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Proposed Accounting Standards Update: *Leases (Topic 842) Narrow-Scope Improvements for Lessors*

The California Society of CPA's ("CalCPA") Accounting Principles and Assurance Services Committee (the "Committee") is the senior technical committee of CalCPA. CalCPA has approximately 43,500 members. The Committee consists of 55 members, of whom 45 percent are from local or regional firms, 32 percent are from large multi-office CPA firms, 12 percent are sole practitioners in public practice, 6 percent are in academia and 5 percent are in international firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

We have the following comments on the proposed ASU.

Sales Taxes and Other Similar Taxes Collected from Lessees

Question 1: *Should a lessor's accounting for sales taxes and other similar taxes collected from lessees be aligned with Topic 606? If not, please explain why.*

The Committee agrees that alignment with Topic 606 is appropriate.

Question 2: *Is the proposed accounting policy election, as written in this proposed Update, operable? If not, please explain why.*

The Committee believes the proposed accounting policy election is operable.

Question 3: *Would the proposed accounting policy election result in a reduction of decision-useful information to users of a lessor's financial statements? If so, please explain why.*

The Committee does not believe the proposed accounting policy election will result in a meaningful reduction of decision-useful information to users of a lessor's financial statements.

Question 4: *Should a lessor's accounting policy election for sales taxes and other similar taxes collected from lessees be applied to new lease contracts only or to all existing and new lease contracts?*

The Committee believes the lessor's accounting policy election for sales taxes and other similar taxes collected from lessees should be applied to all existing and new lease contracts. We acknowledge that some entities have early adopted Topic 842 and/or are in advanced stages of preparation, and as such may have already made judgments with respect to treatment of sales taxes and other similar taxes on existing leases. Making the accounting policy election to exclude taxes from consideration in the contract and from variable payments could result in unwinding these judgments and recalculating the lease amounts. However, we anticipate these entities likely already have a process to assess whether the associated costs are lessor's or lessee's. As such, we anticipate the ability to make such election will be less critical to these entities. On the other hand, applying the election to all existing and new leases will result in consistent treatment of all lease arrangements in the financial statements, and make the information reported more meaningful. Considering that many leases span a term of multiple years, we believe consistency of accounting treatment in the entity's financial statements should be given higher weight.

Certain Lessor Costs Paid Directly by Lessees

Question 5: *Should a lessor be required to exclude certain lessor costs paid directly by lessees to third parties on behalf of a lessor as variable payments when the uncertainty in the amount is not expected to ultimately be resolved? If not, please explain why.*

The Committee believes that directionally, the proposed amendment to exclude certain costs originated by lessee from variable payments is appropriate. However, the Committee disagrees with how the Board has defined which costs to exclude. Specifically, the Committee believes such costs should not be assessed based on whether they are readily determinable by the lessor. Instead, we recommend that lessors exclude from variable payment the costs paid by lessees to third parties where the lessee's involvement in the determination of the amount of the cost is more than incidental.

As an illustration, assume for a particular property, the property tax rate is established by local legislation and does not depend on how the property is used by the lessee, within the limitations established by the terms of the lease. Therefore, whether this amount is paid by lessor or lessee, it is not affected by the lessee, i.e. the lessee's involvement in the determination of the amount of the cost is incidental. It is also readily determinable, using the term from the proposed Update. This cost would be recorded by the lessor, whether or not it is paid directly by the lessee.

As a second illustration, assume in a particular lease, the lessee is responsible for providing insurance coverage on the leased property, including negotiating with the insurance company. The insurance cost is influenced by the insurance risks related to the lessee. Further, it is determined as an outcome of a negotiation between the lessee and the

insurance provider. In this circumstance, the lessee involvement in the determination of the amount of the cost is more than incidental. Accordingly, we believe the lessor should exclude the cost of insurance paid by the lessee to a third party from variable payments. While this recommendation would align with the Board's proposed conclusion in many practical instances, as the amount would not be readily determinable by the lessor, we believe the lessor should exclude the cost of such insurance even if it knows with certainty the amount paid by the lessee for insurance coverage.

We note that our recommendation is not inconsistent with the Board's rationale underlying Issue 2 in the proposed Update, as summarized in paragraphs BC18-BC19. However, we believe there is a logical flaw in paragraphs BC18-BC19 that results in the proposed approach in paragraph 842-10-15-40A that is, to some extent, inconsistent with the underlying premise. Specifically, these paragraphs contrast costs that are Lessee-Paid and Lessee-Reimbursed in that the lessor knows the amount of the costs reimbursed by the lessee which is not subject to lessee-specific factors. We respectfully note that whether the lessor knows the cost amount is not necessarily linked to whether the lessor pays and the lessee reimburses, or whether the lessee directly pays, the cost. The lessor may know the cost paid directly by the lessee simply because the lessee has elected to disclose this amount, even if not required to do so under the terms of the lease, or because the amount may be available through public records. In this regard, we note one may identify four different cost categories, rather than the two discussed in the proposed Update's Basis for Conclusions:

1. Lessee-Reimbursed – costs paid by the lessor, the amounts of which by definition are readily determinable to the lessor. These costs are outside the scope of the proposed Update, and our comment letter does not suggest changes to accounting for such costs;
2. Lessee-Paid-Lessee-Not-Affected-Lessor-Known – costs paid by the lessee, the amounts of which the lessor knows or can determine, either because they are readily determinable (e.g. fixed-rate real estate property taxes), or because the lessee acted as agent to negotiate them on behalf of the lessor (we anticipate this would be rare). In this category, the lessee involvement in the determination of the amount of the cost is incidental, as is the fact that the cost was paid by the lessee;
3. Lessee-Paid-Lessee-Affected-Lessor-Known – costs paid by the lessee, whose involvement in the determination of the amount of the cost was more than incidental. Examples may include insurance negotiated and paid by the lessee, or vehicle property taxes that vary based on the lessee usage of the property. The lessor knows the amount simply because the lessee happens to have communicated it to the lessor, or because it is available through public records; and
4. Lessee-Paid-Lessor-Unknown – costs paid by the lessee, the amounts of which the lessor does not know, and they cannot be readily determined (e.g., through public records). Further, the lessee did not happen to communicate them to the lessor.

The proposed Update would require the lessor to include in variable payments the amounts falling in the above Categories 1, 2 and 3. However, we note the Basis for Conclusions for the proposed update only explicitly assessed costs in the above Categories 1 and 4. While

we agree that costs in Category 2 should be recorded by the lessor as costs and variable payments, based on our analysis below, we do not believe costs in Category 3 should be included in variable payments.

Just like costs in Category 4, the lessee's involvement in determination of the amounts of the costs in Category 3 is more than incidental. While these amounts are likely affected by the characteristics of the leased property that belongs to the lessor, they are also significantly influenced by risks, business activities and other circumstances and factors specific to the Lessee. Many of these costs are customarily negotiated by the Lessee. For instance, the Lessee may secure insurance coverage for the leased building by adding it to an existing umbrella policy. The Lessee conducts the negotiation process, and the cost is influenced by the Lessee's nature of operations, personal property located inside or attached to the leased asset, insurance risk ratings, credit profile, existing property portfolio, and coverage elections, both the minimum required under the lease terms and in excess of the minimum requirements. These costs can also be pre-negotiated by the Lessee even before the lease agreement is executed, because they are an important component of the Lessee's total cost of obtaining right of use of the facility or another leased asset.

In the case of vehicle property taxes which in certain states are assessed on the lessee, the tax amount can be influenced by whether, and how, the lessee chooses to operate the vehicle. Therefore, the lessee involvement in the determination of the amount is more than incidental. While the Lessee may not communicate the tax amount to the Lessor, it may be readily determinable through online records. However, this amount has nothing to do with Lessor operations; it is solely the outcome of a Lessee decision.

Whether such costs are known to or are readily determinable by the Lessor does not change the economic substance of such costs. The amount of the cost, entirely or partially, does not reflect the Lessor's economic activity. In these circumstances, we believe it would be impractical to require entities to assess and allocate the costs between lessor and lessee operations. Therefore, we believe lessor recognition of the amounts in its financial statements would be inconsistent with the idea that financial statements provide information about an entity's economic activities. As such, we believe it is not desirable to include Category 3 costs in the Lessor's variable payments and ultimately in its financial statements.

Additionally, please see practical operability considerations that would arise should the proposed Update be issued as drafted, discussed below in our response to Question 6.

Conclusion

In conclusion, the Committee suggests revising the proposed Update to require lessors to only include in financial statements and report as variable payments the amounts of (i) costs paid by lessor (whether or not reimbursed by the lessee) – this is consistent with the proposed Update; and (ii) costs paid by the lessee to third parties, where the lessee involvement in determination of the amount of the cost is incidental. Conversely, costs paid by the lessee to third parties, where the lessee involvement in the amount of the cost is

more than incidental would be excluded from variable payments, whether or not the lessor knows of the amount.

If the Board does not accept this revision, the Committee would recommend allowing lessors to make an accounting policy election between the amendment as proposed by the Board and the revision as suggested by the Committee.

We recognize our recommendation is different from the established approach in Topic 606, as memorialized in paragraph BC38(c) of Update 2016-08. However, we believe this difference is appropriate. In the case of revenue transactions, we believe it is not the actual lack of information that informs the accounting conclusion to exclude the amounts from the transaction price; rather, the lack of information correlates with the nature of the relationship between the three parties to the underlying revenue transaction that makes it appropriate to exclude these amounts from the transaction price. We believe a similar level of correlation is not necessarily present in lease arrangements, which are often not executed in large volumes, and the information about costs incurred with third parties is, generally speaking, more readily shared between the lessor and the lessee.

Question 6: *Are the proposed amendments for the accounting for certain lessor costs operable? If not, please explain why.*

The Committee believes there may be significant operational challenges and reporting risks arising out of the proposed amendments to accounting for certain lessor costs. Below, we highlighted several realistic scenarios which could be problematic for reporting entities.

- A. The lessor may know with certainty the amount of cost (e.g. insurance) incurred by the lessee in the initial year of the lease, based on direct communication from the lessee, but not in the following year, because the lessee has elected not to communicate the amount. Under the proposed update, the lessor would report different lease amounts in its financial statements based solely on what may be a random decision by the lessee.
- B. The lessee may unintentionally include the cost (e.g. insurance) amount among other information supplied to the lessor, when communicating the cost may not be required. With the volume of the information exchanged (e.g. a poorly legible multi-page pdf document), it is possible the lessor may overlook this information, if it was not required to be supplied. A year or two later, a fresh look by management or the auditor (e.g. at a later year's communication) may discover that the information for all years of a lease was not only readily determinable, but in fact in the hands of management, all along. Under the "readily determinable" threshold, this realistic scenario cannot be characterized as anything other than an error in the prior periods' financial statements that could require a restatement if material. Entities do not habitually have controls to monitor every last bit of unexpected information that may come in their possession; establishing and maintaining such controls can be cost-prohibitive.

- C. An assessment of whether the cost amount is “readily determinable” is made as of a point in time. However, when lessees make this assessment at lease inception to establish the lease discount rate, the discount rate is not subject to change except in defined circumstances, e.g. upon remeasurement of the lease liability under paragraph 842-20-35-5. If the lessor finds the actual costs incurred by lessee subsequent to the lease inception, it is not clear whether the amount would then be deemed “readily determinable” on a prospective basis. We note that paragraph 842-10-15-40 contemplates that variable payments change “when the changes in facts and circumstances on which the variable payment is based occur”.
- D. It is possible that the actual cost amount incurred by the lessee is not known nor readily determinable by the lessor, but may be subject to a minimum. For example, state laws may establish vehicle property tax amounts that vary based on the nature of the vehicle usage. Regardless of usage, there is a minimum amount owed. If the lessor does not know how the lessee actually uses individual vehicles, it is not clear whether the minimum property tax amount should be included in the variable payments, as this portion of the amount is readily determinable based on state laws. Estimating minimum amounts can result in significant complexities in applying the proposed Update.

***Question 7:** Would the proposed requirement for a lessor to not report certain lessor costs paid directly by a lessee to a third party on behalf of the lessor result in a reduction of decision-useful information to users of a lessor’s financial statements? If so, please explain why.*

No, the Committee believes excluding certain costs paid directly by a lessee to a third party on behalf of the lessor will not result in a reduction of decision-useful information to users of a lessor’s financial statements.

***Question 8:** Should the proposed amendment in paragraph 842-10-15-40A to exclude certain lessor costs paid directly by lessees on behalf of a lessor as variable payments be applied to new lease contracts only or to all existing and new lease contracts? Please explain your rationale.*

The Committee believes the proposed amendment to exclude certain costs paid by lessees from variable payments should be applied to all existing and new lease contracts. However, at the same time we believe entities should be allowed to account for the proposed change on either full retrospective or modified retrospective basis. We acknowledge that some entities have early adopted Topic 842 and/or are in advanced stages of preparation, and as such may have already made judgments with respect to treatment of costs incurred by lessees on the existing leases. Implementing the proposed change could result in unwinding these judgments and recalculating the lease amounts. We anticipate adopting the change on a modified retrospective basis will mitigate the impact of implementation. On the other hand, applying the election to all existing and new leases will result in consistent treatment

of all lease arrangements in the financial statements on a going-forward basis, and make the information reported more meaningful. Considering that many leases span a term of multiple years, we believe consistency of accounting treatment in the entity's financial statements should be given higher weight.

Recognition of Variable Payments for Contracts with Lease and Nonlease Components

Question 9: Would the proposed amendments clarify the application of paragraph 842-10-15-40? If not, please explain why.

The Committee believes the proposed amendments properly clarify the application of paragraph 842-10-15-40 and correct what appears to be a technical oversight.

Question 10: Are the proposed amendments for the accounting for certain variable payments for contracts with lease and nonlease components operable? If not, please explain why.

The Committee believes that for certain entities, the proposed amendments may present operability challenges. This could arise, for example, when there are significant differences between how variable payments arise and how, for nonlease components that are performance obligations in scope of Topic 606, control is transferred. These operability challenges are not dissimilar to those entities already address under Topic 606. However, many of these entities are able to recognize variable payments as earned under Topic 606 as these amounts either relate to a previously satisfied performance obligation or doing so would meet the allocation objective in paragraph 606-10-32-28 of that Topic. Conversely, if the variable payments are triggered by lease-related activities not commensurate with the level of activities under an ongoing nonlease performance obligations, an entity may not be able to conclude that recognizing the amounts allocated to nonlease performance obligations as earned would meet the allocation objective.

Notwithstanding the operational challenges some entities will likely face, we do not believe there is an easy way to solve these challenges within the framework of either Topic 606 or Topic 842, without either allowing recognition of revenue for nonlease performance obligations in a manner inconsistent with transfer of control (as the current version of paragraph 842-10-15-40 allows), or adding complex constructs to either Topic 606 or Topic 842 that could have significant unanticipated consequences in the broad application of these accounting frameworks.

Transition and Effective Date for Early Adopters

Question 11: *How much time would be needed to implement the amendments in this proposed Update for an entity that early adopts Update 2016-02 before the proposed amendments are finalized? What transition method and transition disclosures should those entities be required to apply (provide)? Please explain your reasoning.*

To the extent an entity that has early adopted Update 2016-02 has to unwind previously made judgments, recalculations of lease amounts for all affected leases would be required. Further, we respectfully remind the Board that as of this time, calendar-year public entities have less than four months remaining prior to when they must apply Topic 842. We anticipate that significant recalculations could be required even for entities that have not early adopted Update 2016-02, but that are well under way towards adoption, with accounting for many leases completed or nearing completion. Therefore, we recommend that for all entities, not just those who early adopted Update 2016-02, there is at least a twelve-month period to transition.

With respect to the transition method, we recommend that entities be given a choice of either full retrospective or modified retrospective adoption, with the cumulative effect to be recognized in retained earnings as of the initial application date.

As related to the transition disclosures, we recommend to align them with the requirements of paragraph 842-10-65-1(i) through (jj) and thereby the associated disclosures under Topic 250.

Question 12: *Should the effective date for the amendments in this proposed Update be aligned with that of Update 2016-02. If not, please explain why.*

Consistent with our reply to Question 11, the Committee believes all entities should have at least twelve months from the issuance date of this Update to adopt its requirements. Early adoption to align with the effective date of Update 2016-02 should also be permitted.

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We thank you for the opportunity to comment on this matter. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,



Matthew J. Lombardi
Chair
Accounting Principles and Assurance Services Committee
California Society of Certified Public Accountants