

**COMMENTS TO EXPOSURE DRAFT (LEASES TOPIC 840)
BY: STEVE HARDING, CFO
TRANSWESTERN COMMERCIAL SERVICES**

The accounting model

The exposure draft proposes a new accounting model for leases in which:

(a) a lessee would recognize an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortize the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.

(b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to significant 5

risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23–BC27).

Question 1: Lessees

- (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?

ANSWER – NO, I BELIEVE THE CURRENT TREATMENT AND DISCLOSURE IS ADEQUATE. FUNDAMENTALLY I UNDERSTAND WHAT THE BOARDS ARE TRYING TO ACHIEVE BUT I AM CONCERNED ABOUT THE COMPLEXITY AND SUBJECTIVITY OF THE NEW PROPOSED RULES. I COULD ALSO SUPPORT A CHANGE THAT DOES NOT INCLUDE ALL THE SUBJECTIVE / QUALITATIVE / JUDGEMENTAL ASPECTS OF THE PROPOSED RULES; SIMPLY PV THE STATED TERMS AND DISCLOSE THE REST IN YOUR FOOTNOTES.

- (b) Do you agree that 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 and why?

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?

ANSWER – NO AND FOR THE SAME REASON THAT I SAID FOR THE LESSEE. I BELIEVE THE CURRENT TREATMENT AND DISCLOSURE IS ADEQUATE. FUNDAMENTALLY I UNDERSTAND WHAT THE BOARDS ARE TRYING TO ACHIEVE BUT I AM CONCERNED ABOUT THE COMPLEXITY AND SUBJECTIVITY OF THE NEW PROPOSED RULES.

- (b) Do you agree with the boards' proposals 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?

- (c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

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 6

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).

(See also paragraphs BC41–BC46.)

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?

ANSWER – NO, I BELIEVE THAT THE LESSEE AND THE LESSOR SHOULD BOTH SIMPLY RECOGNIZE LEASE PAYMENTS IN THE INCOME STATEMENT OVER THE LEASE TERM FOR SHORT-TERM LEASES; NEITHER PARTY SHOULD HAVE TO PERFORM A PV CALCULATION AND RECORD AN ASSET OR LIABILITY FOR THE “RIGHT OF USE ASSET / LIABILITY”.

Definition of a lease

This 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–BC32). This exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) 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? Why or why not? If not, what alternative definition would you propose and why?
- (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–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

ANSWER – NO, THE GUIDANCE IS NOT SUFFICIENT, PARTICULARLY WITH REGARD TO REAL ESTATE LEASES WHICH ARE COMMON TO MOST COMPANIES. THE FASB & IASB HAVE TO GIVE SPECIFIC GUIDANCE AND DIRECTION RELATED TO COMMON AREA MAINTENANCE (CAM) AND COMMENT SPECIFICALLY ON THE DIFFERENCES BETWEEN GROSS LEASES, MODIFIED GROSS LEASES AND TRIPLE-NET LEASES. I DON'T BELIEVE THERE SHOULD BE ANY DIFFERENCE BETWEEN A NNN LEASE AND A GROSS LEASE OR MODIFIED GROSS LEASES; I.E., I THINK THE EXPENSE PORTION SHOULD BE EXCLUDED FROM THE PV CALCULATION, AND RUN THROUGH THE INCOME STATEMENT.

Scope

Question 5: Scope exclusions

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

Question 6: Contracts that contain service components and lease components

This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, *Revenue Recognition* (Topic 605): *Revenue 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 and lease 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 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?

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 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?

Measurement

This exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that: 8

(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–B20 and BC114–BC120).

(b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be reliably measured.

(c) 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 BC132–BC135).

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?

ANSWER – NO, ASSUMING WE DO HAVE TO APPLY THE RIGHT-TO-USE MODEL THAN I BELIEVE THE TERM SHOULD ONLY BE FOR THE STATED / FIXED-PORTION OF THE LEASE TERM AND IT SHOULD NOT INCLUDE “JUDGEMENTAL / NON-CONTRACT” ASSUMPTIONS RELATED TO WHETHER A TENANT IS GOING TO EXERCISE A RENEWAL OPTION. THE BOARDS TODAY ARE CONCERNED ABOUT SIMILAR LEASES BEING ACCOUNTED FOR DIFFERENTLY; AND THAT WILL CLEARLY BE THE CASE FOR LEASE TERMS UNDER THE NEW PROPOSAL. I’M CONCERNED THAT TENANTS WOULD HAVE TO DISCLOSE THEIR RENEWAL INTENTIONS AND WHAT THAT DOES TO THE WHOLE LANDLORD / TENANT LEASE NEGOTIATION. I’M CONCERNED THAT TENANTS WILL MAKE BAD “BUSINESS DECISIONS” BASED UPON ACCOUNTING RULES; E.G., OPT FOR SHORTER LEASE TERMS, OR OPT FOR NO RENEWAL OPTIONS. I’M CONCERNED THAT TENANTS COULD MANIPULATE THEIR BALANCE SHEET / EARNINGS.

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?

ANSWER – NO, I THINK IT IS WRONG TO MAKE A TENANT OR LANDLORD MAKE ASSUMPTIONS ABOUT CONTINGENT RENTALS THAT GO OUT BEYOND 12 OR 24 MONTHS. THERE IS SIMPLY TOO MUCH RISK OF UNCERTAINTY REGARDING THOSE ESTIMATES OR JUDGEMENTS AND I THINK IT IS ACTUALLY MISLEADING TO FACTOR THEM INTO THE PV CALCULATION. A SIMPLE EXAMPLE REGARDING RETAIL TENANT SALES WHICH ARE IMPACTED BY NUMEROUS CONTROLLABLE AND UNCONTROLABLE FACTORS (MACRO ECONOMIC FACTORS, COMPETITORS, BAD OR GOOD BUYING DECISIONS BY THE RETAILER’S BUYING DEPARTMENT, CONSUMER SENTIMENT, ETC.).

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?

ANSWER – I LIKE RELIABLE BETTER THAN I DO EXPECTED OUTCOME, BUT AGAIN, I THINK IT MAKES NO SENSE TO FACTOR IN CONTINGENT RENTALS IN A PV CALCULATION FOR EITHER THE LANDLORD OR TENANT.

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 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? Why or why not? If not, what other basis would you propose for reassessment and why?

ANSWER – NO, I THINK IT IS SIMPLY TOO DIFFICULT ON SYSTEMS AND PROCESSES TO FORCE LANDLORDS AND TENANTS TO REMEASURE THESE ASSETS AND LIABILITIES. WHAT CONSTITUTES A SIGNIFICANT CHANGE, AND DOES A ONE QUARTER OR ONE YEAR DIFFERENCE REPRESENT A TREND?

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 for 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 and leases. If the contract represents a sale of the underlying asset, the leaseback also would meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

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 BC142–BC159).

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–BC145)? 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?

ANSWER – I WOULD PREFER TO SEE ALL OF THIS IN THE FOOTNOTES OF THE FINANCIAL STATEMENTS.

- (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, BC148 and BC149)? 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?

- (c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial 10

assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? 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?

- (c) 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 BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

ANSWER – I WOULD PREFER TO SEE ALL OF THIS IN THE FOOTNOTES OF THE FINANCIAL STATEMENTS. I THINK IT WILL BE TOO CONFUSING FOR THE READER TO MAKE SENSE OF A NET ASSET OR LIABILITY AND WHY IS THE LIABILITY ON THE HEAD LEASE THE ONLY THING SHOWN SEPARATELY FROM THE OTHER LEASE / SUBLEASE COMPONENTS.

Question 13: Income statement

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

ANSWER – NO, I DON'T THINK IT SHOULD BE PRESENTED SEPARATELY, AND AGAIN THE CONCEPT OF DOING AWAY WITH RENT EXPENSES IN FAVOR OF INTEREST AND AMORTIZATION EXPENSE JUST DOES MAKE SENSE TO ME. THE IMPACT THAT THIS WILL HAVE ON LOAN COVENANTS WILL BE PROFOUND AND COSTLY FOR THE TENANT TO PUT IN PLACE.

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 (paragraphs 27, 45, 63, BC147, BC153 and BC159)? 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?

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 BC168–BC183)? Why or why not? If not, how would you amend the objectives and why? 11

Transition

Question 16

- (a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application 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?
- (c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

Benefits and costs

Question 17

Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

ANSWER – NO, I DO NOT AGREE. I BELIEVE THAT THE COSTS ARE SIMPLY TOO GREAT AND THE BENEFITS TOO LITTLE TO FORCE TENANTS AND LANDLORDS TO APPLY THIS NEW ACCOUNTING; PARTICULARLY AS IT RELATES TO THE COST ASSOCIATED WITH CAPTURING AND MEASURING THE BUSINESS AND NON-BUSINESS FACTORS THAT WILL GO INTO DETERMINING LEASE TERM, CONTINGENT RENTS AND INCREMENTAL BORROWING RATE. I AM EVEN MORE CONCERNED BY THE CURRENT FINANCIAL STATE OF OUR GLOBAL ECONOMY. TENANTS CANNOT AFFORD THAT ADDITIONAL BURDEN TODAY, NOW SIMPLY ISN'T THE TIME FOR THIS CHANGE.

Other comments

Question 18

Do you have any other comments on the proposals?

ANSWER – YES, I HAVE A HOST OF COMMENTS –

- **I THINK THE TIMING OF THIS PROPOSAL IS NOT GOOD. THE REAL ESTATE INDUSTRY IS SUFFERING, AND WE DO NOT NEED ANOTHER ACCOUNTING PRONOUNCEMENT THAT CAN AND WILL HAVE A PROFOUND IMPACT ON TENANT BEHAVIOR.**
- **I AM CONCERNED THAT BUILDING VALUES WILL DROP SIGNIFICANTLY BECAUSE TENANTS WILL WANT TO MOVE TO SHORTER TERM LEASES; THIS WILL BE PARTICULARLY PRONOUNCED IN THE SALE-LEASEBACK AND NET-LEASE MARKET.**
- **I AM CONCERNED ABOUT THE DISCUSSIONS THAT WILL NEED TO TAKE PLACE BETWEEN TENANTS AND THEIR LENDERS REGARDING COVENANTS AND RATIOS; PARTICULARLY IN THE CURRENT TIGHT LENDING ENVIRONMENT.**
- **I AM CONCERNED ABOUT THE SUBJECTIVITY AND JUDGEMENT THAT WILL BE REQUIRED BY THE NEW PROPOSAL, PARTICULARLY CONCERNING LEASE TERM AND CONTINGENT RENTAL.**

- **I AM CONCERNED THAT ACCOUNTING RULES WILL DRIVE BAD BUSINESS DECISIONS REGARD RENEWAL OPTIONS, LEASE TERM, AND OTHER ASPECTS OF THE LEASING DECISION.**
- **I AM CONCERNED ABOUT THE IMPACT OF FRONT-LOADING OF EXPENSE TO TENANTS TODAY, PARTICULARLY GIVEN THAT WE ARE IN THE MIDDLE OF THE “GREAT RECESSION”.**
- **I AM CONCERNED ABOUT THE COMPLEXITY OF THE REQUIRED DISCLOSURES; IT IS SIMPLY GOING TO BE “TOO MUCH” FOR THE NORMAL INVESTOR TO UNDERSTAND.**
- **I AM CONCERNED ABOUT THE COST OF TRANSITION (SYSTEMS, ACCOUNTING FEES, LEGAL FEES, PERSONEL). AGAIN OUR TENANTS SIMPLY DON’T NEED THAT ADDITIONAL BURDEN NOW, NOR SHOULD THEY HAVE TO THINK ABOUT IT.**
- **I AM CONCERNED ABOUT THE POTENTIAL IMPACT ON DEVELOPERS WHEN THE DEVELOPMENT MARKET COMES BACK. TODAY DEVELOPERS ARE ABLE TO OBTAIN FAVORABLE LOAN TERMS BECAUSE THEY HAVE A CREDIT TENANT THAT WILL SIGN A LONG-TERM LEASE; WHAT HAPPENS WHEN THAT TENANT WILL NOT SIGN A LONG-TERM LEASE?**

Non-public entities

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?

ANSWER – YES, I WOULD SUGGEST THAT THE CURRENT ACCOUNTING IS ADEQUATE FOR NON-PUBLIC ENTITIES; OR AGAIN I COULD SUPPORT A SIMPLIFIED RIGHT-TO-USE THAT DOES NOT INCLUDE THE QUALITATIVE / JUDGEMENTAL ASPECTS OF THE PROPOSED RULES.