why there is a requirement to reconcile the beginning and ending balances of a right-to-use asset when there is no requirement to reconcile the beginning and ending balances of other categories of plant, property and equipment.

Question 16

(a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186−BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?
(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

Retrospective disclosure of any kind will be time consuming and costly for highly decentralized organizations with a significant number of leases. We strongly encourage the Boards to allow prospective application of the ASU. As with any new standard, the cost of implementation is a concern for higher education institutions. The effort required to implement accounting standards that were not drafted with them in mind creates a significant resource and financial burden to these institutions, which may ultimately translate into an increased cost of education.

Question 17

Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

We do not agree. As we have noted in the responses to previous questions, the cost in terms of both administrative effort and system enhancements required to implement the standard and support the ongoing accounting would far outweigh the benefits of the information provided to financial statement users. This is particularly true for the plethora of small, individually immaterial leases of photocopiers and the like. It would help if there were a materiality threshold below which lease payments need not be accounted for as described in the ASU. As we noted in our response to Question 1, it seems inconsistent that an item below the organization's capitalization threshold should be required to be recorded on the balance sheet when it is leased, but not when it is purchased.

Question 19

Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

As noted in our responses to previous questions, private company and not-for-profit organizations (including conduit debt obligors) should be exempted from retrospective application (be it full or partial) but should, instead be allowed to adopt the final standard prospectively as leases are entered into or renewed. We also believe that a single footnote disclosure for leases is a better approach than a multitude of separate line items on the face of the financial statements. In particular, leases held as part of endowment or other investment portfolios should have the revenue reported as part of the endowment or investment income. The fact that some portion of the endowment income is from leases is irrelevant to the users of NFP financial statements. However, we would not be averse to disclosure in the notes if the proportion of lease income is material with respect to total endowment income because FASB ASC 958-320-50-1 already requires disclosure of the composition of investment income. We believe that financial statement users would be better served by one detailed note that pulls information together in one place rather than attempting to include too much detail on the face of the financial statements.

In closing, NACUBO continues to be concerned that disclosure requirements that target a particular industry in which a certain transaction type is common affect many others. Because the Boards are reluctant to set industry specific standards, inadequate consideration is given to the impact on NFPs (and other entities). Entities and their auditors are less certain how to consider materiality when there is a disclosure requirement than they are in situations in which there is a recognition requirement. The result is often disclosures that are costly to produce and unnecessary for the user of the financial statements. We recommend that the Boards consider whether there are two levels of required disclosures—one set of disclosures for entities whose lease income (or lease expense) exceeds X% of total revenue (or total expense)—and another set for all other entities.

NACUBO appreciates the opportunity to comment. We hope that the Boards will address our concerns. We look forward to answering any questions the Boards or the staff may have about our response. Please direct your questions to Sue Menditto at 202-861-2542 or sue.menditto@nacubo.org.

Sincerely,

Susan M. Menditto
Director, Accounting Policy