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Financial Accounting Series
Leases (Topic 840)
Exposure Draft
Financial Accounting Standards Board

Thank you for the opportunity to comment on the above exposure draft. I'd like to emphasize that the following opinions are of a personal nature and do not reflect the opinions of my employer. Please find my responses to individual questions below.

Question 1: (Lessees)

I agree with the proposed standards, that in most circumstances, lessees should recognize a right-of-use asset and a liability to make lease payments because such a lease meets the definition of an asset - such leases are the result of past actions, they are expected to result in positive future benefits, and they are under the control of the reporting firm. Such a lease similarly meets the conditions of a liability. Lessors should likewise make adjustments to include right-of-use assets and liabilities. I understand the contrarian argument that some leases should be disqualified from recognition by nature of the fact that lessees and lessors can, and do, shirk their duties as parties to a contract. In this sense, payments from a lessee are not guaranteed as long as contract breaching occurs.

I find this line of thought flawed because it puts into question the legal basis of the accounting system. Arguing that a lessee has no liability because it can breach its contract is akin to saying a Company can't claim ownership of its receivables because there is a chance the counterparty may default. Taken to an extreme, it is similar to the argument that the Company doesn't even own its inventory because of the chance a thief runs off with it all. Accounting standards should uphold, not bypass, contract law.

Question 8: Lease term

I disagree with the proposed standard that the lessee or lessor should recognize the applicable lease term as the longest possible term that is more likely than not to occur. There are 4 main reasons for this difference of opinion. First, I don't agree that the stream of lease payments that would result from exercising a term renewal option meets the definition of liability. Very simply, it is neither a present obligation nor does it arise from an action in the past. Because the company must choose whether it will pay those rents in the future, it implies that, on the whole, such obligations are more a result of a future action than a present one. Moreover, such a rule violates the principle of conservatism by overstating a lessor's assets by including "likely" renewal payments.

An additional factor in favor of a minimum-exposure principle is the transitory nature of management. In many cases 20-year leases outlast company managements and their assessment of whether tacked-on options are "more likely than not" to be executed will not necessarily hold once new management comes in. Relying upon managements'

opinion regarding the most likely lease term places too much subjective influence upon current management.

In addition, whether option terms should be capitalized or not should depend on whether option terms meet the definition of an asset. While options are both the result of past actions and controlled by the firm, only in certain circumstances can they reasonably be expected to result in future benefits.

The nature of an open market is such that most firms possess the opportunity if not the de facto, implicit option to lease certain items at the market rate (i.e. if a Company wants to rent a machine, it generally can – at least at the market rate). Under this line of reasoning, the main difference between a so-called “open-market option” and a contractual option/renewal is the specification of a pre-determined price. The only eventuality in which possessing such an option would result in future benefits to the lessee is if the exercise price is below the future market rate on the expiration date. And since this cannot regularly and repeatedly be expected to occur due to the random fluctuations of prices, it cannot reasonably be called an asset.

However, for certain non-fungible and exclusive goods such as particular buildings/technologies/IP, exclusive use is a compelling benefit, however, and only contractual options lock in the exclusive right to use them in the future (and prevent others from using them). Think of AT&T’s contract to retail Apple’s iPhone devices. Were AT&T to possess an option to extend their exclusivity by a year, it would surely be a worthy asset. Or imagine the future benefits to be found from holding exclusive patents for a suite of potent drug products.

But for most goods – such as machines and generic real estate – exclusivity of usage is not a major concern. The competitive market alone is sufficient to provide opportunities to use them in the future. An example of a fungible lease would be any lease of a basic tool, machine, or typical warehouse location where the item in question is easily substitutable or fungible.

Most would agree that the “no-contract, open market option” (i.e. when the firm merely intends to lease a non-exclusive, fungible good in the future at the available market rate) should not be capitalized because it clearly results from uncertain future action. Merely pre-specifying a price (in the form of a contract option) for that future action does not change the fact that it still results from uncertain future action. Also, locking in a future price is not a guarantee of locking in future benefits (where the benefit associated with an option is the cost savings compared against renewing at future market rates); thus it should not be labeled an asset. For example, the option to purchase an item in 5 years for \$100k will accrue benefits depending on whether market prices rise above \$100k by that time. One cannot say for certain in the present, however, whether the option would actually result in future benefits.

For these reasons, I do not feel that most (fungible) contractual options should be treated as assets/liabilities for purposes of reporting. The stream of future benefits is too

uncertain. Non-fungible leases might provide future benefits as a result of actions today, as long as exclusive use is assumed to provide future strategic value; hence only non-fungible leases should even be considered for capitalization.

Identifying which leases are non-fungible (where locking in now the right to renew holds true strategic value) and which are fungible (where locking in today the right to renew only locks in a price) is likely to be highly subjective and cost prohibitive. Take the example of the lease for a profitable retail store. Are there substitutable properties nearby that could replace the current one? How much true value should be ascribed to the uniqueness of the current spot and by extension to the option to renew? Determining how much value is actually gained via exclusivity is likely prohibitive from a measuring standpoint as it delves far more into business strategy than accounting.

Finally, imagine a lease contract which grants both the lessee and lessor a mutual option to extend the lease term. How would the Board's proposed accounting standard resolve an instance when the lessor intends to exercise but the lessor later changes its mind against renewal? Would the standard require lessors and lessees to continuously monitor each other's intentions in order to evaluate their books?

Conservatism would best be served by simply adopting a minimum-lease term principle. I propose that constituents recognize the applicable lease term as that of the minimum contractual obligation for all lease types. For example, if a Lessee signs a 5-year lease with 3-year renewal, it should originally recognize only the 5 year portion, discounted to the present value as a right-of-use asset and liability. If and whenever the Lessee contractually agrees to exercise the renewal option, then at that time it should recognize the additional liability/asset in line with the Boards' guidance for reassessment.

Thank you,
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12/10/10