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Proposed Accounting Standards Update (Revised)
Leases (Topic 842) | a revision of the 2010 proposed
FASB Accounting Standards Update, *Leases (Topic 840)*

Dear FASB:

Having written extensive comments on the 2009 preliminary views document (50+ pages) and the 2010 exposure draft (another 70+ pages), it is unfortunate that the deadline on the current version slipped my mind. So I apologize that these comments will be a bit late. I assume there is no need to apologize for the fact that the comments are much shorter! While late, I'm sending the comments anyway because I want to congratulate both FASB and IASB for the major improvements contained in this latest version.

Despite the relatively "negative press" I've seen recently in various professional newsletters, the new version has taken out a number of complexities including most contingent rent estimates and estimated lease term (both of which would frequently require extensive revisions to prior treatment of a lease). The attempt to distinguish real estate type leases from other leases is, to my mind, better than the two variations of lessee accounting in the earlier version. Even with the simplifications, the revised standard achieves the goal of getting most leases onto the balance sheet. No standard is ever perfect and there may be issues that arise in implementation but I believe such issues will be at the margins and can be addressed through existing and planned FASB procedures as the standard goes into effect.

Specific Questions

Question 1: Identifying a Lease

Do you agree with the definition of a lease and the proposed requirements in paragraphs 842-10-15-2 through 15-16 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

The definition seems workable to me.

Question 2: Lessee Accounting

Do you agree that the recognition, measurement, and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

I agree there are two basically different types of leases and a lease that consumes more than an insignificant part of the economic benefits of the underlying asset is different from one that does consume a significant part of the economic benefits. Accordingly, it makes sense to have two different categories of leases. However, I suspect there will be application and implementation problems with the Type A and Type B dichotomy, particularly given the exceptions and overrides in paragraphs **842-10-25-8** through **842-10-25-10**.

The underlying rationale is to distinguish equipment-type leases from those related to land and building (“property”). When I think of the existing complexities of accounting for real estate leases (something subject to numerous amendments since FASB 13 was first issued), I worry that similar complexities will arise for Type A and B leases. I assume that **842-10-25-10** is intended to avoid such problems by ignoring the life of the underlying land when the lease is for a building or a portion of a building. Why not add that a lease for land only should always be classified as a Type B lease? After all, from a human perspective (rather than some geological or cosmic perspective), land has an indefinite life (if not infinite). Even large numbers divided by infinity give rise to a nil percentage of useful life. Yes, global warming could inundate large portions of the continent at some future date and volcanoes could erupt at any moment and make land useless for long periods of time. However, I’m not sure that accountants and auditors need to get into the business of estimating the probabilities of various natural disasters to determine a “useful life” of land!

Another potential problem with **842-10-25-10** is that the building may be incidental to the value of the lease, particularly in cases of very long leases where the lessee may be expected to replace or make major renovations to the building(s) on the land over the course of the lease term.

Perhaps a different narrative distinction might be useful: For example, if land is a substantial part of the value of a leased asset, it is automatically a Type B lease. If the value of the land is relatively inconsequential, the lease should be classified as Type A or Type B based on the criteria in **842-10-25-7**.

Question 3: Lessor Accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

See my comments for question 2. For lessors, there is an additional issue for any long-term leases involving property (real estate). The future value of the underlying land may well exceed the initial fair value of the leased property – especially in certain downtown locations, “view” property and the like. Accordingly, I think that it is particularly important that lessors consider all leases involving land as Type B. My rationale includes the inherent problems in estimating the residual values of a lease. In my lease classification projects (intermediate accounting courses), a substantial estimated residual value for land (or any other residual asset) almost always caused the lease to fail to meet the finance lease criteria. But more importantly, the residual value estimates become increasingly unreliable with increasing length of lease term. Economic conditions can make for major decreases as well as increases in the value of real estate. If all property leases (for lessors) are treated as Type B, the lessor will evaluate the underlying assets for impairment in accordance with other existing guidance and, I believe, this will be better and easier (less complex) than continual evaluation of the residual values of real estate.

Question 4: Classification of Leases

Do you agree that the principle on the lessee’s expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 842-10-25-5 through 25-8, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

I think I answered this question as part of my answers to Questions 2 & 3. I suggest that land has a more pervasive impact on lessor leases than what I get out of the paragraphs mentioned in the question. Therefore, lessors should account for any lease that includes land as a Type B lease, with the property included in Land, buildings and equipment on the balance sheet.

Question 5: Lease Term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

The new guidance requires far more on professional judgment than what US preparers have been using since the 1970s so there will undoubtedly be implementation issues from preparers who are used to having bright-line rules. That said, the description of factors to consider in determination of the lease term would seem to cover most of the issues for which we currently have bright-line rules as well as additional factors currently covered by IASB (e.g., specialized nature of assets). I think preparers, auditors, and users can become accustomed to the new approach and, as long as auditors are on their toes, classification and measurement by management should not be able to stray too far from what other “reasonable” parties would conclude.

In addition, I doubt that we will be overly troubled by misclassification of leases by lessees since the accounting treatment for both types of leases requires recognition of a lease liability. The possibility of misclassification is more problematic for lessors since the accounting treatments are quite different. Please consider carefully the complications of evaluating residual values of real estate when it would be easier and less complex for both users and preparers to classify all

real estate leases as Type B. See my comments on Question 2 and particularly on Question 3 above.

Question 6: Variable Lease Payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

This approach is consistent with current US GAAP and much simpler to apply than the previous exposure draft. I concur with the Boards' decision. As illustrated in my earlier comment letter, estimating and re-estimating lease payment (for other reasons like contingent rentals based on a percentage of sales) would generally not have a material impact on any one period or on financial position overall. In such a case, a lower level of complexity results in lower preparation costs with little or no loss of utility for financial statement users.

Question 7: Transition

Subparagraphs 842-10-65-1(b) through (h) and (k) through (y) state that a lessee and a lessor would recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Transition will be challenging for entities with many operating leases, regardless of the exposure draft's relaxation of some of the new rules for existing leases (like ignoring initial direct costs). I didn't notice any particular relaxation of standards for the choice of interest rates – that might be helpful if not already provided for public companies. I know that nonpublic companies will be allowed to use a risk-free rate (which in the current low interest rate environment will give everyone bigger liabilities and right of use assets). The Boards might consider a similar option for public companies or at least permit the use of a single incremental borrowing rate regardless of the nature of the leased asset but based on the average remaining length of existing operating leases. For nonpublic companies, a comparable "relief" would be the option to use the risk free rate appropriate for the average remaining lease term (from "earliest period presented" to end of lease) for all existing operating leases. I doubt the distortion would be significant and it would work its way off the books within a few years.

Are there any additional transition issues the Boards should consider? If yes, what are they and why?

Yes. Why not make the right of use asset computations less onerous by having the "earliest period presented" date count as the commencement date of everything that was previously considered an operating lease? This might be called a 'fresh start' approach. If not acceptable for public companies, I imagine nonpublic companies and not-for-profit entities would be grateful for the additional relief.

Question 8: Disclosure

Paragraphs 842-10-50-1, 842-20-50-1 through 50-10, and 842-30-50-1 through 50-13 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments, reconciliations of amounts recognized in the statement of financial position, and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

Generally, I agree with the disclosure requirements. In particular, I was pleased to find that our current disclosures of lease cash flows for at least five years will still be required. This is important information for financial statement users who would like to apply a different model (or

an older model) of analysis to the lease information. However, I would prefer that the FASB specify a tabular display. Had there been an example in the “55” section, I would have been more quickly able to assure myself that we were not losing information available under current GAAP! It works the same way for someone reading through the notes to financial statements. I much prefer tabular disclosures of the upcoming debt service payments too. I dislike having to hunt through long narrative paragraphs to find an obscure series of five or so numerals. I will admit that this tabular disclosure is more important when leases (or debt service, pension funding, etc.) are substantial with respect to overall financial position. So perhaps this can be addressed as part of the disclosure framework project. On the other hand, financial statement users may want to decide if the information is important for themselves and that, again, leads me to suggest the illustration of (if not a requirement for) a tabular display of future cash flows related to leases.

Question 9: Nonpublic Entities (FASB Only)

To strive for a reasonable balance between the costs and benefits of information, the FASB decided to provide the following specified reliefs for nonpublic entities:

1. To permit a nonpublic entity to make an accounting policy election to use a risk-free discount rate to measure the lease liability. If an entity elects to use a risk-free discount rate, that fact should be disclosed.
2. To exempt a nonpublic entity from the requirement to provide a reconciliation of the opening and closing balance of the lease liability.

Will these specified reliefs for nonpublic entities help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements? If not, what changes do you propose and why?

The relief for nonpublic companies is appropriate and I suggested some other relief in my answer to Question 7 on transition.

With respect to the roll-forward disclosures for all lease liabilities, I’m not sure whether nonpublic financial statement users will be harmed because we are not accustomed to seeing this sort of roll-forward account for any company. In fact, current lease disclosures are primarily future-looking (cash flows in each of next five years). At a later date, when users are accustomed to having the roll-forwards in public company financial statements, there could arise a user demand for similar information from not-for-profit financial statements (although I think it would come from creditors like bondholders rather than donors). In my opinion, most donors are unlikely to study the notes at that level of detail. Instead, they assume the auditors will have assured an appropriate and reliable presentation on the face of the financial statements.

Related Party Leases (FASB Only)

The FASB decided that the recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties based on the legally enforceable terms and conditions of the lease, acknowledging that some related party transactions are not documented and/or the terms and conditions are not at arm’s length. In addition, lessees and lessors would be required to apply the disclosure requirements for related party transactions in Topic 850, Related Party Disclosures. Under existing U.S. GAAP, entities are required to account for leases with related parties on the basis of their economic substance, which may be difficult when there are no legally enforceable terms and conditions of the agreement.

Question 10: (FASB Only)

Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases (for example, to require the lease to be accounted for based on the economic substance of the lease rather than the legally enforceable terms and conditions)? If not, what different recognition and measurement requirements do you propose and why?

Related party transactions are always suspect because they are not at arm's length and may be entered into for nefarious reasons (or at least with an intent to cook the books in a way that will make operations or financial position look better). The fact that there are legally enforceable terms does not negate the opportunity to distort financial position. My only comfort is that the new standards make it much harder to obtain off-balance sheet financing! I think this is an area where we will have to wait and see whether related party leases become less prevalent or at least whether the standards have actually lowered management's ability to distort the economic substance of the arrangements. Disclosure of the existence and rationale for related party leases thus remains important.

Question 11: (FASB Only)

Do you agree that it is not necessary to provide additional disclosures (beyond those required by Topic 850) for related party leases? If not, what additional disclosure requirements would you propose and why?

See my response to Question 10. Disclosure in accordance with Topic 850 may not be sufficient but it is hard to answer that question before we see the impact of the new lease standards.

Problem with the Codification (?)

According to the revised exposure draft there is a presumption that property (real estate) leases are Type B leases:

This revised Exposure Draft would require an entity to apply that consumption principle by **presuming that leases of property are Type B leases** and leases of assets other than property are Type A leases, unless specified classification criteria are met. Those classification criteria are different for leases of property and leases of assets other than property to reflect the different natures of property (which often embeds a land element) and assets other than property.

That sounds good but when I get to the description of the two types of leases in 842-10-25-5, the codification doesn't seem to mention any such presumption. I see that when something is property it is normally Type B but there are caveats. Likewise, something that isn't property will probably be Type A, but again there are caveats. If this truly is a presumption, shouldn't that be clearer in the language of the ASC? To me, just reading the descriptions, I would feel like I had to test each lease against the caveats (and that to me is different than a presumption). Maybe it could be worded differently so that the classification would be more automatic – we would check for possible exceptions only when {something or other} exists. Or maybe the 'check the caveats for every lease' is part of the intended decision process and it is the summary that is misleading. Am I just being too picky? I am one of those who find the codification sometimes confusing because it is so segmented. This does make it easy to find the list of disclosures, for example, but sometimes it makes the overall process less than obvious. Maybe the new ASC section 842 needs a flow chart for the lease classification decision. I remember the spiral booklet on lease flowcharts that FASB produced long ago -- it involved pieces of paper that folded out and out and out to a length of two or more feet! At least with the ASC, length of flowchart is not such a big issue!

Ineffective disclosure requirements

I want to take this opportunity to reiterate one of the problems standard setters face in specifying required disclosures. Proposed sections of the ASC 842-20-50-3 (lessee) and 842-30-50-3 (lessor) both specify a list of items that, most often, result in a single paragraph of vague descriptions that are of very little use to financial statement readers. If an entity has one or two leases or even a half dozen, the disclosures might be useful (assuming some or all of the leases had a substantial impact on financial position). Once the number of leases becomes dozens or hundreds or even thousands, a paragraph that says “Some leases contain purchase options, variable lease payments” is not particularly meaningful. In fact it becomes merely a statement about leasing in general. If there are many leases, one cannot possibly disclose enough information about every individual lease contract to permit the user to independently verify lease liabilities or right of use assets. I’m not sure the “business as usual” type disclosures add anything other than length to the notes! I can think of ways to combine “types of leases” in a matrix that might label columns for length of terms (less than 5 years, 5 to 10 years; over 10 years) and rows for nature of terms (with purchase options; with renewal options; with cancellation penalties, etc.). However, the information would probably be more confusing than helpful and the user still must rely on preparers for the numbers and auditors for reassurance that the resulting figures are reasonably reliable.

I guess I don’t have a solution. Boiler plate language that doesn’t change from year to year seems to be a standard part of the notes to financial statements. Perhaps the Boards should concentrate on the numeric disclosures and only ask preparers to disclose **unusual** lease terms or descriptions of **individually significant** leases or groups of similar leases that would have a significant impact on financial position.

Summary and Conclusions

Lease accounting is changing and it will be a change for the better. We’ve known about the effort for years. The new guidelines are better than those in the preliminary views document and the previous exposure draft. While no standard will be perfect or universally welcomed, I believe it is time to get this new approach out to the “real world” so that unanticipated implementation issues can come to light and be resolved early in the process.

Please do not hesitate to contact me if something I’ve said lacks clarity.

Sincerely,

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PS As I was wrapping up these comments, I had a sudden horrible feeling that there might be an impact on program expense ratios for not-for-profit entities. So I got an audit report for a Seattle theater company (no capital leases but apparently three operating leases) and worked through the numbers to make sure that “rent expense” under either Type A or Type B will not be double counted (amortization of right to use plus interest on lease liability). Of course it isn’t doubled but I do feel better for having crunched the numbers. There are, of course, slight differences in the new expenses as compared to rent expense under existing operating lease accounting. This makes for small differences that will require reconciliation with respect to the statement of cash flows. I still think that this is an unnecessary complexity that has little if any benefit for financial statement users (with respect to comprehensive income or statement of activities). Are the Board members positive that there isn’t a way to get the lease liability on the balance sheet without “messing up” net income? I know the differences are small but they are there and I really see no utility to reporting the expense for at least Type B leases as anything different from cash paid for what we used to call rent expense.