



Setting the global standard for investment professionals

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Re: Comment Letter on Leases

Dear Sir David and Ms. Seidman,

The CFA Institute¹, in consultation with its Corporate Disclosure Policy Council (“CDPC”)², appreciates the opportunity to comment on the joint Exposure Draft (“ED”): International Accounting Standards Board’s (“IASB”) Exposure Draft (“IASB Exposure Draft” or “IASB ED”), *Leases*, and Financial Accounting Standards Board’s (“FASB”) Proposed Accounting Standards Update, *Leases (Topic 840)*, (“FASB Proposed Update” or “FASB Update”). The IASB and FASB are collectively referred to as the Boards.

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

IMPORTANCE OF LEASE ACCOUNTING TO INVESTORS

Leases and other off-balance-sheet financing techniques have been a major concern to investors for many years. CFA Institute surveys have consistently shown that users find off-balance sheet accounting, of which leases comprises a significant subset, to be one of the most deficient areas of financial reporting.

¹ With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 106,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 94,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

² The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners’ perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.



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Under current standards, two leases that are substantially identical may be accounted for differently because one lease has been crafted to fit on one side of the “bright-line” standard. Obligations under operating leases, which may be highly significant to the enterprise (consider retailers in the current economic environment), are relegated to footnote disclosure.

We believe that all lease transactions give rise to assets and liabilities that should be recognized in the statement of financial position and, in many cases, there is an effective economic equivalence between entering a leasing arrangement and separately owning and financing assets. When similar economic transactions are accounted for differently by different enterprises, reported financial statements lose comparability. Companies that lease rather than buy assets generally report:

- Lower financial leverage
- Higher interest coverage
- Higher profitability
- Higher return on assets and equity
- Higher asset turnover
- Lower cash from operating activities

Therefore, it is important that lease accounting standards provide users of financial statements with a complete and understandable picture of an entity’s leasing activities. This is premised on the need for comparable financial statements across reporting entities, to fully reflect all their assets employed to generate returns plus the financing of such assets. Effectively, investors are interested in having knowledge of:

- The nature and total value of assets that entities deploy;
- The associated risk of assets held;
- Effective leverage employed;
- Costs of financing;

Concurrently, the development of a comprehensive standard, which will result in convergence between U.S. GAAP and IFRS, is something that investors unequivocally support, in principle.



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GENERAL COMMENTS

Overview and Organization of Our Response

Lessee Recognition – We support the right-of-use model for lessee accounting although we disagree with certain of the proposed measurements. The ED proposes to eliminate the finance and operating lease categories for lessee accounting, and would instead require the recognition of lease assets based on the right-of-use and a liability based on the obligation to pay rentals. We consider capitalization of the hitherto off-balance sheet operating leases to be a step in the right direction.

Lessee Measurement – On the proposed measurement approach, we support the inclusion of options, contingent rentals and residual value guarantees in the determination of right-to-use asset and liability to pay rentals. However, we disagree with the proposed use of the ‘more likely than not’ lease term as it may result in undesirable subjectivity in application. This concern could be addressed by requiring an additional set of disclosures including a maturity analysis of lease payments, sensitivity analysis of reported liability to pay rentals, and a probability based bucketing of options that are considered to be unlikely to be exercised versus those that are ‘more likely than not’ to be exercised. These disclosures would help users evaluate the uncertainty associated with reported amounts and permit them to make analytical adjustments.

We agree with the use of the lessee incremental borrowing rate as the discount rate. However, we believe that the discount rate should consider the expected lease term, and that the discount rate should be remeasured each period. In other words, the discount rate should not be frozen for the life of the lease.

We do not agree with the notion that lease expense should be “level” so as to be consistent with the cash payments or to be aligned with current income statement effects. We disagree with this notion because: 1) it fails to acknowledge that current lease expense is straight-lined to achieve an appearance of level expense when in fact there may be escalating, or declining lease payments, under the lessee arrangement. Accordingly, current “level” lease expense is “disconnected” from escalating lease payments, and 2) the obligation created under the leasing arrangement is an amortizing debt obligation – not a bullet repayment obligation – and the interest expense accurately reflects this economic distinction.

Definition of Lease – We believe a more comprehensive and centralized definition of a lease is required. The current definitions of key elements are fragmented and some portions outlined in Appendix A and B to the ED rather than the main standard. A comprehensive definition should draw a clear distinction between: a) leases and purchase/sale arrangements; and b) lease and service arrangements.

Scope – On scope, we do not agree with a narrow scope treatment of leases and would have preferred that the Boards address all executory contracts and other items excluded from scope (e.g. intangible assets). Further, there is need to ensure consistency in the accounting treatment of lessors and the revenue recognition approach.

Lessor Accounting – We are cautiously supportive of the hybrid recognition model for lessor accounting, as we believe one model cannot be applied to all circumstances. Each of the two models (i.e. performance



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obligation and de-recognition) bears some conceptual anomalies. We believe the Boards should tighten the conceptual foundations of both underpinning models and provide further application guidance as a part of a single leasing standard. We believe that lessor accounting should be developed in a manner that is substantively aligned to and synchronized in timing with the revenue recognition standard.

We are in strong disagreement with the initial and subsequent measurement of the residual asset which we believe not only lacks economic relevance but is inconsistent with historical cost accounting approaches.

We urge the FASB to address investment properties and to require fair value accounting for these assets as that would provide more decision useful information to investors.

Presentation – With the exception of lessor performance obligation presentation, we support the proposed presentation approaches. We also strongly support the proposed disclosures and provide suggestions regarding further disclosure enhancements.

Disclosures – Disclosure requirements for lessee and lessor arrangements should be specified separately in the ED to ensure that the disclosures are complete and that they accurately disclose the nature of these arrangements. Our view is that the requirements, as currently proposed, will result in general, qualitative, highly aggregated and boilerplate disclosures which will not be especially meaningful and decision-useful to investors

We provide input on addition disclosures which we believe are necessary for the separate elements of lessee and lessor arrangements. Our suggestions are by financial statement caption – which is how we believe the disclosure requirements should be articulated in the ED.

Transition – A new leasing standard will result in a significant discontinuity, as financial statements following transition will not be comparable with those prior to transition. We have carefully considered the transition provisions of the ED and have concluded that neither the full retrospective nor the “simplified retrospective” approach will provide investors with useful measurements and that additional disclosures are needed. Whichever transition method the Boards choose, we strongly urge that the lease liability (asset for lessors) representing the present value of lease payments be clearly identified as a financial instrument, with periodic disclosure of fair value required so that analysts and investors can replace the measurements provided with current value based measurements which is the information they will use to make investment decisions.

Overall – In sum, we support capitalization of all leases on the lessee balance sheet, but consider the proposed measurement approach to be a departure from the most faithfully representational view that can be best provided by the fair value recognition of the lease asset and liability. Therefore, we view this proposal as a starting point for changing lease accounting, rather than a final and optimal solution.

In the next section we provide a summary of our specific responses to the questions posed in the Exposure Draft that are included in the **Appendix** to this letter.

Definition of Lease & Scope***Definition of Lease***

We believe a final standard requires a more comprehensive and centralized definition of a lease than that currently provided in the ED. The current definition is fragmented with some portions of the definition outlined in Appendix A and B of the ED rather than in the main standard. Further, the inclusion or exclusion of items, within the Scope section is meant to help define what constitutes a lease by defining what is not covered by this proposed leasing standard. It is our view that the definition of a lease provided within the ED, lacks sufficient clarity as to allow the unambiguous distinction between, for example: a) a lease and a purchase or a sale, b) a lease and a service; and c) how a sale is distinguished from the application of the lessor derecognition approach. A comprehensive definition should draw a clearer distinction between these items. The standard should also provide some illustrative real world examples to test the robustness of these definitions especially where the boundaries are blurred, such as the distinction between a lease (i.e. right-of-use asset) and service and between when the lessor derecognition approach or sale accounting is most appropriate. Overall, we recommend that the body of the ED include the definition of a lessee arrangement versus purchase or sale. Correspondingly, the definition of a lease should be articulated directly in the ED rather than indirectly through the application of various paragraphs with differing levels of authoritative stature.

We also believe that the ED has a range of conceptual difficulties that arise due to the current inadequate definition of lease contracts. They are as follows:

- 1) ***Executory Contracts*** – We consider leases to be a subset of executory contracts and all executory contracts, not just leases, should be recognized within the financial statements.

It is necessary to develop and provide a clear and robust distinction, if any, regarding what the Boards perceive to be the differences between leases and all other executory contracts, and thereafter substantiate the conceptual basis of any differentiation in lease accounting from the accounting for all other executory contracts. This clarification will enhance both the operability of the standard, and the evaluation by users regarding the extent to which the accounting approach is a faithful representation of the underlying economic transactions.

- 2) ***Transfer of Control*** – It is not clear whether the transfer of control notion applied under lease accounting is consistent with the same notion proposed under the revenue recognition ED. To ensure consistent interpretation of economic substance, it is important for the Boards to provide a tighter definition of control and to explicitly show the differences, if any, between the control of an underlying asset versus control of the right-of-use asset. As with the proposed revenue recognition standard, we also believe a greater understanding regarding the interrelationship of the risk and rewards assessment and the transfer of control definition needs to be articulated.

- 3) ***Leases vs. Services & Specified Asset*** – We believe that all obligations should be capitalized regardless of whether they relate to the use of an asset or to a service. However, if the Boards are to decide that capitalization will be restricted to leases, then there is a need to provide a robust and operational definition that can allow the consistent and economically sound distinction between leases and services. This distinction can be achieved by providing a definition of a service contract alongside a definition of a lease contract. We also do not believe that the presence of a specified asset is either necessary or sufficient towards the definition of a lease. The necessity of a specified asset



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could result in misclassification of a service as a lease and vice versa. It could also result in structuring to avoid capitalization of a right-of-use asset.

- 4) *Tangible vs. Intangible Assets* – It is not clear whether and how the accounting for the lease transactions of underlying tangible and intangible assets is consistent.

Scope

The ED proposes in Paragraph 5 that a lessee or a lessor should apply the proposed standard to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets; leases of biological assets; leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and leases between the date of inception and date of commencement of a lease if they meet the definition of an onerous contract. Paragraph 5 excludes such leases from the proposed ED without having provided – as described above – a comprehensive definition of a lease.

As noted previously, we believe that the ED only provides a very general definition of a lease. Through the Scope section and Appendix B the ED indirectly attempts to provide greater definition/guidance. With a clearer and more comprehensive definition of a lease, and a better distinction of what constitutes a lease versus a purchase or a sale in the lease definition, we believe that the Scope section of the ED could more succinctly establish the boundaries of the proposed standard. Further, greater clarification regarding leases of services and leases of tangible property is needed in order to clarify what is included in the Scope.

We believe that neither the nature of the underlying asset nor the term of the contract should determine whether or not to apply the proposed lease accounting (i.e. capitalisation of right-of-use). Further, in our response to the proposed standard, *Revenue from Contracts with Customers*, we emphasized the need to develop consistent accounting approaches across transactions with substantially the same economic characteristics. Accounting for leases is simply a special case of accounting for contracts and there should be conceptual consistency among the principles applied towards all forms of contracts. Hence, we recommend that the Boards define leases broadly, so that the proposed standard also applies to leases of natural resources and intangible assets and other executory contracts (e.g. take or pay contracts and throughput agreements). In other words, we do not support the scope exclusion of intangible assets, biological and exploration assets.

It is difficult for users to evaluate whether there is a conceptually consistent approach in the accounting for the licensing of intangible assets between the proposed revenue recognition standard and this particular leasing standard. We elaborate further on this in the **Appendix**. These inconsistencies highlight the shortcomings of failing to concurrently develop generalizable and internally consistent principles of accounting for all types of contracts including intangible assets and executory contracts.

We disagree with the exclusion of a purchase option in the determination of the present value of the lease payments to be made or received. We prefer that purchase options be accounted for in a fashion consistent with renewal options, as they are economically equivalent. There needs to be a stronger articulation as to why purchase options are treated any differently from options to renew. It is also not clear the extent to which the proposed approach of accounting for purchase options in this leasing proposal is consistent with the guidance in the proposed revenue recognition standard. An overriding principle should be that



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any categorization of lease contracts as sales should be strictly consistent with the provisions of the revenue recognition standard.

Recognition

Lessee

The ED proposes a new accounting model for leases in which 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. 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 recognize interest expense on the liability to make lease payments.

We agree with the recognition of a right-of-use asset and a liability to make lease payments on the statement of financial position. Financial statement users face interpretation difficulties due to the inconsistent accounting treatment of similar economic lease transactions and the inconsistent and incomplete disclosure related to operating lease transactions. Users currently have to make use of rule-of-thumb approximations when making analytical adjustments.

Depending on the quality of measurement, the recognition of assets and liabilities may result in enhanced transparency along with improved depiction of leverage and asset utilization and it may further facilitate user judgment on asset risk. It can also improve the comparability across reporting entities. If an economically relevant measurement basis is applied, the proposed approach should improve financial reporting by resulting in a more complete display of financial leverage in firms that are currently employing the operating lease method of accounting, and it may reduce structuring opportunities and off-balance sheet financing. As we have consistently argued through various comment letters, the inclusion of information in the principal financial statements rather than disclosure results in greater attention from management and auditors which bestows higher reliability, and, in turn, results in more consistent and comparable information. We further elaborate, in the **Appendix**, on the basis of our support of recognition of all leases in the statement of financial position.

However, we have concerns about aspects of the measurement approach including the determination of the lease term and amortization. We provide our views related to the amortization of the right-of-use asset, interest on liability and other measurement issues in the measurement section that follows and propose disclosures necessary to assuage these concerns. Further, we agree that the recognition of the right-of-use asset should be separately presented on the statement of financial position, as there are differences between the right-of-use of an asset and owning an underlying asset.



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Lessor

The ED proposes a new accounting model for leases in which a lessor would apply either a performance obligation approach or a de-recognition approach to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease.

We acknowledge that the complexity and variety of lease contracts presents challenges towards the application a single approach of lessor accounting for all leases. The IASB during its outreach efforts successfully conveyed the inappropriateness of conveying different types of leases, bearing varied economic characteristics, using a single accounting model.

However, we observe that both these two primary lessor recognition approaches bear some conceptual anomalies. These anomalies, further elaborated on in the **Appendix**, make neither of the two approaches by themselves to be suitable for universal application to all lessor arrangements. Hence, a hybrid approach may present a pragmatic way of overcoming the specific anomalies of either of the approaches. We are cautiously supportive of the proposed hybrid approach should these anomalies be addressed.

We recommend that if the hybrid lessor accounting approach is adopted, the Boards need to strengthen the conceptual foundations of both approaches, so as to allow the consistent choice of either of the models depending on the economics of each type of lease transaction. Further, there is also a need to ensure robust disclosures around the risk-reward assessment applied to determine when to allow one recognition approach over the other. This should all be done as part of a single leasing standard and we do not support the idea of deferring lessor accounting to a separate project. We believe that addressing both lessee and lessor accounting in a synchronized fashion is a sound objective and will help: a) ensure issues do not arise with lessee accounting when lessor accounting is later addressed; b) improve the quality of lease accounting; b) attain the convergence objective; and c) resolve existing difficulties with sub-leases and sale and leaseback transaction.

We would also recommend that the determination of revenue recognition for lessors be consistent with the overall revenue recognition principles being proposed and the Boards should align the timing and substance of development of lessor and revenue recognition standards.

Finally, we recommend that the FASB, similar to the IASB, allow investment properties to be accounted for at fair value.

Costs

This ED proposes to capitalize the direct costs of acquisition for lessees and lessors. However, it is not clear whether there is consistency in the treatment of acquisition costs across all types of contracts. For example, it is not clear whether commissions or legal fees would be treated consistently under both the proposed revenue recognition and leases standards. These items could be classified as contract acquisition costs and expensed under revenue recognition. However, they are allowed to be categorized as initial direct costs essential to acquiring a lease and thereafter capitalized. We strongly recommend consistent accounting treatment of costs related to all forms of contracts including leases, revenue from non-lease contracts, insurance contracts and executory contracts.



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Short-Term Leases

While we do not believe that the term of the lease contract should dictate the related accounting, we concur with the simplified requirements³ for short-term leases as these requirements still necessitate the capitalization of the right-of-use leased asset absent the need to discount related amounts.

Short-term leases which are renewable, or in practice renewed annually, are equivalent to long-term leases, and should not be eligible for this treatment. The simplified treatment may present structuring opportunities such as continually entering into or renewing short-term leases in order to engineer reduced leverage ratios.

In addition, we believe the ED does not adequately articulate the presentation of short-term lease payments and receipts in the statement of comprehensive income for lessees or lessors.

³ The ED proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases (i.e. leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less):

(a) Lessee – 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 profit or loss over the lease term.

(b) Lessor – 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 derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other IFRSs and would recognize lease payments in profit or loss over the lease term.



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Measurement

Overall Perspective

We believe that the certain aspects of the proposed measurement approach are flawed, as set forth below.

Expectations vs. Contractual Approach

In general, we support the use of an expectations based – rather than a contractual approach – because we believe that such an approach reflects the economic reality of how decisions with respect to entering into and continuing a leasing arrangement are made. Not including such expectations and the impact of changes in decisions over time has the effect of not reflecting economic decisions in the financial statements. As a general principle, we believe that expected value is the best way to measure when there are multiple possible outcomes.

We do not share the objections by some to the use of the expected value technique in the ED for leases. This is because a similar approach is required in the insurance project, and for liabilities under the scope of IAS 37, where estimates and projections are far more complicated. Therefore, we find the concerns that the measurements would be unduly complex to be overstated.

Lease Term

Rather than the determination of lease term being based on the ‘more likely than not’ lease period, we prefer a full expected value approach that explicitly factors in the probability of exercising of each option when deriving the expected lease term (i.e. probability weighted expected lease term) as we believe this will result in less subjectivity over time than a ‘more likely than not’ approach.

Some have suggested that a full expected value approach would result in lease terms that are not integers (e.g. 7.2 years) and therefore non-intuitive. As we expect that preparers will generally perform these measurements on a portfolio basis, we find a lease term of 7.2 years to be no less intuitive than a bond portfolio with an average coupon rate of 4.95% and an average maturity of 11.2 years.

In the **Appendix**, we suggest disclosures to assist users if the Boards adopt the ‘more likely than not’ criterion.



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Lease Payments

We support the inclusion of renewal options as well as contingent rentals and residual value guarantees in the determination of right-of-use asset/obligation to pay rentals in the statement of financial position and that this should be done on an expected value basis. We also believe that purchase options should be included in the expected value calculation.

Although we support the inclusion of options in the reported liability to pay rentals, it would be helpful to separately disclose the measurement of the base lease obligation from that of the option obligation, so that users can make an aggregate judgment on the financial flexibility that the reporting entities enjoy. This disaggregation requirement should not be seen as a requirement for the disaggregation of each individual lease, but rather financial statement preparers should exercise reasonableness in their judgment of an economically meaningful level to aggregate and present such information.

Discount Rate

We agree with the use of the lessee incremental borrowing rate as the discount rate. However, we believe that the discount rate should consider the expected lease term, and that the discount rate should be remeasured each period. In other words, the discount rate should not be frozen for the life of the lease. We also strongly encourage the Boards to use conceptually consistent discount rates in measuring liabilities across various projects under development in order to improve the quality of accounting standards.

Lessee Right-of-Use Asset Measurement

While we would prefer fair value for both the right-to-use asset and the liability to pay rentals, we recognize that application difficulties (e.g. fair value determination of right-of-use asset) necessitate that the initial measurement of the asset has to be equal to the liability to pay rentals.

While we would prefer periodic remeasurement of all assets and liabilities at fair value, under the model proposed we do not object to amortization of the right-of-use asset based upon a systematic approach consistent with the method of amortizing other tangible or intangible assets in so far as the amortization reflects the actual economic utilization of the right-of-use asset. We are fearful that arbitrary right-of-use asset measurements will be compounded by flawed amortization, resulting in lease expense that has no conceptual or economic basis. For enterprises that are significant lessees, the result would be income measures that are arbitrary, non-comparable, and therefore of little use for making investment decisions. We do not agree with those who suggest that the expense resulting from a lease should always be level over time. For example, this is not the case for an asset purchase financed by amortizing debt such as mortgage debt, even when straight-line depreciation is used. There is a stronger argument for using a declining expense as, for many assets (trucks for example) maintenance costs increase with asset age. If lease-related expense declines over time, total cost may be approximately level.

It is therefore important for the Boards to be more specific on the amortization approach so as to lower the likelihood of misapplication of amortization requirements. Also, the Boards should consider the merits of an impairment approach to a greater extent than is the case in the ED. In sum, we urge the Boards to reconsider the conceptual foundation of specific amortization approaches is required on the subsequent measurement of the right-of-use asset.



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As we support a fair value based model for measurement of assets, we do not object to the right-of-use asset revaluation provisions of the ED.

Level Lease Expense

We do not agree with the notion that lease expense should be “level” so as to be consistent with the cash payments or to be aligned with current income statement effects. We disagree with this notion because: 1) it fails to acknowledge that current lease expense is straight-lined to achieve an appearance of level expense when in fact there may be escalating, or declining lease payments, under the lessee arrangement. Accordingly, current “level” lease expense is “disconnected” from escalating lease payments, and 2) the obligation created under the leasing arrangement is an amortizing debt obligation – not a bullet repayment obligation – and the interest expense accurately reflects this economic distinction.

Lessor Residual Asset Measurement

We are in strong disagreement with the initial and subsequent measurement of the residual asset which we believe not only lacks economic relevance but is inconsistent with historical cost accounting approaches. This is discussed further in the **Appendix**.

Sale & Leaseback

We believe that the criteria to determine if a sale has occurred should be consistent with the criteria set forth in the proposed revenue recognition standard. We agree that the sale and leaseback should be connected if entered into simultaneously, but it would appear that the sale should be accounted for under guidance in the proposed revenue recognition standard and the leaseback should be accounted for under the lessee performance obligation approach. As such, it is not clear as to why separate guidance is needed for such transactions in the ED.



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Presentation

We are generally supportive of the presentation requirements proposed in the ED. We disagree with the notion that the disclosure requirements in IAS 1, *Presentation of Financial Statements*, and IAS 7, *Statement of Cash Flows*, are sufficient to guide preparers on the separate presentation requirements. Many users have indicated that the Financial Statement Presentation Project (FSP Project) should be a major priority of the Boards. With the delay in the FSP Project we believe it is even more important than the ED, and any final standard, include the proposed presentation requirements.

We discuss the presentation requirements for lessee and lessor arrangements in greater detail and provide certain suggestions in the **Appendix**. Some of the more significant points are set forth below.

Lessor Performance Obligation Approach

The most significant presentation issue relates to lessor arrangements accounted for under a performance obligation approach. Our views are as follows:

- 1) **Statement of Financial Position** – We support the linked presentation of the underlying asset, right to receive lease payments receivable and lease liabilities such that users of the financial statements can understand the relationship between the balances and the economics of the transaction. However, we would prefer the linked presentation of the lease asset and lease liability as proposed to be in the notes rather than in the statement of financial position. We believe the underlying asset, right to receive lease payments receivable, and lease liabilities should be presented separately within the appropriate section of the statement of financial position. Although there is no loss of information content with the linked presentation, some users could still be confused by this presentation, especially if it is being applied only for a limited category of assets including lease transactions, on the statement of financial position. Therefore, we recommend that the linked presentation be in the notes, to complement the statement of financial position presentation.
- 2) **Statement of Comprehensive Income** – We support the IASB’s decision to separately present interest income on the right to receive lease payments receivable, lease income from satisfaction of the lease liability and depreciation expense on the underlying asset separately from other interest income, income and depreciation expense. We note that the FASB presentation, which requires separate presentation of these income statement elements followed by a net lease income or net lease expense presentation (i.e. linked presentation), is more consistent with the presentation on the statement of financial position. As noted for the statement of financial position, we would prefer the linked presentation to be in the notes rather than of the face of the financial statements, so as to avoid confusing some users.

Lessor Derecognition Approach

As it relates to lessor arrangements accounted for under a derecognition approach; we do not support the provisions of the ED as it relates to the presentation of rental income (Paragraph 61) based upon the lessor’s business model as such a model does not change the economic value of the transaction to the entity.

Short-Term Leases

As it related to short-term leases, the ED is silent as to the presentation of lease payments and receipts on the statement of comprehensive income. We believe the ED should clarify how such amounts should be presented under the proposed simplified approach.



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Disclosures

Disclosure requirements for lessee and lessor arrangements should be specified separately in the ED to ensure that the disclosures are complete and that they accurately disclose the nature of these arrangements. Presently, the disclosure requirements for leases are principally articulated on a combined basis in Paragraphs 70 through 86 in the ED and many of the key disclosures are described in very general terms for both lessee and lessor arrangements in Paragraphs 73, 83 and 84 of the ED. Consistent with the recognition, measurement and presentation requirements of the ED, we believe the disclosure requirements for lessee and lessor arrangements should be articulated separately to ensure disclosures are presented in a disaggregated, but concise, comprehensive and understandable manner which is not boilerplate in nature.

Our view is that the requirements, as currently proposed, will result in general, qualitative, highly aggregated and boilerplate disclosures which will not be especially meaningful and decision-useful to investors. We do not believe that these disclosure requirements will result in quantitative disclosures of how contingent rentals, termination payments, renewal options, or residual value guarantees were utilized in the determination of the performance obligation under the lessee arrangement. Overall, we don't believe the requirements will result in a sufficient level of detail of measurement attributes, inputs and assumptions and changes therein to be meaningful.

In the **Appendix**, we set forth other disclosures which we believe are necessary for the separate elements of lessee and lessor arrangements. Our suggestions by financial statement caption – which is how we believe the disclosure requirements should be articulated in the ED – are described there.

Transition & Effective Date

Transition

We have carefully considered the transition provisions of the ED and have concluded that such provisions – particularly as it relates to lessee arrangements and lessor arrangements accounted for as performance obligations – will not result in a meaningful analytical construct for users. Until such time as all leasing arrangements in effect at the date of adoption of a new standard using the proposed transition approach have fully expired, the income statement effects of an organization's leasing activities under the accounting basis proposed in the ED will not be evident to users.

A new leasing standard will result in a significant discontinuity, as financial statements following transition will not be comparable with those prior to transition. We believe that neither the full retrospective nor the "simplified retrospective" approach will provide investors with useful measurements and that additional disclosures are needed.

The full retrospective method attempts to create financial statements that would have existed had the standard always been followed. The resulting balance sheet and income statement suffers from all of the shortcomings of the historical cost and will include leases entered into at a variety of times at a variety of interest rates. As we have argued in other contexts, with support from empirical research, we believe that all financial liabilities should be reported at fair value.



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The “simplified retrospective approach” measures leases currently in-force on the balance sheet at initial application at the present value of future expected lease payments discounted at the incremental borrowing rate at the date of application rather than the date of the inception of the lease. Some analysts believe that the use of a single interest rate would facilitate analytic adjustments by those who wish to estimate fair value.

This simplified retrospective approach would, however, result in measurements that are extremely sensitive to the transition date, which may differ among enterprises. If the transition date coincides with unusually high interest rates, the liability (and the related expense) will be low; if interest rates were extremely low at transition, the opposite effect ensues. These effects will persist in the financial statements until all of the leases in force at transition have terminated – which could be several decades. And, as at present, analytical adjustments will be approximate at best.

Whichever transition method the Boards choose, we strongly urge that the lease liability (asset for lessors) representing the present value of lease payments be clearly identified as a financial instrument, with periodic disclosure of fair value required.

In the **Appendix**, we further delineate some observed incongruities within the transition provisions and the anticipated impact of these on specific financial statement components.

Transition Alternatives

Some have proposed that transition alternatives be allowed whereby organizations can choose to adopt the ED using a simplified retrospective approach or a fully retrospective approach. The presence of alternatives would reduce the quality of accounting guidance, and calls for this approach reflect a lack of understanding regarding the importance of comparability in financial reporting data between organizations when making investing decision. Multiple options should not be considered by the Boards.

Early Adoption

We do not support early adoption as it results in a period of incomparability between organizations. Given the transition provisions of this ED – which are heavily dependent upon assumptions at initial application – we strongly object to any early adoption option as differences will exist beyond adoption dates due simply to differences in market conditions at dates of application. As it relates to first-time adopters of IFRS, our comment letter on effective dates and transition will address this issue.

Effective Date

We would not object to an effective date which allows companies to plan for adoption and improve the quality of retrospective application. However, we would observe that even such a delay would not prevent some element of retrospective application as many leasing arrangements extend beyond a two to three-year period. In our comment letter on effective dates and transition we will address our views on proposed effective dates.

Benefits and Costs

We agree with the considerations raised by the Boards in their analysis of the costs and benefits of the proposed standard.



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Other Comments

FASB Proposed Update vs. IASB Exposure Draft

Though we understand there to be minimal differences between the FASB and IASB proposals, no document summarizes or analyzes the differences. An analysis should be provided to enable users to quickly grasp the differences. If the objective of the joint issuance of these EDs and the 2006 MoU is convergence, the issuance of standards with a convergence objective should include an analysis of the differences such that stakeholders are not required to identify the differences themselves. Rather they can devote their attention to the analytical impact of these differences.

Additional Matters to Address in a Final Standard

We believe the ED fails to address how common lease provisions such as rent holidays, rent incentives, termination costs, taxes or special tax considerations should be addressed under new guidance. Such issues are currently addressed in U.S. GAAP literature and without consideration or guidance on how they would be treated under a new standard could result in diversity in practice and the potential for restatements.

Non-Public Entities

We strongly support a single model for recognition and measurement of lease arrangements across both public and non-public entities.

DETAILED COMMENTS

See **Appendix** for detailed comments and answers to specific questions posed in the ED.

CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, PhD, CFA, by phone at +44.207.531.0763, or by e-mail at vincent.papa@cfainstitute.org or Sandra J. Peters, CPA, CFA by phone at +1.212.754.8350 or by email at sandra.peters@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht
Kurt N. Schacht, JD, CFA
Managing Director
Standards and Financial Markets Integrity

/s/ Gerald I. White
Gerald I. White, CFA
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council

RESPONSES TO SPECIFIC QUESTIONS

In this Appendix we respond to the specific questions raised in the ED pertaining to key aspects of the proposed leases model. Our responses are organized as follows commencing with disclosures requirements for the reasons articulated in the body of our letter:

- Definition of a Lease
- Scope
 - Exclusions
 - Contracts Containing Service and Lease Components
 - Purchase Options
- Recognition
 - Lessee
 - Lessor
 - Costs
 - Short-Term Leases
- Measurement
 - Overall Perspective
 - Lease Term
 - Lease Payments
 - Reassessment
 - Discount Rate
 - Other Lessee Considerations
 - Other Lessor Considerations
 - Sale and Leaseback
- Presentation
- Disclosures
- Transition and Effective Date
- Benefits & Costs
- Other Comments
 - FASB Proposed Update vs. IASB Exposure Draft
 - Additional Matters to Address in A Final Standard
 - Appendix C – Amendments to Other IFRSs
- Non-Public Entities

Definition of a Lease (FASB and IASB Question #4)

Appendix A of the ED proposes to define a lease as a contract in which the right to use a specified asset or assets (the underlying asset) is conveyed, for a period of time, in exchange for consideration. There is no definition of lease included within the body of the ED. The Scope section (Paragraphs 5 through 9) of the ED appears to attempt to define a lease indirectly by defining what is not covered by the ED. For example, Paragraph 8 excludes from the scope of this proposed leasing standard those items which represent a purchase or sale and Paragraph 6 seeks to explain that service elements will be covered by the *Revenue from Contracts with Customers* proposed standard. Further, the ED utilizes application guidance in Appendix B – which would not be authoritative under IFRS – to accomplish what the ED itself does not address. Specifically, Paragraphs B1 through B4 of Appendix B include application guidance regarding the definition of a lease as set forth in Appendix A. Appendix B also includes Paragraphs B9 and B10 which are application guidance regarding making the distinction between a lease and a purchase or sale.

Our view is that the definition of a lease provided in Appendix A lacks sufficient clarity so as to allow the unambiguous distinction between a lease, purchase or sale. Further, the interaction and/or interrelationship between the Scope and Appendix B paragraphs makes understanding the distinction even more complicated. We believe the body of the ED should include the definition of a lease versus purchase for a lessee arrangement and a lease versus sale for a lessor arrangement. The definition of a lease should be articulated directly in the ED rather than indirectly through the application of various paragraphs with differing levels of authoritative stature.

As it relates to lessor arrangements, we also believe the guidance included in Paragraphs 28 and 29 regarding when to apply the performance obligation approach versus the de-recognition approach should be included in the definition of a lessor arrangement. We find the guidance in the ED – because of its location and indirect definition – makes it challenging to make the distinction between when something is a sale and when the contract is a lessor arrangement where the derecognition approach should be applied. Review of the application guidance regarding when to apply the performance obligation approach or the derecognition approach as set forth in Appendix B, Paragraphs B22 through B27 raises further questions regarding how to distinguish a derecognition approach and a sale. For example, Paragraphs B22 and B24 provide considerations a lessor should evaluate when determining whether to apply the performance obligation or the derecognition approach, but do not clarify how these considerations tilt the analysis towards one approach versus the other. Discerning the line between derecognition and sale is further complicated by a comparison of the risk and reward considerations evaluated in applying the performance obligation versus derecognition approach when you consider them in the context of the transfer of control guidance in Paragraph B9 regarding what constitutes a sale. Our view is that a more direct articulation of a lease versus purchase or sale definition would improve the ability to understand and apply the guidance in the ED.

We also believe that the ED has a range of conceptual difficulties that arise due to -the current inadequate definition of lease contracts. A robust definition of a lease will help stakeholders understand any justification of exclusion from scope. The following issues, in our view, require further attention:

- 1) Executory Contracts – We consider leases, in principle, to be a subset of executory contracts and all executory contracts, not just leases, should be accounted for consistently. As articulated in the Association for Investment Management and Research's (CFA Institute's predecessor organization) report, *Financial Reporting in the 1990s and Beyond*, we believe, leases and all other executory contracts should be recognized within the financial statements. The ED does not comprehensively clarify the differences between leases and all other executory contracts and why leases are recognized in the financial statements before other executory contracts. The Boards should clearly define why they consider leases to be different from all other executory contracts and thereafter substantiate the conceptual basis of any differentiation in lease accounting from the accounting for all other executory contracts.
- 2) Transfer of Control – Paragraphs B4(a) – (c) delineate the concept of transfer of control. However, it is not clear whether this notion is consistently applied relative to the proposed revenue recognition standard. To ensure consistent interpretation of economic substance, it is important for the Boards to provide a tighter definition of control and to explicitly show the differences, if any, between the control of an underlying asset versus control of the right-of-use asset. Further, the guidance on distinguishing between the application of the derecognition approach and the performance obligation as it relates to lessor accounting is based upon an assessment of risk and rewards. As with the proposed revenue recognition standard, we believe a greater understanding regarding the interrelationship of the risk and rewards assessment and the transfer of control definition needs to be articulated.
- 3) Purchase Options – Greater clarification is needed regarding the impact of purchase options on the assessment of risk and rewards as well as transfer of control and the economic equivalence of renewal options combined and purchase options. This is addressed further in response to Question 7 which follows.
- 4) Tangible vs. Intangible Assets – It is not clear whether and how the accounting for the lease transactions of underlying tangible and intangible assets⁴ is consistent. The proposed revenue recognition standard deals with licensing of intangible assets using the criteria of exclusivity to determine whether to use a performance obligation versus de-recognition approach or not. Under the leases standard, the application of the performance obligation versus derecognition approach is dependent on the outcome of a risk-reward assessment, and the notion of exclusivity is not applied. The Boards should develop more conceptually consistent treatment of tangible and intangible assets.
- 5) Leases vs. Services – We believe that all obligations should be capitalized regardless of whether they relate to the use of an asset or to a service. However, if the Boards are to decide that capitalization will be restricted to leases, then there is a need to provide a robust and operational definition that can allow the consistent and economically sound distinction between leases and services and thereafter allow the selection of the appropriate accounting choice. A clear and robust definition of services

⁴ The revenue recognition ED deals with licensing of intangible assets using the criteria of exclusivity to determine whether to apply a performance obligation approach or not. Under the leases standard and depending on the outcome of the risk-reward assessment, and whether the service is distinct, services will be accounted for through either the derecognition or performance obligation approach.

and leases, and thereafter a justification of the conceptual foundations of any differentiated accounting treatment of service contracts relative to leases, will enhance both the operability of the standard, and the evaluation by users regarding the extent to which the accounting is a faithful representation of underlying economic transactions.

- 6) Specified Asset – Based on the definition provided in the ED (i.e. Paragraph B2), the presence of a specified asset is germane to the categorization as a lease. However, there are many situations where specific or specified assets could also be applied in service arrangements and due to the blurred boundaries between lease and service, this could result in the misclassification of leases as services or vice versa. This raises the question of whether the presence of a specified asset is either necessary or sufficient towards the definition of a lease. Further, there is the risk that this requirement of a specified asset could open the door for entities to avoid the right-of-use capitalization due to the nature of underlying asset being interchangeable; for example, if business requirements necessitate frequent replacement of the same asset.

In sum, the definition of a lease as proposed in the ED should be improved, integrated within the main body of the standard and directly rather than indirectly articulate. In addition, a final standard should provide some illustrative real world examples to test the robustness of these definitions especially where the boundaries are blurred, such as the distinction between a lease (i.e. right-of-use asset) and service and between when the lessor de-recognition approach is more appropriate than a sale.

The definition should also make it clear why services are different from licensing of intellectual property, which is the same as leasing of an intangible asset. In other words, clarity in articulation of the differences between right-of-use assets and services associated with lease contracts is necessary.

Scope – Exclusions (FASB and IASB Question #5)

The ED indicates in Paragraph 5 that a lessee or a lessor should apply the proposed standard to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets; leases of biological assets; leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and leases between the date of inception and date of commencement of a lease if they meet the definition of an onerous contract. Paragraph 5 excludes such leases from the proposed ED without having provided – as described above – a comprehensive definition of a lease.

As noted previously, we believe that the ED only provides a very general definition of a lease. Through the Scope section and Appendix B the ED indirectly attempts to provide greater definition/guidance. With a clearer and more comprehensive definition of a lease, and a better distinction of what constitutes a lease versus a purchase or a sale in the lease definition, we believe that the Scope section of the ED could more succinctly establish the boundaries of the proposed standard. Further, greater clarification regarding leases of services and leases of tangible property is needed in order to clarify what is included in the Scope.

Our view is that neither the nature of the underlying asset nor the term of the contract, should determine whether or not to apply the proposed lease accounting (i.e. capitalisation of right-of-use) standard. Further, in our response to the proposed standard, *Revenue from Contracts with Customers*, we emphasized the need to develop consistent accounting approaches across transactions with substantially the same economic characteristics. Accounting for leases is simply a special case of accounting for contracts and there should be conceptual consistency among the principles applied towards all forms of contracts. Hence, we recommend that the Boards define leases broadly, so that the proposed standard also applies to leases of natural resources and intangible assets and other executory contracts (e.g. take or pay contracts and throughput agreements). In other words, we do not support the scope exclusion of intangible assets, biological and exploration assets.

It is difficult for users to evaluate whether there is a conceptually consistent approach in the accounting for the licensing of intangible assets between the proposed revenue recognition standard and this particular leasing standard. Under the proposed revenue recognition standard, the performance obligation approach is applied and revenue recognized over the term of the license, when the licensing to the customer is exclusive, otherwise full revenue is recognized immediately if the license is non-exclusive. The application of exclusivity of use as a criterion is confined to a particular form of contract (i.e. intangible assets). These inconsistencies highlight the shortcomings of failing to concurrently develop generalizable and internally consistent principles of accounting for all types of contracts including intangible assets and executory contracts.

Scope – Contracts that Contain Service & Lease Components (FASB and IASB Question #6)

The ED proposes that lessees and lessors should apply the proposals in *Revenue from Contracts with Customers* to a distinct service component of a contract that contains service components and lease components. As we believe that all obligations should be capitalized regardless of whether they relate to the use of an asset or to a service, the requirement to make this distinction stems from the accounting construct where different accounting is required for leases than services. We don't believe such a distinction has economic merit; however, if the Boards are to decide that capitalization will be restricted to leases, then there is a need to provide a robust and operational definition that can allow the consistent and economically sound distinction between leases and services.

If the service component in a contract that contains service components and lease components is not distinct; however, there are divergent⁵ approaches between the IASB and FASB in the recognition of distinct service component.

As noted in the discussion of definition, the current definition of a lease should be further developed to allow the meaningful distinction between the lease of tangible property and a contract to acquire services. Starting from the premise that the lease and service components of a contract are of a fundamentally different nature, we would support unbundling on the premise that elements within contractual arrangements that yield differing patterns and timing of cash flows, should be accounted for differently. However, we would reiterate the views raised in our response to the exposure draft on *Revenue from Contracts with Customers* where we expressed our concerns about the robustness of principles of separation of performance obligations based on differentiated profit margins and differences in timing of satisfaction of performance obligations. The same concerns would be extended to lease contracts.

Given our preference for the unbundling of service and lease component, we would prefer the IASB's approach as it recognizes that lessees and lessors may have informational asymmetry which allow the lessor to unbundle the service and the lease component more readily as they generally have greater information (i.e. information on profit margin) upon which to make such determination than the lessee. We are generally supportive of the guidance in Appendix B, Paragraphs B5 through B8 regarding the approach to determining the distinct nature of the service and lease components. However, we believe that whether under the performance obligation approach or derecognition approach the service and lease components should be separated unless the separation under a performance obligation approach would not be material. We do, however, believe the guidance in Paragraph 6(c) will be difficult to apply when utilizing the derecognition approach because it requires separate treatment of the service and lease components even if not distinct. If not distinct, separation seems unlikely to be practicable.

⁵ FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract if the service is not distinct. In contrast, the IASB proposes that if service is not distinct:

- (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 proposals in *Revenue from Contracts with Customers*.

Scope – Purchase Options (FASB and IASB Question #7)

The ED proposes that a lease contract should be considered as 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.

We disagree with the exclusion of a purchase option in the determination of the present value of the lease payments to be made or received. We prefer that purchase options be accounted for in a fashion consistent with renewal options, as they are economically equivalent. There needs to be a stronger articulation as to why purchase options are treated any differently from options to renew.

It is also not clear the extent to which the proposed approach of accounting for purchase options in this leasing proposal is consistent with the guidance in the proposed revenue recognition standard. An overriding principle should be that any categorization of lease contracts as sales should be strictly consistent with the provisions of the revenue recognition standard.

Recognition – Lessee (FASB and IASB Question #1)

The ED proposes a new accounting model for leases in which 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. 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 recognize interest expense on the liability to make lease payments.

We agree with the recognition of a right-of-use asset and a liability to make lease payments. There is empirical evidence showing that capital market participants capitalize the right-of-use of operating leases and the associated liability on the statement of financial position. A paper⁶ reviewing existing academic evidence related to leases, found that archival studies generally tend to show that both operating and capital leases are treated like debt for risk assessment and valuation purposes by capital market participants. However, the current accounting regime leaves users with little choice but to make rule-of-thumb guesstimates when making the analytical adjustments required to reflect the economic leverage and ‘full asset utilization’ picture. This imperfect, but necessary, analytical adjustment by investors occurs due to incomplete and inconsistent disclosure of related operating lease information provided in the footnotes. A recent study⁷ by Credit Suisse, evaluated 494 S&P 500 companies, obligated to make \$634 billion in total future minimum payments under operating leases. The study included estimating the operating lease liability. The findings of this study showed that significant variation existed between operating lease liabilities estimates based on: a) using a popular rule-of-thumb of eight times the rent, and b) discounting future lease payments using guesstimate parameters such as the incremental borrowing rate and contingent rental adjustment. The rule-of-thumb yielded an estimate of \$940 billion whereas the discounted approach yielded \$549 billion. The rule-of-thumb is 71% higher than an attempted discounted approach. This finding shows that the full spectrum of users will be subject to measurement error, if they are restricted to making analytical adjustments based on the existing information provided through disclosures as it is unlikely that all investors will use the same valuation approach. Depending on the quality of measurement, the proposed approach of capitalization can result in a significant improvement to financial reporting as it could provide users with a right-of-use asset valuation that is based on management’s more complete knowledge of the specifics of the lease contract.

Capitalization can result in enhanced transparency, an improved depiction of leverage and asset utilization, facilitate user judgment on asset risk and improve the comparability across reporting entities. Further, as we have consistently argued through various comment letters, the inclusion of information in the main financial statements rather than disclosure results in greater attention from management and auditors, which bestows higher reliability, and, in turn, results in more consistent and comparable information.

However, we have concerns about aspects of the measurement approach including the determination of the lease term and amortization. We provide our views related to the amortization of the right-of-use asset, interest on liability and other measurement issues in the measurement section that follows and propose disclosures necessary to assuage these concerns. Further, we agree that the recognition of the right-of-use asset should be separately presented on the statement of financial position, as there are differences between the right-of-use of an asset and owning an underlying asset.

⁶ Ryan, S.G.; Herz, R.H.; Iannaconi, T.E.; Maines, L.A.; Palepu, K.G.; Schipper, K; Schrand, C.M.; Skinner, D.J.; and Vincent, L.; 2001; *Evaluation of the Lease Accounting Proposed in G4+1 Special Report*; Accounting Horizons; Vol.15, No.3; pp 289-298.

⁷ Zion, D. & Varshney, A; 17th August 2010; *Leases Landing on Balance Sheet*, Credit Suisse – Equity Research.

Recognition – Lessor (FASB and IASB Question #2)

The ED proposes a new accounting model for leases in which a lessor would apply either a performance obligation approach or a de-recognition approach to account for the assets and liabilities arising from a lease depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease. We acknowledge that the complexity and variety of lease contracts presents challenges towards the application a single approach of lessor accounting for all leases. The IASB during its outreach efforts successfully conveyed the inappropriateness of conveying different types of leases,⁸ bearing varied economic characteristics, using a single accounting model.

In our response to the discussion paper, we argued for and deemed it desirable to address lessee and lessor accounting concurrently, so as to ensure symmetrical accounting between lessees and lessors. Nevertheless, despite the appeal of a synchronized and symmetrical resolution of lessee and lessor accounting, there is clearly need for further development of the conceptual building blocks of the lessor accounting model, so as to ensure its operationality and to allow users to consistently differentiate leases that have differing economic characteristics. We recognize that lessee accounting has been subject to greater development effort by the Boards and due process scrutiny from all stakeholders, having been subjected to a discussion paper process. Further, relative to lessor accounting reform, we consider the proposed changes to lessee accounting to be more far reaching and requiring more immediate need of financial reporting reform because of the lack of representation of leases on balance sheets is a more pervasive problem. Still, due to the insufficiently developed conceptual building blocks for lessors, there is the risk that the costs of a flawed lessor standard will outweigh the benefits of synchronized development of lessee and lessor accounting. Below, we highlight some of the conceptual difficulties:

Risk-Reward Framework as a Differentiating Criterion

Under existing literature, the risk-reward criterion is currently applied to differentiate the accounting treatment between operating and capital leases for lessees and this has not pre-empted the occurrence of structuring geared towards achieving what is considered to be the more favorable accounting treatment (i.e. off balance sheet treatment of operating leases). Given the application of the same risk-reward criterion for lessors, it remains hard to rule out unintended consequences (e.g. structuring) arising from applying either performance obligation or de-recognition approaches. Other issues related to risk-reward criterion include:

- ***Asymmetrical Accounting:*** The lease definition connotes a notion of transfer of control to the lessee. However, the lessor accounting approach is based on a risk-reward assessment. This could potentially result in asymmetrical accounting due to the application of a risk-reward assessment as a basis of de-recognition for the lessor versus the application of transfer of control as a basis of recognizing right-of-use of asset by the lessee. Further, it is difficult to evaluate the difference between de-recognition and a sale, based on the current definitions within the ED. De-recognition is premised on the lessor no longer bearing the risk-reward of underlying asset.
- ***Exacerbating Cross-standard Inconsistencies:*** The notions and application of ‘control’ and ‘bearing risk-reward’ of assets, in the context of both tangible and intangible assets, seems to vary from standard to standard when you consider the standards currently under development. The introduction of risk-reward framework for the lessor simply compounds the cross-standard (i.e. revenue recognition and lessor) inconsistencies.

⁸ IFRS slide presentation, *Exposure Draft Leases*, presents six examples including: a) a 1 week rental of a Ford Focus by Hertz; b) a 3 year Boeing 737 lease with an estimated useful life of 25 years; c) a 5 year lease of a retail outlet; d) a 20 year Boeing 737 lease; and e) Siemens lease of its X-ray machine for 9 years with an estimated useful life of 10 years; f) the Queen leasing out land to developers for 99 years.

Hence, it would appear to be more meaningful to apply the notion of transfer of control for lessor accounting, so as to ensure consistency across different standards (i.e. revenue recognition and lessor accounting).

Performance Obligation Approach Anomalies

We recognize that the performance obligation approach represents some conceptual challenges including the following:

Inconsistency with Revenue Recognition & Lessee Accounting: The definition of a lease implies that the performance obligation of the lessor is fulfilled at commencement of the lease (i.e. right to use asset is conveyed) and the lessee bears an unconditional right to pay rentals over the term. Despite the fulfillment of performance obligation by the lessor at inception, the performance obligation approach requires the recognition by the lessor of a performance obligation liability. This differs from the situation of revenue recognition for non-lease contracts, where the performance obligation would exist or is fulfilled over the contract duration and thus warrant the recognition of a performance obligation liability. This is an area where a robust conceptual definition of performance obligation needs to be developed so as to encapsulate a consistent treatment for both revenue recognition and lessor accounting requirements.

Double Counting on Balance Sheet: Another often articulated concern of the performance obligation approach is that the balance sheet is bloated and double counting is occurring when the whole asset and receivable asset (i.e. right to receive rentals) are recognized. However, under the performance obligation approach, users would still be able to work out the offsetting effects of the 'wholesale asset' from the 'lease liability' and eliminate the double counting misrepresentation. Further, this approach is analogous to the existing accounting treatment of repo transactions as it is to the recording of inventory that has been generated by recorded property, plant and equipment. Hence, our view is that this concern is overstated.

Misrepresentation of Business Model: The performance obligation can result in financial institutions that mainly bear credit risk when organizing lease transactions, having to reflect underlying asset risk on balance sheet.

Derecognition Approach Anomalies

We would agree that in some cases it is appropriate to recognize day 1 profit as this faithfully represents the economics of some types of lease transactions (e.g. manufacturer-dealer). We also recognize that the de-recognition approach does not result in the concerns about double counting of the leased asset on both the lessor and lessee balance sheets. In this vein the de-recognition approach has some appeal. However the derecognition approach also has its anomalies. These include the below:

Residual Asset Misrepresentation: The partial de-recognition approach results in an economically meaningless residual asset where only a portion of an asset is leased (e.g. 1 floor in a 30 storey apartment) or if the lease term is significantly lower than the economic useful life of the asset. Further compounding this lack of meaning, is the manner in which residual is subsequently measured under the proposed standard with adjustments only made upon reassessment of expected cash flows under a method which bears no relation to the historical amortized cost or fair value of the residual.

Inconsistency with Revenue Recognition: The de-recognition approach is also conceptually inconsistent with the revenue recognition model, as far as treatment of licensing of exclusive rights to intellectual property is concerned.

Reduced Transparency on Whole Asset Value: With the split into right-of-use asset for the lessee and residual asset for the lessor, there is loss of transparency on whole asset value.

Complexity: The derecognition approach appears to be more difficult to apply. The lessor is required to calculate how much of the underlying asset to derecognize both at inception and when there is a reassessment of whether an option in the lease contract will be exercised. This requires information about the fair value of the underlying asset.

Our Preferred Approach

We observe that both of these two primary lessor recognition approaches bear some conceptual anomalies. These anomalies make neither of the two approaches by themselves to be suitable for universal application to all lessor arrangements. Hence, a hybrid approach may present a pragmatic way of overcoming the specific anomalies of either of the approaches. We are cautiously supportive of the proposed hybrid approach should these anomalies be addressed. If the hybrid lessor accounting approach is adopted we recommend the following:

- Robust disclosures around the risk-reward assessment applied to choose the de-recognition model;
- Ensure that judgments on transfer of control are consistent with the risk-reward assessment, so as to allow symmetrical accounting between lessor and lessee;
- Sufficient implementation guidance to enunciate the application of a risk-reward framework to determine whether to apply performance obligation or de-recognition. Paragraphs B22 to B27 provide some indicators, but these need to be applied across a range of complex, real world examples, so as to effectively convey to users, whether the accounting approach depicts the economic reality of the lease.

Despite the anomalies with each individual model, we believe the Boards should primarily tighten the conceptual foundations of the two underpinning models and provide further application guidance, so as to allow the consistent choice of either of the models depending on the economics of each type of lease transaction. This should be done as part of a single leasing standard and we do not support the idea of deferring lessor accounting. We believe that addressing both lessee and lessor accounting in a synchronized fashion is a sound objective and will help: a) ensure issues do not arise with lessee accounting when lessor accounting is later addressed; b) improve the quality of lease accounting; b) attain the convergence objective; and c) resolve existing difficulties with sub-leases and sale and leaseback transaction.

Further, given, the recurring range of cross-project inconsistencies, the lessor accounting model can be strengthened by the development of the conceptual framework with generalizable definitions of assets, liabilities and performance obligations. We would also recommend that the determination of revenue recognition for lessors be consistent with the overall revenue recognition principles being proposed and the Boards should align the timing and substance of development of lessor and revenue recognition standards.

Finally, we recommend that the FASB, similar to the IASB, allow investment properties to be accounted for at fair value.

Recognition – Costs

The proposed standard requires that a lessee measure the right-of-use asset initially at the amount of the liability to make lease payments, plus any initial direct costs incurred by the lessee. Similarly, the lessor measures the right to receive rental payments including direct costs incurred by the lessor. This ED proposes to capitalize the direct costs of acquisition for lessees and lessors. However, it is not clear whether there is consistency in the treatment of acquisition costs across all types of contracts. For example, it is not clear whether commissions or legal fees would be treated consistently under both the proposed revenue recognition and leasing standards. These items could be classified as contract acquisition costs and expensed under revenue recognition. However, they are allowed to be categorized as initial direct costs essential to acquiring a lease and thereafter capitalized.

We strongly recommend the consistent accounting treatment of costs related to all forms of contracts including leases, revenue from non-lease contracts, insurance contracts and executory contracts.

Recognition – Short-Term Leases (FASB and IASB Question #3)

While we do not believe that the term of the lease contract should dictate the related accounting, we concur with the simplified requirements⁹ for short-term leases as these requirements still necessitate the capitalization of the right-of-use leased asset absent the need to discount related amounts.

Short-term leases which are renewable, or in practice renewed annually, are equivalent to long-term leases, and should not be eligible for this treatment. The simplified treatment may present structuring opportunities such as continually entering into or renewing short-term leases in order to engineer reduced leverage ratios.

In addition, paragraphs 64 and 65 of the ED do not adequately articulate the presentation of short-term lease payments and receipts in the statement of comprehensive income for lessees or lessors. Will short-term lessee amounts be included as a separate “rent expense,” presented along with amortization of the right-of-use asset, or as interest expense? Similarly, will short-term lessor amounts be included as a separate “rental income,” along with amortization of the performance obligation in rental income, or as interest income?

⁹ The ED proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases (i.e. leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less):

- (a) Lessee – 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 profit or loss over the lease term.
- (b) Lessor – 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 derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other IFRSs and would recognize lease payments in profit or loss over the lease term.

Measurement – Overall Perspective

We believe that the certain of the proposed measurement approach are flawed as set forth below.

Further, as we consider the questions posed for comment in the ED related to measurement matters, we note that many of the questions focus on the measurement of the lessee performance obligation and the lessor right to receive lease payments (i.e. under both a performance obligation and derecognition approach). And, while one question relates to the appropriateness of the reassessment of expected lease terms and payments, views regarding the appropriateness of the proposed subsequent measurement approaches are not solicited in the ED.

Additionally, no input is sought on the appropriateness of the discount rate at initial or subsequent measurement and there are no questions in the ED which address the appropriateness of the amortization of right-of-use assets for lessees or the amortization of lessor performance obligations for the lessor.

There is no comment sought on the appropriate initial or subsequent measurement of the residual asset under the derecognition approach.

Because we consider the aforementioned items important to communicating our overall perspective on the ED, we have responded to the specific questions posed and provided our comments on these additional matters below.

Measurement – Expectations vs. Contractual Approach

In general, we support the use of an expectations based – rather than a contractual approach – because we believe that such an approach reflects the economic reality of how decisions with respect to entering into and continuing a leasing arrangement are made. Not including such expectations and the impact of changes in decisions over time has the effect of not reflecting economic decisions in the financial statements. As a general principle, we believe that expected value is the best way to measure when there are multiple possible outcomes.

We do not share the objections by some to the use of the expected value technique in the ED for leases. This is because a similar approach is required in the insurance project, and for liabilities under the scope of IAS 37, where estimates and projections are far more complicated. Therefore, we find the concerns that the measurements would be unduly complex to be overstated.

Measurement – Lease Term (FASB and IASB Question #8)

The ED proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that 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.

Rather than the determination of lease term being based on the ‘more likely than not’ lease period, we prefer a full expected value approach that explicitly factors in the probability of exercising of each option when deriving the expected lease term (i.e. probability weighted expected lease term) as we believe this will result in less subjectivity over time than a ‘more likely than not’ approach.

Some have suggested that a full expected value approach would result in lease terms that are not integers (e.g. 7.2 years) and therefore non-intuitive. As we expect that preparers will generally perform these measurements on a portfolio basis, we find a lease term of 7.2 years to be no less intuitive than a bond portfolio with an average coupon rate of 4.95% and an average maturity of 11.2 years.

These aforementioned subjectivity concerns related to a ‘more likely than not’ approach can be partially addressed by requiring an additional set of disclosures including a maturity analysis of lease payments, sensitivity analysis of reported liability to pay rentals, and a probability based bucketing of options that are considered to be unlikely to be exercised versus those that are ‘more likely than not’ to be exercised. These disclosures will provide a reasonableness check and convey to users the uncertainty associated with reported statement of financial position numbers, so that they can accordingly factor this into their valuation models.

Measurement – Lease Payments (FASB and IASB Question #9)

The ED proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that 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. Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.

We strongly support the inclusion of options to renew, term option penalties, residual value guarantees, and contingent rentals because we believe inclusion of such financial instruments – from the outset of the leasing arrangement – best reflect the economic substance of the arrangements. Not including such features in the expected cash flows would have the impact of failing to reflect the changes in economic circumstances and management’s decisions. We strongly support the measurement of all these options on an expected value basis.

We also believe that purchase options should be included. As noted previously, there can be an economic equivalence between purchase options and options to extend and while we understand the conceptual justification for not including purchase options (i.e. to do so would imply a sale or purchase), there is clearer guidance needed so as to make the distinction regarding why purchase options should be treated differently from renewal options. Further, while we understand that the proposed standard only requires lessors to include contingent rentals, expected payments under term option penalties and residual value guarantees that can be measured reliably to be consistent with the proposed revenue recognition standard, we believe that lessors should make every effort to be able to obtain the information to reliably measure lease payments from lessees and that it should not be construed that lessees are required to include estimates which may not be reliably measurable.

Although we support the inclusion of options in the reported liability to pay rentals, it would be helpful to separately disclose the measurement of the base lease obligation from that of the option obligation, so that users can make an aggregate judgment on the financial flexibility that the reporting entities enjoy. This disaggregation requirement should not be seen as a requirement for the disaggregation of each individual lease, but rather financial statement preparers should exercise reasonableness in their judgment of an economically meaningful level to aggregate and present such information.

Measurement – Reassessment (FASB and IASB Question #10)

The ED proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that 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.

We agree with the measurement principle which requires remeasurement of lease payments or the right to receive lease payments based upon significant changes in the aforementioned lease features as we believe this best represents the economics of the transaction. We agree that subsequent re-measurement for items related to current or prior periods should be adjusted through profit and loss and remeasurements related to future periods should adjust the right-of-use asset or performance obligation. We do, however, believe clearer guidance needs to be provided on the “facts or circumstances which indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments” and when such indicators exist. If there is not regular periodic updating required we believe that guidance on circumstances which may necessitate a remeasurement are necessary.

We do not agree with the remeasurement principle which allows changes in expected lease payments or the right to receive lease payments be discounted at the rate in effect at the inception of the lease rather than the current interest rates. We discuss our views on that under the discount rate section which follows.

As we noted below in the description of our views on the residual asset created under the derecognition approach, we find the value produced by the reassessment of the right to receive lease payments on the residual asset to produce a number which has little relevance to the amortized historical cost or the fair value. As such, we are not supportive of the provisions in Paragraph 56.

Measurement – Discount Rate

We agree with the use of the lessee incremental borrowing rate as the discount rate. As we have noted in our previous comment letters related to MoU Projects we have expressed concern regarding the conceptual inconsistency with respect to the Board's choice as it relates to discount rates for various liabilities. For example, the insurance project would require liabilities be discounted at a risk-free rate, IAS 37 liabilities would be discounted at a rate reflecting the characteristics of liabilities, pension liabilities would be discounted at a high-grade corporate bond rate, and contracts with customers having a significant time value element would be discounted at a rate reflecting the customer's credit. Overall, we believe the leasing ED provides the most explicit and economically rational discount rate; however, we believe that the discount rate should consider the expected lease term of the leasing arrangement.

With respect to the lessor, we believe the ED should be more descriptive regarding the discount rate to be used in the computation. Presently, Paragraph 33 simply indicates the rate to be used is the rate the lessor charges the lessee. If this is not explicitly stated in the lease agreement, it is not clear how the lessor is to derive this rate and over what term it was estimated.

Finally, we believe subsequent measurement of performance obligations under lessee arrangements, and the right to receive lease payments receivable under lessor arrangements should be updated each period for changes in the lessee's incremental borrowing rate and the rate the lessor would currently charge the lessee, respectively. Leases are effectively financial instruments and our view is that financial instruments should be measured at fair value. Though using updated expected cash flows and an updated discount rate will not equate to fair value, this would be closer to fair value than the subsequent measurement being proposed under the ED.

Measurement – Other Lessee Considerations

As it relates to lessee arrangements, we have the following comments related to other measurement matters not specifically queried:

- 1) Right-of-Use Asset – We strongly prefer fair value for both right-to-use asset and liability to pay rentals. However, recognize application difficulties (e.g. fair value determination of right-of-use asset), necessitates that the starting point of initial measurement of the asset has to be equal to the liability to pay rentals.

While we would prefer periodic remeasurement of all assets and liabilities at fair value, under the model proposed we do not object to amortization of the right-of-use asset based upon a systematic approach consistent with the method of amortizing other tangible or intangible assets in so far as the amortization reflects the actual economic utilization of the right-of-use asset.

We are fearful that arbitrary right-of-use asset measurements will be compounded by flawed amortization, resulting in lease expense that has no conceptual or economic basis. For enterprises that are significant lessees, the result would be income measures that are arbitrary, non-comparable, and therefore of little use for making investment decisions.

We do not agree with those who suggest that the expense resulting from a lease should always be level over time. For example, this is not the case for an asset purchase financed by amortizing debt such as mortgage debt, even when straight-line depreciation is used. There is a stronger argument for using a declining expense as, for many assets (trucks for example) maintenance costs increase with asset age. If lease-related expense declines over time, total cost may be approximately level.

It is therefore important for the Boards to be more specific on the amortization approach so as to lower the likelihood of misapplication of amortization requirements. Also, the Boards should consider the merits of an impairment approach to a greater extent than is the case in the ED. In sum, we urge the Boards to reconsider the conceptual foundation of specific amortization approaches required on the subsequent measurement of the right-of-use asset.

As we support a fair value based model for measurement of assets, we do not object to the right-of-use asset revaluation provisions of the ED.

- 2) Performance Obligation – Our preferred approach as it relates to the performance obligation is that it be measured at fair value upon both initial and subsequent measurement. As noted above, we agree with the reassessment of cash flows, but we believe the discount rate should be updated each period to arrive at a liability value which more closely approximates fair value. Under the model proposed, we do not object to the recognition of interest expense on the performance obligation liability.
- 3) Level Lease Expense – We do not agree with the notion that lease expense should be “level” so as to be consistent with the cash payments or to be aligned with current income statement effects. We disagree with this notion because: 1) it fails to acknowledge that current lease expense is straight-lined to achieve an appearance of level expense when in fact there may be escalating, or declining lease payments, under the lessee arrangement. Accordingly, current “level” lease expense is “disconnected” from escalating lease payments, and 2) the obligation created under the leasing arrangement is an amortizing debt obligation – not a bullet repayment obligation – and the interest expense accurately reflects this economic distinction.

Measurement – Other Lessor Considerations

As it relates to lessor arrangements, we have the following comments related to other measurement matters not specifically queried:

- 1) Right to Receive Lease Payments – Our preferred approach as it relates to the right to receive lease payments is that it be measured at fair value upon initial and subsequent measurement. As noted above, we agree with the reassessment of cash flows, but we believe the discount rate should be updated each period to arrive at a value which more closely approximates fair value. Under the model proposed, we do not object to the recognition of interest income on the right to receive lease payments.
- 2) Performance Obligation – Our preferred approach as it relates to the performance obligation is that it be measured at fair value upon initial and subsequent measurement. While we favor subsequent measurement of all assets and liabilities at fair value under the model proposed, we do not object to amortization of the performance obligation based upon the systematic and rational methods proposed in Paragraph 38 of the ED.
- 3) Underlying Asset – We understand the underlying asset will be accounted for under the respective IFRS guidance. As with the aforementioned balances related to leasing transactions, our preference is always for fair value.
- 4) Residual Asset –
 - a. Initial Measurement – The initial computation of the residual asset to remain on the books of the lessor upon application of the derecognition approach appears to be an allocation of the historical cost of the underlying asset based upon the ratio of the lessor receivable payments to the then current fair value of the underlying asset. This method of allocation seems arbitrary and lacks connection to underlying economic value. The computation does not result in a “residual value” of the asset but rather an “apportionment of the asset’s original cost.” If upon transition – as per the transition provisions in the ED – the fair value of the residual asset can be determined, so too can the fair value be determined when applying the provisions of the ED on new lessor arrangements. We support a fair value approach to determining the value of the residual asset at lease inception because it reflects the economics of what the lessor is retaining.
 - b. Subsequent Measurement – Further, the ED suggests – although never explicitly articulates – that the residual asset will not be changed after initial measurement unless there is a reassessment of the right to receive lease payments. We support fair valuing the residual asset at initial and subsequent measurement so the ED’s approach is inconsistent with our views, but it is also conceptually inconsistent with the proposed model for the following reasons:
 - i) If the residual asset is an apportionment of the historical cost, at initial measurement, of the underlying asset, existing accounting guidance for tangible assets would require the asset be amortized over the term of the useful life of the asset or the term of the lease. As the proposed standard requires no amortization of the initial measurement of the residual asset, the method proposed is inconsistent with existing guidance on historical cost measurements for tangible assets.
 - ii) The ratio of the lessor receivable payments to the current fair value of the underlying asset implicitly includes a current assessment of interest rates. Just as these fair values and present values would change due to the simple passage of time, so should the residual asset to which they are being applied.
 - c. Reassessment – The ED requires the value of the residual asset be adjusted by the ratio of the change in expected lessor receivable payments to the revised fair value of the underlying asset applied to the original assessment of the residual asset. While we understand the mechanics of the computations, we do not believe the resulting value represents something which is related to the historical cost, or amortized cost, of the derecognized asset or any relevance to the fair value of the residual asset. Overall, we find the computation to lack conceptual or economic relevance and we do not support the computations in Paragraph 56 or illustrated in Paragraph B31.

Measurement – Sale and Leaseback (FASB and IASB Question #11)

The ED proposes that a transaction 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 the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee. If the transfer does not meet the definition of a sale, the arrangement is considered a financing of the underlying asset.

We believe that the criteria to determine if a sale has occurred should be consistent with the criteria set forth in the proposed revenue recognition standard. We agree that the sale and leaseback should be connected if entered into simultaneously, but it would appear that the sale should be accounted for under guidance in the proposed revenue recognition standard and the leaseback should be accounted for under the lessee performance obligation approach. As such, it is not clear as to why separate guidance is needed for such transactions in the ED.

Further, some have raised issues with respect to: a) the gain on the sale of the entire asset involved in the sale and leaseback transaction (i.e. versus a gain on the residual asset only); b) deferred gains on existing sale and leaseback transactions; and c) the need for additional transition guidance for sale and leaseback transactions. Before issuing a final standard, we believe it would be appropriate to address such issues.

If the Boards decide to defer their consideration of lessor accounting, we believe that issues associated with current sale-leaseback accounting will need to be addressed during such a deferral period.

Presentation – Statement of Financial Position, Comprehensive Income and Cash Flows
(FASB and IASB Questions #12, #13, & #14)

Lessee Accounting

Statement of Financial Position

As a general principle, we support the decision to separate the right-of-use asset from other assets and to separately present the related lease liability from other financial liabilities as specified in Paragraph 25. Although we consider that in many cases there is an economic equivalence between the buy/own versus lease decision, the disaggregated presentation by nature still provides useful information to investors on the extent of dependence by reporting entities on lease financing and the costs associated with lease transactions. However, the right-of-use asset should be classified separately irrespective of whether the underlying asset is a tangible or intangible asset. This will be a more faithful representation of the nature of the right-of-use asset.

Statement of Comprehensive Income

We support the decision to separately present interest expense on the lease liability and amortization of the right-of-use asset from other interest expense and amortization as articulated in Paragraph 26. We would prefer that the presentation be required to appear on the statement of comprehensive income rather than in the notes to the financial statements.

Statement of Cash Flows

We support the presentation of the cash payments for rentals within financing activities in the statement of cash flows. We believe Paragraph 27 should clarify that when using the indirect method that interest expense on the lease liability and amortization of the right-of-use asset should be separately presented in the reconciliation from net income to cash flow from operations.

Other

We believe the presentation and disclosure requirements should also consider how items such as revaluations and impairments of right-of-use assets and reassessments of lease liabilities should be presented in the financial statements. Paragraph 23 requires revaluations be presented in the statement of comprehensive income. We believe such revaluations should be separately presented.

Short-Term Leases

As noted previously, Paragraphs 64 and 65 of the ED do not adequately articulate the presentation of short-term lease payments and receipts in the statement of comprehensive income for lessees or lessors. Will short-term lessee amounts be included as a separate “rent expense,” presented along with amortization of the right-of-use asset, or as interest expense? Similarly, will short-term lessor amounts be included as a separate “rental income,” along with amortization of the performance obligation in rental income, or as interest income?

Lessor Accounting – Performance Obligation Approach***Statement of Financial Position***

While we support of the linked presentation, as proposed in Paragraph 42, of the underlying asset, right to receive lease payments receivable and lease liabilities such that users of the financial statements can understand the relationship between the balances and the economics of the transaction; we would prefer this type of presentation be in the notes rather than statement of financial position. We believe the underlying asset, right to receive lease payments receivable, and lease liabilities should be presented separately within the respective/appropriate section of the statement of financial position. Although there is no loss of information content with the linked presentation on the balance sheet, some users could still be confused by this presentation, especially if it is being applied only for a limited category of assets including lease transactions. In other words, limited asset and liability matching on the statement of financial position can be confusing for some users. Therefore, we recommend that the linked balances can be presented in the notes to the financial statements, to complement user understanding of the statement of financial position presentation.

Statement of Comprehensive Income

We support the decision to separately present interest income on the right to receive lease payments receivable, lease income from satisfaction of the lease liability and depreciation expense on the underlying asset separately from other interest income, income and depreciation expense as proposed in Paragraph 44.

We note that the FASB approach, which requires separate presentation of these income statement elements followed by a net lease income or net lease expense presentation (i.e. linked presentation), which is more consistent with the presentation on the statement of financial position. As noted for the statement of financial position, we would prefer the linked presentation be in the notes rather than of the face of the financial statements, so as to avoid confusing some users.

Statement of Cash Flows

We agree with the proposals in Paragraph 45 which require separate presentation of the cash receipts under lessor arrangements as operating activities and the requirement to present the change in right to receive lease payments receivable separately within the reconciliation of net income to cash flow from operations. We would note that this paragraph should also include a requirement to disclose separately the depreciation from the underlying asset and the interest income from the right to receive lease payments receivable as well as the change in the lease liabilities separately when reconciling from net income to cash flow from operating activities.

Other

We believe the presentation and disclosure requirements should also consider how items such as impairments of underlying assets and reassessments and impairments of the right to receive lease payments receivable should be presented in the financial statements.

Lessor Accounting – Derecognition Approach***Statement of Financial Position***

We support the requirement to present the right to receive lease payments receivable and residual asset separately from other financial assets and other property, plant and equipment, respectively, as proposed in Paragraph 60.

Statement of Comprehensive Income

We support the decision to separately present interest income on the right to receive rental payments from other interest income as proposed in Paragraph 62. However, we do not support the provisions of Paragraph 61 as it relates to the presentation of rental income as follows:

- a) Paragraph 61(a) requires that a lessor separate lease income and lease expense and present such income and expense on separate lines within the statement of comprehensive income when a lessor utilizes leasing as an alternative means of realizing values from the goods it would otherwise sell. We agree with this provision of Paragraph 61(a); however, this same paragraph also enables a lessor applying the derecognition approach to present rental income and cost of sales from lessor arrangements together with income from sales contracts and their related cost of sales. We believe if there is sufficient economic evidence to require different accounting (i.e. lessor derecognition approach versus a sale) then the income statement should reflect that separate presentation. If they are deemed sufficiently different to require separate recognition and presentation on the statement of financial position that differentiation should not be obfuscated by combined presentation on the income statement.
- b) Paragraph 61(b) enables a lessor who uses leasing arrangements as a means of financing to net the presentation of lease income and lease expense on the statement of comprehensive income. We disagree with such net presentation as this is akin to the net presentation of interest income and interest expense. The gross presentation conveys a message to users about the magnitude of an entities lessee and lessor activities.

Statement of Cash Flows

We agree with the proposals in Paragraph 63 which require separate presentation of the cash receipts under lessor arrangements as operating activities and the requirement to present the change in the right to receive lease payments receivable separately within the reconciliation of net income to cash flow from operations.

Other

We believe the presentation and disclosure requirements should also consider how items such as impairments of residual assets and reassessments and impairments of the right to receive lease payments receivable should be presented in the financial statements.

Disclosures (FASB and IASB Question #15)

Disclosure requirements for lessee and lessor arrangements should be specified separately in the ED to ensure that the disclosures are complete and that they accurately disclose the nature of these arrangements. Presently, the disclosure requirements for leases are principally articulated on a combined basis in Paragraphs 70 through 86 in the ED. Consistent with the recognition, measurement and presentation requirements of the ED, we believe the disclosure requirements for lessee and lessor arrangements should be articulated separately to ensure disclosures are presented in a disaggregated, but concise, comprehensive and understandable manner which is not boilerplate in nature. Below we set forth the disclosures which we believe are necessary for the separate elements of lessee and lessor arrangements.

Lessee Accounting

Paragraphs 77 and 85 are the only paragraphs in the ED which specifically address lessee disclosure requirements. Paragraphs 73, 83 and 84 are applicable to both lessee and lessor arrangements. While we don't disagree with these disclosure requirements, they could be more explicit and specific to lessee arrangements such that the disclosures are not aggregated with lessor arrangements and that the disclosures are correlated with the respective financial statement captions resulting from the lessee arrangements. This would ensure users receive the information they require to understand the nature of lessee arrangements. Our suggestions by financial statement caption – which is how we believe the disclosure requirements should be articulated in the ED – are as follows:

- Nature of the Lessee Arrangements – Paragraph 73 requires disclosure of the nature of leasing arrangements including a general description of the leasing arrangements, contingent rentals, renewal and termination options, purchase options, residual value guarantees, amortization methods, the nature of direct costs and the restrictions imposed by the arrangements. Our view is that such requirements, as currently proposed will result in general, qualitative, highly aggregated and boilerplate disclosures which will not be especially meaningful and decision-useful to investors. We do not believe that these disclosure requirements will result in quantitative disclosures of how contingent rentals, renewal options, or residual value guarantees were utilized in the determination of the performance obligation under the lessee arrangement. Overall, we don't believe the requirements in Paragraph 73 will result in a sufficient level of detail of measurement attributes, inputs and assumptions and changes therein to be meaningful.
- Measurement of Performance Obligation –
 - Lease Term – While Paragraphs 73(a) (iii) and 83 require general disclosures regarding renewal and termination options, there is no disclosure requirement regarding the actual or expected lease term and only a limited requirement to provide a narrative of how the options were used in the determination of the performance obligation. We believe the actual and expected lease terms for significant leases should be disclosed and we believe that a weighted average life of lease term should be disclosed.
 - Lease Payments – The extent to which expected lease payments exceed contractual lease payments, and the impact of contingent rentals, residual value guarantees, and term option penalties on expected cash flows should be separately disclosed such that users are able to understand contractual obligations versus expected amounts. We would observe that elements of these disclosures requirements are included within Paragraphs 73, 83 and 85; however, we believe the requirements should be more explicitly articulated for lessees separately from lessors such that the disclosures are separately presented.
 - Base Lease versus Options Disaggregation – It would be helpful to provide a disclosure that separates the measurement of the base lease obligation from that of the options obligations such that users are able to make an aggregate judgment on the financial flexibility that reporting entities enjoy. This disaggregation requirement should not be seen as a requirement for the disaggregation of each individual lease, but rather financial statement preparers should exercise

- reasonableness in their judgment of the economically meaningful level to disaggregate and present such information.
- Probability-Based Disaggregation of Lease Amounts – There is a need for a probability based bucketing of optional leases so that users can differentiate the amounts that are considered ‘more likely than not’ to be exercised versus those that are not. Some granularity in the disaggregation (e.g. three or four probability) buckets will convey to users useful information on the uncertainty associated with future lease related cash flows.
 - Capitalized Costs – We are supportive of the requirement to disclose initial direct cost incurred as per Paragraph 73(a)(vii).
 - Discount Rate – Paragraph 83 requires disclosure of the discount rate utilized in the computation of the present value of lease payments. It does not, but should, require discount rates for lessees and lessors to be presented separately. We believe this disclosure should not simply consist of a wide range of rates which represent the rates employed in making the lessee performance obligation measurements over many years. For material lease arrangements, the discount rate should be disclosed and provided in the context of the respective performance obligations and expected lease payments to which they relate.
 - Reassessments – The ED provides no disclosure requirements regarding significant reassessments of the performance obligations as specified in Paragraphs 17 through 19 of the ED. The rollforward in Paragraph 77 would imply that such reassessments would be disclosed – at least the quantum in the aggregate – but does not require such disclosure as the elements of the rollforward are not specifically articulated. Further, the reasons for the reassessments should be explained to users of financial statements.
 - Right-of-Use Asset – Proposed disclosure requirements provide little information regarding the nature of the right-of-use asset other than the presentation within the statement of financial position (e.g. property, plant & equipment or investment property) and a rollforward of the balance. We believe the following additional information is necessary:
 - Amortization Method – Paragraph 73(a)(v) requires disclosure of amortization methods and changes in the methods, assumptions and judgments; however, it does not specify that this disclosure relates to the right-of-use asset per se, nor does it require disclosure based upon the nature of the presentation as specified in Paragraph 25. Further, it does not require separate presentation of amortization methods for lessee or lessor arrangements. We believe the amortization method for right-of-use assets should be disclosed based upon the nature of the underlying tangible asset consistent with the financial statement presentation. Users do not find aggregated or generic descriptions of amortizations useful.
 - Average Life – We also believe the amortization period and average life of the right-of-use asset should be disclosed based upon the nature of the underlying tangible asset consistent with the financial statement presentation.
 - Revaluation – Presently, there are no disclosure requirements in the ED for right-of-use assets which are revalued in accordance with Paragraphs 21 through 23 of the ED. We believe the ED should include a requirement to include disclosures regarding the nature of assets revalued, the method used to revalue the assets and the regularity of their remeasurement.
 - Impairment – The ED does not require disclosure of any impairment of the right-of-use asset. The impairment is measured in accordance with IAS 36, but Paragraph 24 of the ED does not go further to require disclosure of the impairment in accordance with IAS 36.
 - Rollforward – We strongly support the provision of the proposed rollforward disclosures in Paragraph 77; however, we believe more specificity should be provided as to the captions to be required to be presented within the rollforward. Using the performance obligation liability as an example, we would suggest the rollforward requirements include: opening balance, current period reassessments of prior period performance obligations (including the nature and reason for the change), performance

obligations created under new lessee arrangements, cash paid, interest expense, foreign currency fluctuations, impact of business combinations, and closing balance.

- Reconciliations – We believe the disclosure requirement should include that the rollforward be reconciled to the related financial statement caption to which it relates (e.g. balance sheet & income statement). The components of the rollforwards should have direct linkage to the related presentation on the balance sheet and income statement.
- Risk Disclosures – The specific risk disclosures related to leases should be more explicitly stipulated and required. We think the simple cross reference to IFRS 7, and the resulting lack of clarity, will result in little or no disclosure in compliance with these provisions. The applicability of Paragraphs 31 to 42 of the risk disclosures of IFRS 7, *Financial Instruments: Disclosures*, as required by Paragraph 84 of the ED is not clear – other than the applicability of the liquidity disclosures in IFRS 7, Paragraph 39 which are further specified in Paragraph 85 of the ED. We would expect that the credit risk provisions – from a lessee perspective – would not be applicable and the liquidity risk provisions would be covered by the maturity analysis in Paragraph 85. For market risk disclosures, we strongly support the provision of a sensitivity analysis of reported liability to pay rentals, so as to convey uncertainty associated with the reported amounts. This sensitivity analysis is necessary and should indicate the sensitivity to reasonably probable changes in discount rate, lease terms and be carried out showing the interdependence of key risk factors.
- Maturity Analysis – We strongly support the requirement to provide a maturity analysis in Paragraph 85; however, we believe that the maturity analysis should not be arbitrarily trunked at five years with all remaining periods presented in the aggregate. We believe the maturity schedule period should extend out based upon the significance of the expected term of the lease. Further, we believe the maturity analysis should be separated into lease payments which are contractually due and those which are expected to be made based upon assumptions used in deriving the performance obligation. We note that such separation is required for contingent rentals, term option penalties, and residual value guarantees which impact the amount of expected lease payments. We believe the ED should also require disclosure of expected lease payments derived from renewal and termination options which impact the expected term of the lease. This would provide users with information regarding contractually due payments and those payments which were expected to be made based upon management’s judgement and intent.
- Fair Value Disclosures – We note that the fair value disclosure provisions of IFRS 7 have not been included in the disclosure requirements for leases. As these are financial instruments, we do not believe they should be excluded from such disclosures. We would encourage the inclusion of disclosures related to the fair value of obligations to pay rentals by the lessee if performance obligations are not remeasured at fair value. We would also like the fair value of the right-of-use assets to be provided as such information is useful to investors. The disclosure of fair value information assists users in the calculation of the cost of capital. It also provides useful information content and gives investors a sense of a reporting entity’s efficacy in lease management and asset utilisation. For example, fair value can convey whether an entity has market advantage in lease negotiations or intrinsic value from below market lease arrangements.

Lessor Accounting

Paragraphs 78 through 82 and 86 are the paragraphs in the ED which address lessor disclosure requirements. Paragraphs 73, 83 and 84 are applicable to both lessee and lessor arrangements. While we don't disagree with these disclosure requirements, for similar reasons as those articulated for lessees they are substantially less in scope than what we believe users require to understand the nature of the lessor arrangements. Our suggestions by financial statement caption are as follows:

- Performance Obligation Approach vs. Derecognition Approach – We agree with the disclosure provisions in Paragraph 78 which require disclosure regarding how the lessor determined it should apply the performance obligation or derecognition approach. Factors included in the analysis as required by Paragraphs 28, 29 and B22 through B27 should be disclosed.
- Nature of the Lessor Arrangements – Our concerns with respect to the disclosure requirements for lessors in Paragraph 73 are similar in nature to those expressed for lessees.
- Measurement of Right to Receive Lease Payments –
 - Lease Term – While Paragraphs 73(a)(iii) and 83 require general disclosures regarding renewal and termination options, there is no disclosure requirement regarding the actual or expected lease term and only a limited requirement to provide a narrative of how the options were used in the determination of the performance obligation. We believe the actual and expected lease terms for significant leases should be disclosed and we believe that a weighted average life of lease term should be disclosed.
 - Lease Payments – The extent to which expected lease payments exceed contractual lease payments, and the impact of contingent rentals, residual value guarantees, and term option penalties on expected cash flows should be separately disclosed such that users are able understand contractual rights versus expected amounts. We would observe that elements of these disclosures requirements are included within Paragraphs 73, 83 and 85; however, we believe the requirements should be more explicitly articulated for lessees separately from lessors such that the disclosures are separately presented.
 - Base Lease versus Options Disaggregation – It would be helpful to provide a disclosure that separates the measurement of the base lease obligation from that of the options obligations such that users are able to make an aggregate judgment on the financial flexibility that reporting entities enjoy. This disaggregation requirement should not be seen as a requirement for the disaggregation of each individual lease, but rather financial statement preparers should exercise reasonableness in their judgment of the economically meaningful level to disaggregate and present such information.
 - Probability-Based Disaggregation of Lease Amounts – There is a need for a probability based bucketing of optional leases so that users can differentiate the amounts that are reliable and those which may have been excluded from the receivable. Some granularity in the disaggregation will convey to users useful information on the uncertainty associated with future lease related cash flows.
 - Capitalized Costs – We are supportive of the requirement to disclose initial direct cost incurred as per Paragraph 73(a)(vii).
 - Discount Rate – Paragraph 83 requires disclosure of the discount rate utilized in the computation of the present value of lease payments. It does not, but should, require discount rates for lessees and lessors to be presented separately. We believe this disclosure should not simply consist of a wide range of rates which represent the rates employed in making the lessee performance obligation measurements over many years. For material lease arrangements, the discount rate should be disclosed and provided in the context of the respective performance obligations and expected lease payments to which they relate.
 - Reassessments – The ED provides no disclosure requirements regarding significant reassessments of the right to receive rental payments as specified in Paragraphs 39, 40, 56 and 57 of the ED. The rollforward in Paragraph 77 would imply that such reassessments would be disclosed – at

least the quantum in the aggregate – but does not require such disclosure as the elements of the rollforward are not specifically articulated. Further, the reasons for the reassessments should be explained to users of financial statements.

- Impairment – We support the requirement in Paragraph 79 to disclose the impairment on the right to receive lease payments asset. We agree that separate disclosure should be made regarding those impairments associated with lessor arrangements where the performance obligation approach was applied and those where the derecognition approach was applied.
- Performance Obligation – Proposed disclosure requirements provide little information regarding the nature of the lessor performance obligation other than the presentation. Based upon Paragraph 42, the performance obligation will be netted against the underlying asset to arrive at a net lease asset (liability). As we described in the Presentation section we believe the amounts should be presented gross and we believe the following information regarding the lessor performance obligation is necessary:
 - Amortization Method – Paragraph 73(a)(v) requires disclosure of amortization methods and changes in the methods, assumptions and judgments; however, it does not specify that this disclosure relates to the lessor performance obligation per se. Further, it does not require separate presentation of amortization methods for lessee or lessor arrangements. We believe the amortization method for lessor performance obligations should be disclosed and we believe it is important for such amortization method to be explained relative to the depreciation/amortization of the underlying asset. The methods determined based upon the application of Paragraphs 37(b) and 38 should be disclosed in the financial statements. Users do not find aggregated or generic descriptions of amortizations useful.
 - Average Life – We also believe the amortization period and average life of the performance obligation should be disclosed based upon the nature of the underlying tangible asset consistent with the financial statement presentation.
- Underlying Asset – Proposed disclosure requirements provide little information regarding the nature of the underlying asset other than the presentation within the statement of financial position in Paragraph 42(a). We believe the nature of the underlying asset, its estimate life and the amortization/depreciation method should be disclosed.
- Residual Asset – Paragraph 81 requires disclosure of the nature and amount of each class of residual asset while Paragraph 80 requires a rollforward of the residual asset. We do not find the initial or subsequent measurement of the residual asset to be meaningful. We believe fair value to be the most meaningful measurement for users and if not included in the financial statements, we believe it should be a required disclosure.
- Rollforward – We strongly support the provision of the proposed rollforward disclosures in Paragraph 80; however, we believe more specificity should be provided as to the captions to be required to be presented within the rollforward. Using the right to receive lease rentals asset as an example, we would suggest the rollforward requirements include: opening balance, current period reassessments of prior period right to receive lease rentals receivable (including the nature and reason for the change), lease rentals receivable created under new lessee arrangements, cash received, interest income, foreign currency fluctuations, impact of business combinations, and closing balance.
- Reconciliation – We believe the disclosure requirement should include that the rollforward be reconciled to the related financial statement caption to which it relates (e.g. balance sheet & income statement). The components of the rollforwards should have direct linkage to the related presentation on the balance sheet and income statement.
- Risk Disclosures – The applicability of Paragraphs 31 to 42 of the risk disclosures of IFRS 7 as required by Paragraph 84 of the ED is not clear – other than the applicability of the liquidity disclosures in IFRS 7, Paragraph 39 which are further specified in Paragraph 86 of the ED. We would expect that the credit risk provisions to be applicable and relatively straight forward and the liquidity risk provisions would be covered by the maturity analysis in Paragraph 86. We think the simple

cross reference to IFRS 7, and the resulting lack of clarity, will result in little or no disclosure in compliance with these provisions. For market risk disclosures, we strongly support the provision of a sensitivity analysis of reported right to receive rentals, so as to convey uncertainty associated with the reported amounts. This sensitivity analysis is necessary and should indicate the sensitivity to reasonably probable changes in discount rate and lease terms and should be carried out showing the interdependence of key risk factors.

- Maturity Analysis – We strongly support the requirement to provide a maturity analysis in Paragraph 86; however, we believe that the maturity analysis should not be arbitrarily trunked at five years with all remaining periods presented in the aggregate. We believe the maturity schedule period should extend out based upon the significance of the expected term of the lease. Further, we believe the maturity analysis should be separated into lease payments which are contractually due and those which are expected to be made based upon assumptions used in deriving the performance obligation. We note that such separation is required for contingent rentals, term option penalties, and residual value guarantees which impact the amount of expected lease payments. We believe the ED should also require disclosure of expected lease payments derived from renewal and termination options which impact the expected term of the lease. This would provide users with information regarding contractually due payments and those payments which were expected to be made based upon management’s judgement and intent.
- Fair Value Disclosures – We note that the fair value disclosure provisions of IFRS 7 have not been included in the disclosure requirements for leases. As these are financial instruments, we do not believe they should be excluded from such disclosures. We would encourage the inclusion of disclosures related to the fair value of the right to receive lease payments if they are not remeasured at fair value. We would also like the fair value of the residual asset to be provided as such information is useful to investors. Fair value can convey whether an entity has market advantage in lease negotiations or intrinsic value from above market lease arrangements.

Other

Subleases

Paragraph 74 of the ED provides that for subleases only the natures of and amount of the significant subleases should be disclosed in accordance with Paragraph 73. We believe the disclosures for subleases should be equivalent to those of direct leases.

Short-Term Leases

We agree with the guidance in Paragraph 75 that requires disclosure regarding an entity’s use of the short-term lease election and disclosure for lessees of the amounts recognized in the statement of financial position relative to leases. Further, as we have articulated above, we believe that further guidance is needed in any final standard regarding the presentation of short-term leases in the statement of comprehensive income.

Sale Leaseback

We agree with the provisions in Paragraph 76 which require separate disclosure regarding gains/losses on sale and leaseback transactions. We also believe the balances created by the transaction should be disclosed separately in the notes to the financial statements and the transactions explained in a cohesive fashion.

Transition and Effective Date (FASB and IASB Question #16)

Incongruities within Transition Provisions

The ED proposes that lessees and lessors recognize and measure all outstanding leases as of the date of initial application using a “simplified retrospective approach.”

As we consider the transition provisions for lessees, lessors following the performance obligation approach, and lessors following the derecognition approach, we find the ED’s use of the term “simplified retrospective approach” to describe the transition provisions to be somewhat of a misnomer. While application of the proposed standard may be used in the prior comparative period when initially applied for lessee accounting, the lessee transition guidance appears to be a “modified prospective approach” with leases currently in-force reflected on the balance sheet at initial application at the present value of future expected lease payments discounted at the incremental borrowing rate at the date of application of the proposed standard rather than the date of the inception of the lease.

The lessor performance obligation approach, on the other hand, results in a lease rental payments receivable which would more closely – although not perfectly – resemble a fully retrospective approach with expected future cash flows discounted at the rate in effect at the inception of the lease.

The lessor derecognition approach results in a receivable computed in the same manner. The transition approach is further complicated by the manner in which the related assets – recognition of a right-of-use asset (lessee), underlying asset (lessor performance obligation approach) or residual asset (lessor derecognition approach) – and performance obligations in the case of the lessor performance obligation approach, are determined at transition and reflected on the balance sheet.

We provide our views on each transition approach – lessee, lessor performance obligation approach, and lessor derecognition approach – but our overriding conclusion is that we do not believe the transition provisions will result in a meaningful analytical construct for the user community.

With a significant volume of leases reflected on the balance sheet utilizing the proposed transition guidance upon adoption, we believe that trends will be obscured and that the long-term impacts/trends of implementing the new approach will be distorted for many years until the existing leasing arrangements fully expire. Additionally, the impact of adoption will not result in comparability between organizations.

Our view is that the proposed transition guidance will not only reduce the quality of the decision-usefulness of the information provided under the new standard, but may distort the impact of leasing arrangements on an entity’s reported operating results.

User Requirements Related to Transition

As noted above, a new leasing standard will result in a significant discontinuity, as financial statements following transition will not be comparable with those prior to transition. We believe that neither the full retrospective nor the “simplified retrospective” approach will provide investors with useful measurements and that additional disclosures are needed.

The full retrospective method attempts to create financial statements that would have existed had the standard always been followed. The resulting balance sheet and income statement suffers from all of the shortcomings of the historical cost and will include leases entered into at a variety of times at a variety of interest rates. As we have argued in other contexts, with support from empirical research, we believe that all financial liabilities should be reported at fair value.

The “simplified retrospective approach” measures leases currently in-force on the balance sheet at initial application at the present value of future expected lease payments discounted at the incremental borrowing rate at the date of application rather than the date of the inception of the lease. Some analysts believe that the use of a single interest rate would facilitate analytic adjustments by those who wish to estimate fair value.

This simplified retrospective approach would, however, result in measurements that are extremely sensitive to the transition date, which may differ among enterprises. If the transition date coincides with unusually high interest rates, the liability (and the related expense) will be low; if interest rates were extremely low at transition, the opposite effect ensues. These effects will persist in the financial statements until all of the leases in force at transition have terminated – which could be several decades. And, as at present, analytical adjustments will be approximate at best.

Whichever transition method the Boards choose, we strongly urge that the lease liability (asset for lessors) representing the present value of lease payments be clearly identified as a financial instrument, with periodic disclosure of fair value required.

Observations on Transition Approaches by Type of Lease Arrangement

The preceding paragraphs provide our overall views with respect to the transition provisions. Below we consider more specific issues related to each transition method:

1) Lessee Transition Approach –

- i. Performance Obligation Measurement – As noted previously, we believe the transition provisions related to computation of the lease liability (performance obligation) in Paragraph 90(a) are more of a “modified prospective approach” in that, for existing lease arrangements, they compute expected future lease payments using current discount rates at the application date.
- ii. Right-of-Use Asset Measurement – Further, Paragraph 90(b) records the right-of-use asset as the offsetting entry to the computation of the performance obligation. When applying such an approach to the measurement of the right-of-use asset at transition, the asset’s value may be reflected in the financials at an amount which is more, less, or equal to the value it would be carried at had the value been computed based upon the origination date of the lease and subsequent amortization. Accordingly, it will be difficult for the user community to utilize the resulting income statement impacts to make any meaningful assumptions/conclusions regarding the impact of leasing arrangements on the ongoing results of the operations of the company.
- iii. Impact to Equity – Assuming there is no impairment to the right-of-use asset, there will be no impact to equity at adoption. Given the financing nature of the leasing arrangement and the discussions regarding the amortization of the right-of-use asset plus interest on the lease liability and the non-level nature of the expense it seems unlikely that this would be the economic result had the lease been accounted for under the new guidance since inception.
- iv. Existing Capital/Financing Leases – We have no objection to the accommodation related to retaining lease balances for the existing capital (U.S. GAAP) or financing (IFRS) should they not have significant options, contingent rentals, term option penalties, or residual value guarantees. This appears to be a practical expedient with limited differences in financial statement impact.
- v. Short-Term Leases – The guidance related to transition provisions for short-term leases in Paragraph 93 seems consistent with the ongoing accounting in Paragraph 64.

2) Lessor Performance Obligation Approach –

- vi. Right to Receive Lease Payments Receivable Measurement – As noted previously, we believe the transition provisions related to computation of the right to receive lease payment

receivable measurement in Paragraph 94(a) would more closely – although not perfectly – resemble a fully retrospective approach with expected future cash flows discounted at the rate in effect at the inception of the lease. The use of the discount rate at the inception of lease seems most appropriate; however, it is unclear why such approach can't be required in the lessee transition approach.

- vii. Performance Obligation Measurement – The transition provisions related to computation of the lease liability (performance obligation) in Paragraph 94(b) are to set the performance obligation equal to the computation of the right to receive lease payment receivable. Given the amortization choice made in Paragraph 38, the resulting value of the performance obligation and accordingly the rental income recognized could be quite different than if transition amounts were computed on a fully retrospective approach.
 - viii. Underlying Asset Measurement – Paragraph 94(c) essentially requires a full retrospective approach to be applied to the underlying asset. It is unclear how the amortization of this asset – determined using a retrospective approach – will compare economically to the amortization of the performance obligation. The impact to net income in future periods from the amortization of the underlying asset would be consistent with a fully retrospective approach while the amortization of the performance obligation would not be fully retrospective.
 - ix. Impact to Equity – Assuming there is no impairment to the right to receive lease payment receivable, there will be no impact to equity at adoption other than the reinstatement of the previously derecognized asset at its amortized historical cost.
- 3) Lessor Derecognition Approach –
- x. Right to Receive Lease Payments Receivable Measurement – The measurement of the right to receive lease payment receivable measurement is consistent between the lessor performance obligation and derecognition approaches.
 - xi. Residual Asset Measurement – Paragraph 95(b) requires the residual asset be measured at fair value at the date of initial application of the ED. We find this to be economically correct; however, it seems counterintuitive that the Boards believe that fair value is appropriate at transition but not at initial or subsequent measurement. If feasible and acceptable on transition, fair value measurement for residual assets should be utilized on an ongoing basis.
 - xii. Impact to Equity – The impact to equity would be equivalent to the right to receive lease payment receivable plus the fair value of the residual asset.

Transition Alternatives

Some have proposed that transition alternatives be allowed whereby organizations can choose to adopt the ED using a simplified retrospective approach or a fully retrospective approach. The presence of alternatives would reduce the quality of accounting guidance, and calls for this approach reflect a lack of understanding regarding the importance of comparability in financial reporting data between organizations when making investing decision. Multiple options should not be considered by the Boards.

Early Adoption

We do not support early adoption as it results in a period of incomparability between organizations. Given the transitions provisions of this ED – which are heavily dependent upon assumptions at initial application – we strongly object to any early adoption option as differences will exist beyond adoption dates due simply to differences in market conditions at dates of application. As it relates to first-time adopters of IFRS, our comment letter on effective dates and transition will address this issue.

Effective Date

We would not object to an effective date which allows companies to plan for adoption and improve the quality of retrospective application. However, we would observe that even such a delay would not prevent the need for those enterprises with long-term contracts (e.g. greater than two to three years in



duration) to engage in some element of retrospective application as many leasing arrangements extend beyond a two to three year period. In our comment letter on effective dates and transition we will address our views on proposed effective dates.

Benefits and Costs (FASB and IASB Question #17)

We agree with the considerations raised by the Boards in their analysis of the costs and benefits of the proposed standard as articulated in the Basis of Conclusions, Paragraphs BC 200 through BC 205.

Other Comments (FASB and IASB Question #18)

FASB Proposed Update vs. IASB Exposure Draft

For purposes of our responses to the aforementioned questions we have reviewed, and prepared responses to, the IASB Exposure Draft. Though we understand there to be minimal differences between the FASB and IASB proposals, no document summarizes or analyzes the differences. From the FASB Draft we clearly see differences such as Paragraph 6(c) related to the service components of leases have been omitted, the differences in treatment of investment properties allowed per Paragraph 7 and the ability to revalue right-of-use assets as per Paragraph 21 through 23. We also acknowledge that references to legacy U.S. GAAP and IFRS literature are different. However, an analysis should be provided to enable users to quickly grasp the differences. If the objective of the joint issuance of these EDs and the 2006 MoU is convergence, the issuance of standards with a convergence objective should include an analysis of the differences such that stakeholders are not required to identify the differences themselves. Rather they can devote their attention to the analytical impact of these differences.

Additional Matters to Address in A Final Standard

We believe the ED fails to address how common lease provisions such as rent holidays, rent incentives, termination costs, taxes or special tax considerations should be addressed under new guidance. Such issues are currently addressed in U.S. GAAP literature and without consideration or guidance on how they would be treated under a new standard could result in diversity in practice and the potential for restatements.

Appendix C – Amendments to Other IFRSs

We find analyzing the impact of amendments, modifications, and removals of existing IFRS literature as set forth in Appendix C to be very difficult. The amendments described there seem to be a high-level description of the changes to be made rather than a marked version of the changes whereby reviewers can best understand the impact of the changes to existing guidance. The EDs should have pointed out full sets of consequential amendments. We believe that the final standard should include a marked version with the exact changes to such literature.

Non-Public Entities (FASB Question #19)

We strongly support a single model for recognition and measurement of lease arrangements across both public and non-public entities. Given the needs of fixed income investors and the growth of private equity, the line between public and non-public entities is increasingly difficult to discern. As such, we believe one model across all enterprises is most appropriate.