Colleagues,

Thank you for the opportunity to critique Leases -840 {Ref. 1850-100}. Details follow.

Background

The new rules would have the lessee recognize a right to use as an asset with a concurrent liability to make lease payments. The lessor would have the right to receive lease payments. Depending upon exposure, there would be recognition as follows:
(a) a recognition of the lease liability while continuing to recognize the asset (performance obligation approach )
(b) derecognition of the rights transferred to the lessee and recognizing the residual asset at the end of the lease term.

There would be no separate approach for leveraged leases.
The lessor recognizes the underlying asset and right to receive the leased payments and accompanying lease liabilities under the contract. If the lessor does not retain exposure to significant risks and benefits of the underlying asset, the lease would be accounted for as a capital lease. i.e. manufacturer/dealer leases
There would be a change in the right to receive lease payments, as well as lease income and the measurement of residual assets.

The lessor satisfies the lease liability at the commencement of the lease by delivery of the right to use an asset to the lessee and recognizing lease income representing the sale of the right to use the underlying asset for a predefined period of time.

Existing operating leases, signed prior to the implementation of Leases 840, will require reclassification as capital leases accounted for on the balance sheet. Real estate businesses must consider the effect that existing and planned leases will have on financial statements once the new lease rules are implemented. Operating lease obligations can represent a greater liability than all balance sheet assets combined; and so, lease reclassification can change the entity balance sheet significantly.

Critique:
Questions 1, 2, 4, 5, 7, and 11-15 may be answered in the affirmative. There are problems in implementation as discussed below.

The impact of recording these lease obligations on the balance sheet can have cascading effects. For instance, businesses may need to re-write or re-negotiate their loan covenants to encompass restated financial statements. Finance ratios used to evaluate business creditworthiness may be negatively impacted, as well as the restatement of a lessee's financial statement. Implementation of these changes may result in a lower equity balance, as well as changes to financial accounting ratios and ratios employed by professional investment analysts, brokers and financial advisers. (Questions 3, 8, 10, 12)

The conceptual basis for lease accounting would evolve from "the transfer of substantially all the benefits and risks of ownership" to recognizing the "right to use" an asset and segmentation of assets (and related liabilities) between the contractual parties. Thus, lease agreements may become more complex and some tenants may have a significant incentive to seek out shorter term lease contracts. Leasing of computer equipment and facilities may be impacted adversely because the evolution of computer technology is changing at a greater pace and longer term contracts may become highly problematic. (Questions 1, 2, 4, 5, 7)

For instance, spintronics methodologies and techniques are aimed at employing electrons and electron pathways for data management instead of the traditional machine language methodologies. Cloud computing is another major technology on the horizon, as is biotechnology in computing. These new developmental stage technologies may render longer term lease commitments less valuable and technologically relevant when contrasted to the power of new computing in the not too distant future. The "Artificial Sun" which uses fusion power and virtual power may render many existing power systems technologically obsolete and irrelevant in the intermediate term. In addition, the "Artificial Sun" could make desalination plants less costly; thereby, impacting the current high cost systems and processes adversely (Question 8, 10, 18)

The shorter term leases create financing issues for owner (lessors) and investors prefer longer term leases to enhance the predictability of investment returns. Landowners and landlords may need to secure financing for purchase or refinancing to anticipate these new changes. (Question 3, 10)

The accounting change will increase the paperwork and compliance burden for reporting entities. Separate disclosure of leased assets, liabilities, income, expense and cash flow may be in the interest of investors when the amounts are material to the financial statements. Materiality is defined as > 3 - 5% of the applicable account balance. (12-15, 18)

The leasing premium for single tenant buildings may evaporate as a consequence of the implementation of the new rules. The lessee may have a greater compliance burden when leases have a greater deferred tax element. There will be balance sheet implications, as well as more detailed financial statement comparative analyses and disclosure. Supplemental SEC disclosure will be required in all likelihood to clarify the impact of the new rules for investors and other strategic financial constituencies. Portions of the Uniform Commercial Code may require reworking or clarification. (Questions 12 - 15, 18)

Lessees will come to appreciate that the new rules take away the off balance sheet benefits of the past. Consequently, leasing may become a less desired option in certain cases depending upon the design and implementation of the lease and the accompanying contract.