# David L Wagner, CPA 635 S Maple Rd Ann Arbor, MI 48106

Sept 29, 2010

Technical Director File Reference 1850-100

I appreciate the opportunity to comment on the proposed lease accounting standards. The final decisions will have far reaching effects on costs of compliance as well as quality of information reporting. Therefore, consider well the comments you receive on this ED.

#### Question 1

- I agree with the basic principle that there should be some balance sheet recognition for major commitments such as long term leases for facilities and/or equipment, in order to present a more accurate depiction of an entity's obligations for future cash flows.

#### Question 3

The requirement to set up an asset and related liability for short term leases is likely to result in costs of tracking & accounting for such leased items that exceed any benefit gained. It is also likely to cause many entities to be in default of loan covenants by adding more short term debt, thus deteriorating the current ratio. Moreover, the ED par. 64 is not clear what other alternative(s) are available to "elect." The last sentence of the paragraph appears to contradict the liability/asset recognition method by saying "...shall recognize lease payments in the income statement..." This implies more of a cash method as is currently the widespread practice. If the ED means to require some form of capitalization, then the proper phrase would be "...amortize the asset..." The wording appears to authorize the continued use of a cash method of accounting for short term leases, if not require it by the use of "shall recognize lease payments..." I urge the Boards to drop the requirement for short term leases and allow the lessee to "recognize" lease payments in the income statement" without setting up an asset and liability. Although dropping the requirement entirely is preferable, at least consider a *de minimis* exception. As currently written, a short term lease of a month (or even less) that spans a reporting date would have to be recorded. Surely there must be a point where the Boards would agree the costs to analyze, track, and record these leases has crossed the line to the negative side of the cost/benefit spectrum?

Non-public entities often have inexperienced and/or untrained individuals responsible for recording accounting transactions in some sort of basic accounting software. These duties are often combined with other duties normally filled by someone else in order to maintain separation of duties. The bookkeeper may also bill customers and record bills and pay vendors. Keeping track of short term leases and making the necessary accounting entries will likely be beyond their abilities without additional training and ongoing supervision. Their supervisor is often the owner of the entity, and may know even less about accounting, and have less time for supervision. And even if the bookkeeper

can be trained, the record keeping time required may be burdensome in view of their other responsibilities. For these reasons, if the short term lease provisions are kept, non-public entities should be exempt and allowed to record expense as payments are made.

#### **Ouestion 8**

- The lease term should not include options. Only the base lease period should be accounted for as an asset with a liability. The method suggested by the ED to calculate the asset and liability involves estimating the probability for each possible term for each lease. The cost of implementing and maintaining this method will far outweigh the benefits, particularly for large entities with hundreds (or possibly thousands) of leases. Whole new systems of internal control, data collection processes, and software development will be required. Estimating a probability will introduce much subjectivity into the process, thereby decreasing the comparability and usefulness of the resulting information. And finally, there would be considerable added cost to audit the information.

Non-public entities often have no personnel with the skills and time to perform these calculations. This will result in adding costs of consulting with an outside CPA or other advisor for assistance, in order to generate information that is highly likely to be of no use to either management or the users of the entity's statements.

Due to the potentially high cost and low utility of the information, the provision to record the asset and liability using option periods should be dropped. If the provision is kept, non-public entities should be exempt.

### **Ouestion 9**

- The following discussion centers mostly around retail facilities with contingent rentals, I believe most contingent rentals should be accounted for as charges to current operations, and not subject to the new standard. I think the Boards are stretching the definition of liability in this case. Although there is a present obligation to pay a rental, the contingent part does not become an obligation until some future event occurs. The contingent part of the rental is therefore not a present obligation, and in fact may never become an obligation.

In par. BC123, the Boards state "... the liability to pay contingent rentals and the right to receive lease payments exist at the date of inception of the lease. Such contingent rentals meet the definition of a liability...and an asset...It is only the amount to be paid that is uncertain."

To quote from the most recent decisions of the Boards' Conceptual Framework Update project regarding liabilities: "A liability of an entity is a <u>present</u> economic obligation for which the entity is the obligor." To continue with the Boards' amplification: "Present (italics in original) means that <u>on the date</u> of the financial statements both the economic obligation exists and the entity is the obligor." And "An economic obligation is an <u>unconditional</u> promise or other requirement to provide or forgo economic resources, including through risk protection." (<u>all emphasis mine</u>)

I don't see by what stretch of the imagination a contingent rental can be considered to meet these conditions. A contingent rental is not a PRESENT obligation- it only arises if a specified future event occurs. The contingent economic obligation does not, therefore, exist ON THE DATE of the financial statements. And finally, since the rents are CONTINGENT on a FUTURE EVENT, they are NOT UNCONDITIONAL.

The Boards are implicitly assuming that the future sales or other trigger upon which the contingent rents are based are certain to occur, a characteristic that is banned in other financial prognostications. Additionally, the sales levels specified in a typical retail contingent lease are not always totally within the control of the lessee. In shopping malls for example, sales are often dependent on total traffic in the mall. This in turn is dependent on the quality of the overall facilities and the vendors that mall management is able to attract to lease space in the mall. This element of the lessor's responsibility may be a factor in the contingent portion of the rent. Part of the risk is retained by the lessor; it should not be shown on the lessee's balance sheet as a liability for contingent rentals.

The Boards state in the discussion on Stand Ready Obligations in the aforementioned Framework, "it can be helpful to assess if there is an accompanying unconditional obligation that presently requires the entity to perform." While this could be stretched to bring contingent rentals into the definition, I believe it should also be considered that the lessor's retention of risk in its responsibility to maintain the quality of the facilities and vendor roster is an unconditional obligation it must fulfill in order to receive the contingent rentals. Overall then, since the lessor is possibly key to realization of the contingent rentals, they should not be included as part of the initial rental obligation.

In addition to the questionable theory used in BC123, the Boards' requirement would introduce considerable complexity in application. In the case of a retail sales contingent lease, how would an entity forecast sales for a lease of 15-20 years to come to a reasonable amount for the contingent portion? How does an entity determine its distribution of expected outcomes? How could such a guess (for that is what it will amount to) be audited? There would also be the increased possibility of subjective assessments of key factors, which would then *decrease* rather than increase comparability. The cost of both the application and the auditing will be enormous in some cases. It would be much more conceptually and operationally sound to disclose the basis for the contingent rents and let users draw their own conclusions.

The Boards state "...it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible cash flows." I see no evidence that this has been field tested. In fact, it is a change of mind for FASB, which had stated in the discussion paper that it favored the most likely outcome approach. It appears the IASB preference has been adopted without any practical consideration as to whether it is operational. Instead, it has been added almost as an afterthought, "...an expected outcome technique could be costly." The Boards should consider that in these tough economic times, an entity's resources may be better used to develop the business and create jobs rather than comply with an accounting pronouncement of dubious utility.

In BC125, I understand the Boards' concern that not including contingent rentals could lead to opportunities to structure leases to avoid recognition. There are very few

instances in which a lessor would accept the possibility of receiving no rent at all, or an amount significantly below what they could get from another tenant. This could be dealt with by providing a presumption that a base rent must be reasonable in relation to the local market and guidance that a value should be calculated based on some significant relationship to the value of the facility in cost per square foot or some other objective measure. I don't believe implementation of such guidance would be as complex, or at least would not affect as broad a constituency, as the requirement to recognize the contingent rents as proposed by the Boards.

I can hardly believe I'm reading a question, "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?" What earthly good is a number in a financial statement if it's not reliably measured? How does an auditor sign off on an estimate that management cannot provide evidence of reliability? So yes, any calculated amounts should be required to be reliably measured. But see above for my disagreement with including any contingent payments or option periods at all.

In any event, if the final decision is to confirm the boards' preliminary views, I believe the FASB's view on measurement should be adopted (par 7.21 of the Discussion Paper). The reasons cited in par 7.16 are controlling. Measuring the probability of potentially hundreds (or more) leases in a large enterprise would be too costly and fraught with accuracy problems, and using the measurement outcome that cannot be paid (DP par 16(c)) just makes no sense.

Non-public entities generally do not have personnel with the time or skills to perform the analyses necessary to develop then numbers needed to record the assets and liabilities. Moreover, the generally limited number and type of users renders the value of benefits much less than the cost to produce them.

### Question 10

The only events requiring remeasurement should be exercise of a renewal option or significant change in a residual value guarantee. Neither contingent payments nor renewal options should affect the original measurement, and therefore need not be accounted for when later changed. The exercise of an option changes the actual term and should be measured and accounted for, and the actual incurrence of contingent payments obviously affects cash flow and should be accounted for. Options and contingent payments should always be adequately disclosed in the notes.

### Questions 12-14

- I believe entities should have the choice to report the information on lease liabilities and assets vs. owned assets and related liabilities either on the statement of financial position or in the notes. This will allow an entity to choose the most appropriate place based on the relative importance and materiality of the leasing activity(ies) and how much other information is already presented in each place. The same should be true for the income statement items and statement of cash flows when deciding whether to show as separate line items or show detail in notes.

## Question 15

- I believe the proposed reconciliation is going too far with disclosure. It sounds like another table would be required, and there are already several tables required by the disclosure literature. The Boards need to keep in mind that the disclosures on each individual project are often fine in and of themselves, but the cumulative effect is starting to make the statements and notes so packed with information that they are becoming unwieldy and difficult to read. I suggest that if an entity uses this reconciliation, they would not be required to show the detail in Questions 12-14 in the body of the statements or in any other form. Disclosure of the detail in Q 12-14 or the reconciliation also would seem sufficient to identify and explain amounts recognized as arising from leases.

The description of how leases may affect the amount, timing and uncertainty of future cash flows is a good place for options and contingent payments, rather than on the face of the statements. The currently required disclosure of lease obligations over the next 5 years and a total for after 5 years also fits here (as in par. 85). Complex, long winded explanations are costly to develop and difficult to understand- the best option for entities and financial statement users alike is to keep it as simple as possible.

#### Question 16

- Leases previously classified as capital under Topic 840 should not require an adjustment for options, contingencies, etc., since these features should not be part of initial measurement as explained above. The cost of retro-identifying short term leases to accumulate a liability could be significantly in excess of any benefit. Since the information was not required to be tracked it likely wasn't, and payments are expensed as made. Whether the Boards decides to finalize the requirement in par. 64 as is or not, existing short-term leases should be optionally excluded from measurement and allowed to flow through operations as before. There won't be more than an 11 month delay in any case. A statement explaining the existence of these leases and that their effect is not determined could be included in the explanation required above.

## Question 17

I partly agree with the Boards' assessment of costs and benefits. My objections are noted above. I believe, however, there is one potential cost that has been left out. What of the effect of recording of significant amounts of debt on entities' balance sheets? Many of these entities will have debt covenants that include liquidity and debt-to-equity provisions. This proposed statement will put hundreds (or more) of these entities in violation of their covenants. While it is possible that a knowledgeable loan officer has already considered the entity's off-balance-sheet leases in formulating the covenants, it is far from sure that a violation will be forgiven in today's climate, particularly if the debtor was already only marginally meeting the covenants and the bank is more interested in protecting its recovery options than making allowances for the effect of new accounting standards that have overnight made the entity into a violator. Thus the Boards put at risk an unknown number of jobs at a time when the global economy is struggling to create jobs for millions of unemployed. Have the Boards considered the cost of possibly creating another crisis of entities being unable to find sufficient financing to stay in business, and the resultant cost in both financial and human terms? Would we recover if such a scenario actually occurred? Probably. Would it take still longer than it already

has to restore affected economies to a proper balance of employment? Is it worth the risk?

# Question 18

Issues missing or not clearly addressed:

From the viewpoint of the lessee:

- Does the scope of the proposed standard include day-rentals, such as a construction firm that rents equipment on per-day basis when needed? Example: a small earth mover is required for certain jobs, and is only rented as needed.
- How would a month-to-month lease be measured and recorded? Example: a small business uses its facilities and/or equipment owned by an unrelated party on a month-to-month basis. How would the answer change if the party were a related party? How would a related party be defined?

#### Question 19

I have already mentioned some areas where relief for non-public entities is needed. To facilitate your analysis I will list them here. See the respective Questions above for reasons.

Question 3- relief from requirement to record short term leases.

Question 8- relief from any calculation regarding accounting for options. The requirement to include option periods should be dropped, at

The requirement to include option periods should be dropped, at least for non-public entities.

Question 9- relief from inclusion of contingent rentals.

The two main broad principles I believe the Boards should keep in mind when considering application to non-public entities are the limited abilities and/or availability of staff, and the number and nature of users. Like it or not, non-public entities use people with little or no accounting knowledge to do the accounting. They simply are not capable of performing some of the analyses required by complex provisions such as these, and the information may or may not be looked at by a CPA prior to issuance. The consequences of forcing compliance and risking all sorts of errors seem to me to be much lower than those of simplified requirements focusing more on disclosure. The users are typically banks and insurance companies and have far more capacity to formulate the numbers they need using the adequate disclosures. Additionally, the closeness of the user to the source of the information should be utilized to get information not normally available to users of public entity financial statements. This mitigates the need for such extensive accounting recognition requirements. The requirements generate costs with little to no benefit.

I hope the Boards find some useful information in the foregoing to add to their analyses. Thank you once again for the opportunity to comment.

David L. Wagner, CPA