

ABRAHAM E. HASPEL CPA

Comments on the Financial Accounting Standard Board's:

Proposed Accounting Standard Update
Leases (Topic 840) (ED)

I am pleased to submit the following comments in response to the joint proposed standards from the Financial Accounting Standard (FASB), and the International Accounting Standard (IASB) Boards request for comments on the proposed standards listed above. While I generally support the concept of recognizing unrecorded liabilities in the financial statements, I question the amount and usefulness of the liability produced by the right to use model.

I further believe that the question of how to account for all executory contracts should be addressed as part of the part of the conceptual framework and financial statement presentation projects. I realize that the Boards are under tremendous time pressure to complete the project under the Memorandum of Understanding by June 2011 however, because of the scope of this ED additional time should be devoted to integrate this standard within the conceptual framework.

Following are my responses to the questions asked by the Boards

Kindly feel free to contact me if you would like to discuss these comments.

Sincerely

Abraham Haspel

QUESTION 1 LESSEES

Question 1(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?

Question 1(b) Do you agree 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?

Response:

Question 1(a) A qualified yes because I have the following concerns as follows:

- *While I recognize that a lease commitment is a liability that should be reflected on the balance sheet, of concern to me is the amount of the liability reflected on the financial statements. I believe that the amount of the right to use asset and the related liability is based on hypothetical values, which use guesses of contingent rents, lease term renewals and hypothetical incremental interest rates, which do not reflect the lease payable in cash as of the balance sheet date or in the future.*
- *The Boards right-to-use model does not represent the economic substance of a leasing transaction and is inconsistent with the current accounting method for loans. The economic substance of a leasing transaction is that a leased asset is borrowed. Control of the leased asset is transferred to the lessee at the commencement of the lease, and returned to the lessor at the expiration of the lease term; in the same way as loan principal is received at the commencement of a loan and returned to the lender at the maturity date. Rent is payment to the lessor for the use of the asset during its lease term, in the same manner as loan interest, is payment for the use of loan principal. Under current GAAP, a borrower records loan principal as a liability and expenses the interest over the lease term.*

The Boards are proposing that rent, which is the economic equivalent of interest, is in substance split between principal and interest. The principal portion of a lease is the leased asset which is the equivalent of loan principal, and control of which is returned to the lessor at the end of the lease term. The leasing transaction is in substance the economic equivalent of an interest-only loan. The effect of the Exposure Draft's proposed accounting treatment is that at no point is the actual amount of cash payable under the lease ever reported on the balance sheet except, at the expiration date of the lease.

Under existing accounting standards total loan interest payments are not shown as a liability on the balance sheet even though there is an unconditional

requirement to pay that interest at the inception of the loan, as there is with a lease. Both the current and proposed method of accounting for leases rely on conveying important cash flow information via the notes to the financial statements rather than the balance sheet, and in fact total loan interest payable is not reflected in either the balance sheet or the notes to the financial statements. I recommend that the Boards address this inconsistency as part of the conceptual framework project

- *Estimates of future contingent rents and lease renewals are not liabilities unless it is probable that they will occur and therefore should be recognized when the liability is incurred. I do not believe that a lesser standard of “more than likely than not” (greater than 50% chance of occurring) should replace the probability standard (75-80% chance of occurring).*
- *Also there are great uncertainties in estimating lease terms and contingent rents where there are lease options and contingent rents that will be payable in the future. Further, for IFRS users similar guidance concerning contingent rents has not been provided under the existing IFRS literature IAS 17 consequently, practical application of this ED may be more difficult than expected.*
- *It is extremely difficult if not impossible to estimate the incremental borrowing rate of a long-term lease when all other entity debt has shorter terms and may not be collateralized. As an example: what is the incremental borrowing rate for a ninety nine year ground lease? Further, an incremental borrowing rate would be higher for an entity with a poor credit rating, than one with a good credit rating producing for the same lease arrangement, a smaller liability than the entity with the good credit rating. This distortion destroys financial statement comparability and is quite misleading because; both entities have obligations to pay the same fixed amount of cash. If the objective of present valuing future lease payments is recognizing the reduction of the purchasing power of the dollar in the future then why not use an estimated inflation rate rather than the incremental borrowing rate.*
- *I am aware that one of the methods used by major credit rating agencies is to calculate the present value of minimum future rents that are disclosed in the financial statements, using an average borrowing rate, to attempt to treat lease commitments as long term debt in evaluating an entity’s credit worthiness. This appears to be a shortcut in lieu of adequate prospective cash flow information. However, some of the analysts have expressed to me that they have great concern about the use of marginal or incremental rates proposed by the ED, because of the reason cited above, and the lack of comparability that it produces. Further, their present value technique is a financial analysis technique that does not reflect the amount of cash that is actually payable either at the balance sheet date or in the future. Credit analysts and appraisers make many adjustments to financial statements, that are in one way or another attempts to estimate future cash flows.*

- *It would be far more productive to provide as an additional financial statement, a short term cash flow forecasts for the whole entity and possibly a longer term cash flow projection accompanied by the necessary assumptions in the notes to the financial statements. Cash flow forecasts and projections will directly address the financial statements user concerns and eliminate hypothetical present value data that is more complex, costly to administer and serves to frustrate the goal of transparent financial statements. The reporting mechanism for prospective information has been very capably described as part of the AICPA's attest literature and can serve as a guideline to the Boards. I would like to point out that many company's- large and small- currently provide their lenders with short term cash flow forecasts, and develop longer cash projection for internal use, which would probably involve far less work for the accounting community than that imposed by the ED.*

- *Leases that are in substance loans (i.e., finance company acquires the leased asset and leases the asset to the lessee using the implicit interest rate) many times meet the requirements of a capital lease under current standards. The criticism of the current standard is that it created bright line tests that were easily circumnavigated. Two of the criteria: title transferring at the end of the lease, and bargain purchase option are treated under the proposed standard as purchases. The two other criteria: present value of future rentals equal to 90% of the fair value of the asset, and the lease term equal to the 75% of the useful life of the asset, can be replaced; by recognizing that where the lessor does not retain significant risks or benefits associated with an underlying asset, that lease should also be treated as a purchase as well. I feel that lessees can make the determination that a leased assets has very little remaining value, because, they have an intimate knowledge of the asset and its value. We also suggest that loans that have substantial residual guarantees by the lessee be included as purchase criteria as well. I need not remind the Boards that the significant risk and benefit criteria mentioned above is used to differentiate between performance obligation and derecognition models in the proposed leasing standard.*

- *The proposed right of use model is in many ways more complex and difficult to administer than the existing standard because it imposes present value calculations which requires estimates of future contingent payment and renewal options. Under current standards present value calculations are only required for capital lease transactions, contingent rents are recognized when incurred and lease terms are evaluated when it becomes apparent that the lessee would incur a penalty or there is a bargain renewal option etc. is present.*

Question 1(b) A qualified yes subject to my comments to Question 1(a)

Question 2 Lessors

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

(b) Do you agree with the board's proposal for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

© Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC 15)? If not? What approach should be applied to those leases and why?

Response:

Question 2 (a & b) No: I believe that lessor accounting should be divided between real estate rental properties and equipment leases:

- ***Real estate rental properties (RERP)s the Users of RERP financial statements want to see lease income as stated in the lease in the period that the lease income is earned. They do not perceive that the lease is a loan to be paid repaid by the lessee with interest. Users want to compare lease income per square feet to market rents. Real estate leases do not reflect imputed interest they reflect market rents and scheduled rent increases that are supposed to track expected increase in future market rents and operating expenses. The user of a RERP financial statement is primarily interested in the cash flow that the property produces for valuation and financing purposes. The right to receive future rents is perceived as being part of the value of the real estate. Accordingly, I recommend that rental property be reflected at its fair value in the financial statements. I realize that the Boards are considering fair value treatment for companies that have the characteristics of investment companies. I suggest that the scope of that project include all RERPs. This would result in a far more meaningful and relevant presentation and avoid the distortion of rental income on the income statement that would inevitably occur using the "Right to Use " model currently proposed by the Boards.***
- ***Equipment leases: Generally involve leases with imputed interest and substantial residual values are in substance loans and therefore should be accounted for as loans consequently the performance obligation model makes a great deal of sense if the lessor retains exposure to significant risks and uncertainties.***
- ***If the lessor does not retain exposure to significant risks or benefits associated with the underlying asset then he appears to have sold (or surrendered control)***

of the asset and therefore the transaction should be evaluated in light of the proposed Revenue Recognition ED.

Question 3: Short Term Leases:

This exposure draft proposes that a lessee or a lessor may apply the following 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:

- a) At the date of inception of a lease, a lessee that has a short term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64)
- (b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65)

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?

Response:

I agree, however, I suggest that additional guidance be provided to address month-to-month leases where circumstances indicate that the lease may be extended for a substantial period of time. The guidance should address initial and subsequent measurement. Month-to-month leases can commonly be oral or contractual leases that can extend beyond the short term. I think you should be aware that a holding company of a lessee or a commonly held entity can be obligated on a lease, and lease that asset (usually space) to its subsidiary or brother sister company on a month to month basis; and the lessee will not have to show that lease on its balance sheet because the lessee may not be a primary beneficiary.

Definition of a lease:

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1-B4 and BC29-BC-32). This exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, (B!) and BC59-BC-62) and on distinguishing a lease from a service contract (paragraphs B1-B4 and BC29-BC32).

Question 4

- a) Do you agree that a lease is defined appropriately?
- b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or Why Not? If not, what alternative criteria would you propose and why?
- c) Do you think that the guidance in paragraphs B1 and B4 for distinguishing leases from service contracts is sufficient? Why or Why Not? If not, what additional guidance is necessary and why?

Response:

a. Yes

b, Yes but should not include leases that the lessor retains no significant risk and reward in the leased asset at the expiration of the lease.

c. Yes

Scope:

Question 5: Scope exclusions

This exposure draft proposes that a lessee or lessor should apply the proposed guidance to all leases, including leases of right-of-use assets in a sublease, except leases of biological assets and leases to explore 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?

Response:

I agree. However, the Boards should exclude assets that are valued at their fair value.

Question 6: Contracts that contain service components and lease components

This exposure draft proposes that lessees and lessors should apply the guidance proposed in Accounting Standards Update Revenue Recognition (Topic 605): *Revenue Recognition 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 is not distinct:

- (a) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

- (b) The IASB proposes that:
- (i) a lessee should apply the lease accounting requirements to the combined contract.
 - (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
 - (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.

Do you agree with either approach to accounting for leases that contain a 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?

Response:

I agree with the IASB approach because it will be easier to apply.

Question 7: Purchase options

This exposure draft proposes that a lease contract should be considered terminated when an option to purchase the underlying asset is exercised. Thus a contract should be accounted for as a purchase. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

Response:

I agree because waiting until the option is exercised eliminates any uncertainty that option will be exercised.

Measurement

This exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

- (a) assumes 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 (paragraphs 13, 34, 51, B16-20 and BC114-BC120).

(b) includes in the lease payments contingent rentals and expected payments under term options penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121-131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual guarantees that can be reliably measured.

© is updated 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 (paragraphs 17, 39, 56 and BC 132-BC 135).

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?

Response:

I do not agree: I feel that the lessee or lessor should choose a lease term that is probably going to be selected based on qualitative not quantitative factors. I believe that the factors currently in use i.e., bargain renewal option, nonrenewal penalties etc. (AC 840) should continue to be applied because, the most likely than not test substantially increases the degree of uncertainty in the estimate and comparability of financial statements. Lessors and lessees of the same property are likely to estimate different lease terms. The lessor has far less information about a lessee's plans than the lessee. It also requires the recognition of a liability that the lessee/lessor is not legally obligated for.

As you may be aware a multichain retail lessee will always be renting space regardless of whether renewal options are included in a lease. In fact financial analysts take that into consideration in their analysis and assume continuous leasing throughout the life of a multichain retail company. The analysts are looking for cash flow information, and that argues for entity cash flow forecasts/projections. The balance sheet should be the starting point of a cash flow forecast. Consequently, present valuing a liability does not provide useful cash flow information.

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?

Response:

I do not agree: We believe that expected outcome method will never be realized because of the averaging of outcomes of various probabilities. I believe that payments should be recognized in the financial statements by lessees and lessors when it is probable that those events will occur and they can be reliably measured.

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 these payments or in the right to receive lease payments arising from changes in the lease term or contingent payments including expected 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 reassessment and why?

Response:

I agree subject to the fact that remeasurement should occur only when it is probable that events will occur that warrant remeasurement.

Sale and leaseback

This exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions of a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales or leases. If a contract represents a sale of the underlying asset the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66-67, B31 and BC160-BC167).

Response:

I agree this is a substantial improvement over current practice

Presentation

This exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25-27,42-45, +60-63 and BC 142-BC 159).

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 BC143-145)? 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?

Response:

I agree

b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totaling to a net lease asset or lease liability (paragraphs 42, BC 148 and BC 149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

Response:

I disagree. As previously stated decisions on the accounting for Real Estate Rental Properties (RERP) should reflect the fair value of the leased asset. In any event the netting of assets and liabilities would not be meaningful to the users of the financial statements.

c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC 154 and BC 155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

Response:

I agree

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 BC 156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

Response:

I disagree I feel that the note should be used to disclose the relevant information with a net number in the statement of financial position. However, the financial statement issuer should have the option of displaying this information on the balance sheet in the manner described in the ED.

Question 13: Income statement

Do you think that lessees and lessors should present lease income and lease expense differently from other income and expense in the income statement (paragraphs 26,44,61,62, BC146, BC 151, BC 152, BC 157 and BC 158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

Response:

No the financial statements are confusing enough no purpose is served by increasing their complexity.

Question 14: Statement of cash flows:

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraph 27, 45, 63, BC 147, BC 153 and BC 159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not? If not, do you think a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Response:

No the financial statements are confusing enough no purpose is served by increasing their complexity. Notes to the financial statements should be used when necessary.

Disclosure:

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 BC 168-BC183? Why or why not? If not how would you amend the objectives and why?

Response to a) & b) above-

Yes I agree however, the estimates of future contingent payments can be enormously misleading as previously discussed in my response Further, that paragraph 71 allows the user to decide which disclosures should be aggregated or disaggregated. This level of discretion on the part of the issuer of the financial statements can create a lack of comparability and leave open the possibility for abuse. I recommend that some kind of guidelines or examples be provided.

Transition:

Question 16

(a) This exposure draft proposes that lessees and lessors should recognize and measure outstanding leases as of the date of initial obligation 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?

© Are there any other transitional issues that the boards need to consider? If yes, which ones and why?

Response:

(a) Subject to the previous comments made regarding the right to use model and the use of the incremental borrowing rate we agree with the simplified retrospective approach.

(b) Do not agree because of the reasons cited in the basis for conclusions in the ED

© *None that we think of*

Other Comments:

Question 18

Do you have any other comments on the proposals?

Response:

Yes:

- *The examples of initial direct costs the lease does not include leasehold improvements. Leasehold improvements are a cost of acquiring a lease either by the lessee or the lessor and should be amortized over the shorter of the economic useful life or, the term of the lease.*
- *Lease incentives have not been addressed- how under the right to use model how are they to be accounted for?*
- *Does the Boards use of the term “Contingent Rents” conform to the current definition of contingent rents in ASC 840? Or, does it include executory costs?*

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?

Response:

Yes:

As we have previously stated we have grave reservations about the right to use model and the use of incremental borrowing rates. We feel that it introduces a level complexity and opaqueness rather than transparency and simplicity. It is also far more complex and costly to administer, then the existing method of accounting for leases. Most private entities issue financial statements to relatively few users, chief among them lenders. The private companies provide their lenders a great deal of information not included in the traditional financial statements such as, cash flow forecasts, rent rolls, aged accounts receivable schedules, debt covenant calculations, etc. on an interim basis. It will be burdensome for private entities to implement and maintain this complex right to use model. We strongly recommend that the Boards consider the actual information needs of the users of the financial statements of small private companies rather than subject them to a one size fits all solution, which will only confound rather than enlighten the users of the financial statements.

