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October 14, 2013

Mr. Russell Golden
Chair
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856
United States

Mr. Hans Hoogervorst
Chair
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Re: Comment Letter on FASB & IASB Lease Accounting Exposure Drafts

Dear Mr. Golden and Mr. Hoogervorst,

The CFA Institute[1], in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB") Exposure Draft ("IASB Exposure Draft" or "IASB ED"), *Leases*, and the Financial Accounting Standards Board's ("FASB") Proposed Accounting Standards Update, *Leases (Topic 840),*("FASB Proposed Update" or "FASB Update"). The IASB ED and FASB Update are referred to herein, collectively as the "Revised Exposure Draft" or "Revised ED". The IASB's 2010 Exposure Draft and the FASB's 2010 Proposed Update on this same topic are collectively referred to herein as the "Original Exposure Draft", "Original ED", or "2010 Leases ED". 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.

[1] With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 116,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 137 countries, of whom nearly 108,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 138 member societies in 60 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.

EXECUTIVE SUMMARY

Summary of Our Position

It has been recognized for a number of decades that the accounting for lease contracts requires improvement as companies that choose to lease rather than buy assets report lower financial leverage. The update to the lease accounting standards proposed in the Revised ED provides an opportunity for the Boards to enhance the transparency of lease contracts and to improve the comparability of financial statements across the globe. This joint project also provides an opportunity to further converge US GAAP and IFRS standards.

Widespread Acknowledgement:
Investors Adjust Financial Statements to Reflect Leases as Leverage

Our support for capitalization of lease obligations is a longstanding position that can be traced back to the 1970s, when our predecessor organization in a comment letter[3] expressed that a requirement to capitalize operating leases would improve the comparability of financial statements. Similar to our 2010 comment letter on the Original ED,[4] we re-emphasize in this response that capitalization of leases is important to investors because capitalization provides the best starting point for investors to make analytical adjustments. Furthermore, as evident from their analytical adjustments, most investors believe that obligations arising from leasing arrangements are economic obligations. This widespread investor view is reflected in the survey results reported herein. The outreach during the many years of this project's life has unequivocally demonstrated this perspective such that it is widely acknowledge by virtually all stakeholders to the standard-setting process. The presence of an obligation, correspondingly, implies the presence of an asset, and both the asset and liability should be recognized on the balance sheet.

Capitalization of leases will enable different market participants (i.e., investors, auditors, academics, preparers) to better assess the lease obligation and, therefore, the total financial leverage of reporting companies. In this respect, capitalization will provide the best opportunity for ongoing improvement to lease accounting and provide data points that allow verification of the value relevance and decision-usefulness of the proposed information.

Principal Concern: Measurement Issues

The principal reservation with the model from some investors arises from anticipated measurement errors with different aspects of the proposals (e.g., due to the partial recognition of options, dual income statement recognition, etc.). We share many of these articulated measurement concerns. That said, we note that under current requirements investors are left to make widely varying and costly to process guesstimates of the obligations arising from the lease contracts. We anticipate that management's measurement of the lease obligation will provide a meaningful and consistent starting point for analytical adjustments and lessen the aggregate estimation error of all investors. For this reason, we believe that the proposed standards would improve financial reporting and urge the Boards to move forward.

[3] The Financial Analysts Federation (1971), *Comment Letter on Leases*, http://www.cfainstitute.org/ethics/Documents/letter_1971.pdf
[4] CFA Institute (2010), *Comment Letter on Leases*, http://www.cfainstitute.org/Comment%20Letters/20101215.pdf

The Tradeoff: Relevance vs. Reliability

We also note that the debate about whether to recognize leases on the balance sheet is another manifestation of the tradeoff between relevance versus reliability of accounting standards. It could also, to some extent, be reflecting the conceptual tension[5] and different perspectives on the relative importance, for investor analytical purposes, of the balance sheet versus income statement. Hence, these reservations about recognition of lease obligations and 'right-of-use' assets, due to anticipated measurement error, are not unusual and simply echo many similar debates held in relation to the carrying amounts of other assets and liabilities.

Enhanced Disclosures Necessary: But Not a Substitute for Capitalization

Our longstanding position has been that if there are assets and liabilities, they should be recognized on the balance sheet, ideally at their fair value. Regardless of the applied measurement basis, there should be accompanying comprehensive disclosures to help investors better discern the measurement uncertainty of reported carrying amounts.

While capitalization of leases will inform investors of management's view of the carrying amounts of the leased right-of-use assets and the obligation to pay rentals, enhanced disclosures can enable investors to make any desired analytical adjustments to the reported amounts. In addition, there is greater scrutiny of reported amounts and disclosures, whenever items are recognized on the balance sheet and income statement, than when they are not. For these reasons, the question of whether investors would be comfortable with either capitalization or a 'comprehensive disclosure' solution only, would amount to a false choice.

For multiple reasons, we are concerned about the efficacy of a 'disclosure only' solution, which is seen by some as an alternative to the Boards current proposals. Disclosures are not an adequate substitute for recognition. A 'disclosure only' approach would impose on investors the burden of estimating lease obligations with susceptibility to greater measurement error compared to beginning analytical judgments using capitalized obligations. There is substantial evidence that investor estimates of lease obligations using current disclosures are subject to significant measurement error. Only providing more disclosures will not remedy the analytical burden and measurement error that investors experience with current reporting.

Another reason for our concern is the inconsistent posture of various stakeholders on the subject of disclosures. Specifically, some are willing to pursue the 'comprehensive disclosures' solution, while at the same time expressing reservations about the volume of disclosures and the appropriateness of including 'forward looking' disclosures in financial statements. Past experience on resolution of investor-desired disclosure requirements makes us question whether a 'disclosure only' option is a plausible solution for enhancing the long-term transparency of lease contracts.

[5] Biondi, Y.; Glover, J.; Jamal, K.; Ohlson, J.A.; Penman, S.H.; Sunder, S; and Tsujiyama, E.; 2012; *Some Conceptual Tensions in Financial Reporting*; Accounting Horizons; Vol.26, No.1; pp. 125-133. The paper highlights various recurrent conceptual tensions including different emphasis placed on stocks (i.e. balance sheet) versus flows (i.e. income statement) by different stakeholders involved in analysing companies.

The Imperative: The Need to Reach a Conclusion

Over the last ten years, the Boards and all stakeholders have expended considerable effort and resources in deliberations regarding the model required to improve existing lease accounting deficiencies. We acknowledge that the Boards have explored multiple models and faced substantial difficulties in gathering consensus around several fundamental issues. That said, we consider that the proposed change to capitalize leases will be an acceptable way forward and an important first step to enhance transparency of leases. To make this proposal more workable, the Boards should tighten several conceptual foundations (e.g., clarify the distinction between lease and service, and the definition of the economic consumption of leased asset principle), and strengthen the application guidance by providing illustrative examples. As we discuss in the specific comments, a tighter definition and distinction of lease versus service, is necessary to avoid structuring in pursuit of favored accounting outcomes. The Boards should also require an amortization versus interest disaggregation for all leases, and require the consistent classification of interest in the statement of cash flows. If the Boards made these proposed refinements, we would consider this proposal to be a positive evolutionary change, which would pave the way for further improvements at a future date. For this reason, we encourage the Boards to adopt the proposal after making refinements, but resist pursuing yet another fresh model.

We are concerned that the continuous search for a model that can presumably satisfy all stakeholders will delay long overdue transparency for an indefinite time period. As this stage in the project, it seems reasonable to expect that all the plausible options have been subject to outreach, stakeholder education and included in one or all of the consultative documents (i.e., Discussion Paper (DP) in 2009, Original ED in 2010 and Revised ED in 2013). Accordingly, consideration of additional new models at this stage is likely to result in the lease accounting project being perceived as a theoretical undertaking with limited prospects of practical improvements. We are concerned that further extensive analysis and discussion will likely result in investors' disengagement due to fatigue and a perceived minimal 'return on engagement.'

We encourage the Boards to complete the lease accounting proposals. We believe it improves upon current requirements and the integrity of financial statements, whilst retaining the opportunity for further future improvements as has been the case on other standards (e.g. pensions, stock options, derivatives).

Overview of the Comment Letter Response

In our previous comment letters we have provided extensive commentary on the detailed aspects of the Boards' leasing proposals both from a lessee and lessor perspective. For purposes of this letter, we have taken a different approach. To inform this letter, we asked our members for their perspectives on what we believed were the issues central to moving the project forward – capitalizing leases and/or improving disclosures. We also asked for their perspectives on certain of the perceived economic consequences of the Boards' proposals. The results of the survey, along with representative comments, are included in detail in the sections which follow. The summary of our position corresponds to the detailed findings included in the body of the letter.

The focus of our comment letter response is on the capitalization and disclosure issues associated with lessee accounting as we believe they have the broadest applicability and interest for our members. In addition to highlighting key takeaways from the investor survey results, we also provided commentary on certain specific issues of particular interest to us. As we note in the

detail sections of the letter, we are not supportive of the dual income statement approach. We believe improvements in disclosure are necessary to provide investors with the same information for both approaches such that they are able to make the analytical adjustments necessary to improve comparability as well as address any measurement concerns they perceive important to their analysis. Similarly, we express interest in certain presentation changes to improve comparability and transparency of approaches and facilitate any necessary adjustments. We also highlight our concerns regarding the transition and effective date provisions as they may impair comparability.

SCOPE & BASIS OF OUR RESPONSE

Focus of Our Response: Lessee Capitalization & Disclosure Enhancements

Through the years, CFA Institute has provided input to both Boards related to the proposed changes to lease accounting. In the recent past, we have provided input as follows:

- Comment Letters – Submitted comprehensive comment letter responses to both the Original ED and the DP, addressing the questions posed at the time;
- Outreach Participation – Participated in several outreach meetings to investors conducted by standard setter staff whilst they were developing and getting feedback on different aspects of these proposals (e.g. dual income statement recognition approach); and
- In-Person Liaison Meetings – Articulated our positions during the in-person liaison meetings with the Boards.

Through these varied platforms, we have expressed, in detail, our views regarding the specific and general aspects of proposed changes to lessee and lessor accounting. As our previously articulated positions on the technical detail have not changed, rather than responding to all questions being posed in the Revised ED, the emphasis of our response is on the 'big picture' of why the Boards need to act in the interest of investors by completing the proposal to capitalize all leases for lessee companies and to concurrently require comprehensive disclosures related to lease contracts.

We also respond to several specific issues that we believe are especially important to investors. These include the definition of leases, certain specific lessee recognition and measurement issues, presentation matters and our views on effective dates and transition methods related to a final standard.

Excepted From Our Response: Lessor Accounting, General Observations Unchanged

In this response, we primarily focus on lessee accounting as this aspect has applicability across a broad variety of industries, while lessor accounting tends to be mainly relevant to a narrower set of businesses (e.g. property developers, equipment manufacturers and some financial institutions-albeit often not as a core activity).

In our previous comment letter responses to the Original ED and DP, our broad messages on lessor accounting related to the need for the Boards to do the following:

- *Address Simultaneously* – Address lessee and lessor accounting at the same time;
- *Strengthen Conceptual Foundations* – Strengthen the conceptual foundations of the lessor accounting approaches that were proposed in the Original ED. We highlighted the conceptual shortcomings that we perceived existed with both the performance obligation and de-recognition approach. Some of these have been addressed (e.g. symmetry between criteria for de-recognition and Type A leases).
- *Disclosures* – Require comprehensive disclosures by lessors.

The Boards have, to some extent, addressed the points we raised for lessor[6] accounting. The recognition and measurement concerns we have with lessee accounting regarding the distinction[7] between Type A and Type B leases, can be extended to lessor accounting. That said, there is need for the guidance to clarify if/when the consumption principle could result in asymmetrical judgments by the lessor and lessee regarding the level of consumption of the leased asset (i.e. where lessee concludes significant consumption in a specific lease whereas the lessor reasons that the consumption is insignificant or vice versa). In addition, our reading of the proposals is that for Type B lessors, the revenue recognition would be consistent across the lease term (i.e. revenue recognized ratably over lease term). If this is the case, we would be concerned that this could result in revenue recognition that does not reflect the economic pattern of value accretion for lessors with Type B leases (i.e. interest earned from leased asset and required yield from forgone residual asset). Beyond these concerns, we do not have significant additional commentary on lessor accounting beyond what we expressed in our previous comment letters.

As a general comment, we would recommend that the Boards provide additional application guidance and examples for different types of leasing arrangements (e.g. shipping, fiber optic equipment, landfills etc.) to enable investors to obtain a better appreciation for how the model and distinction by Type A and Type B leases would be applied by lessors.

Informing Our Response: Member Survey Results

In this letter, we share the results of a recent CFA Institute member survey (see **Appendix** for survey background) recently conducted related to key aspects of the proposed changes to lease accounting.

The survey questions were focused on investor expectations related to capitalization, disclosures and the economic implications of a change to capitalize operating leases. In the background to the survey, we highlighted the salient aspects of the Revised ED including the dual income statement approach. However, we did not evaluate user views of the proposed dual income statement approach, except on the question of whether respondents would like similar information for both income statement approaches. We considered the capitalization on the balance sheet and required additional disclosures to be the principal aspects of the leasing proposal that warranted validation from users of financial statements. We considered that the adopted approach of specifying two leases for income statement recognition is simply a practical expedient to retain aspects of existing income statement treatment. We've previously expressed our preference for a single income statement recognition approach.

The survey results are additive to our extensive previous commentary on this subject and they provide support for capitalizing leases as well as illustrate that investors require comprehensive disclosures.

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[6] The Boards have proposed that lessee and lessor accounting treatment will depend on a distinction between Type A and Type B leases. For lessor accounting, the Boards have moved away from the choice between either a performance obligation approach or a de-recognition approach. The performance obligation approach which had elements of a 'whole asset approach' (i.e. the full asset and right-of-use of asset are recognized) is no longer under consideration. In addition, the factors used to judge whether de-recognition of an asset by the lessor should occur, have been aligned with considerations used to evaluate whether the lessee has a Type A lease.

[7] As we understand, there will be a two-step determination of whether a lease can be classified as Type A or Type B. The first step and default classification will be based on the nature of leased asset (i.e. property leases will be considered to be Type B and other than property leases such as equipment, vehicle leases will be considered as Type A). Thereafter, there will be an evaluation of whether more than an insignificant consumption occurs to affirm the initial classification. In other words, the judgment of whether significant consumption has occurred can override the initial classification that is done by nature of the underlying leased asset.

OVERALL COMMENTS

We provide general comments and member survey results in respect of the economic consequences of changes to lease accounting along with respondents' views on the capitalization of leases and the necessary disclosures. As we described previously, we considered these areas as the most essential to investors with respect to concluding the leases project. We conclude this section by analyzing what we perceive to be the false choice between capitalizing leases or improving disclosures.

Economic Consequences of Lease Accounting Changes

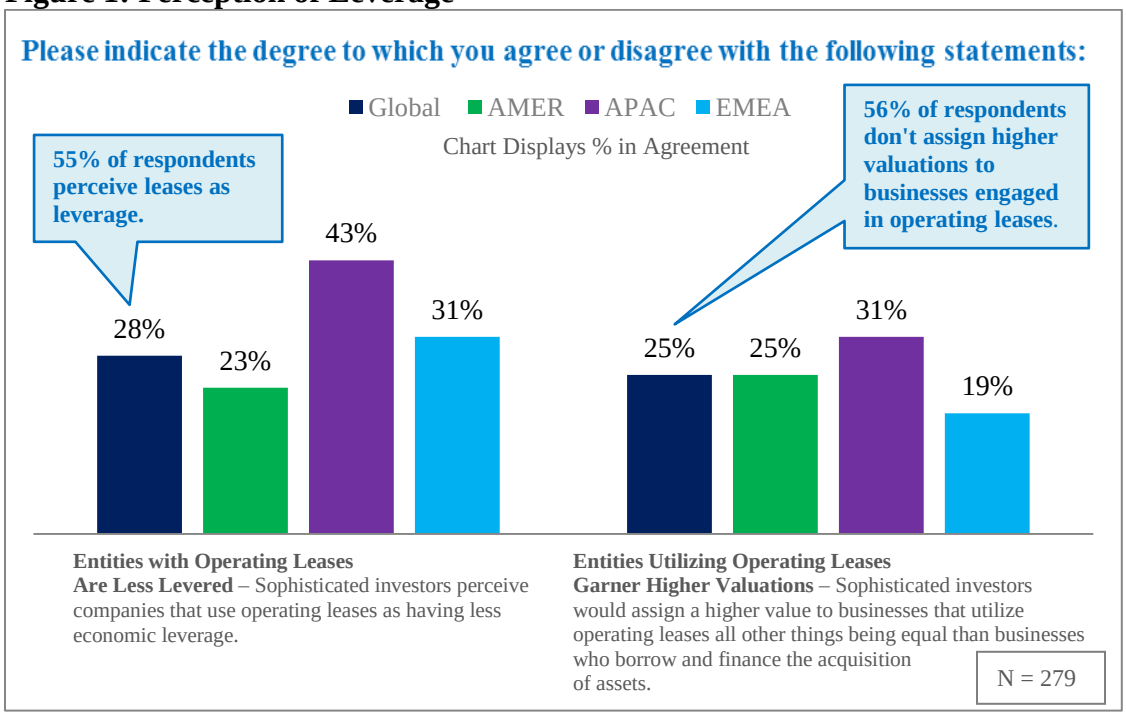
There has been a great deal of discussion regarding the perceived economic consequences which may result from the Boards' decision to capitalize leases. Many argue that capitalization will damage the leasing industry while others have argued that the cost of implementing the standard will exceed the benefits of increased transparency associated with the recognition and measurement of leasing obligations in the financial statements. Accordingly, we queried our members on their perspectives on these issues.

Investors: All Types of Leases Result in Economic Leverage

Investors assume that operating leases entered into by companies result in economic leverage. The results in **Figure 1** illustrate that

- 55% of respondents see operating leases as representative of economic leverage. Only 28% considered that operating leases do not represent leverage.
- 56% consider that there is no valuation premium due to a perception of lower leverage for companies that use operating leases. Only 25% considered that there is a valuation premium.

Figure 1: Perception of Leverage



Bar charts represent percentage of respondents that agreed with the statement while side-box annotation represents those that disagreed. The percentage responses of those who had no view on the matter are not reflected in the chart.

As one respondent notes:

> *"An operating lease is debt…. Therefore, it should be treated as debt on the balance sheet. This is similar to the old pension debate and now pension deficits are on balance sheet, as they should be."*

Investors: Benefits of Capitalization Exceed Cost Concerns

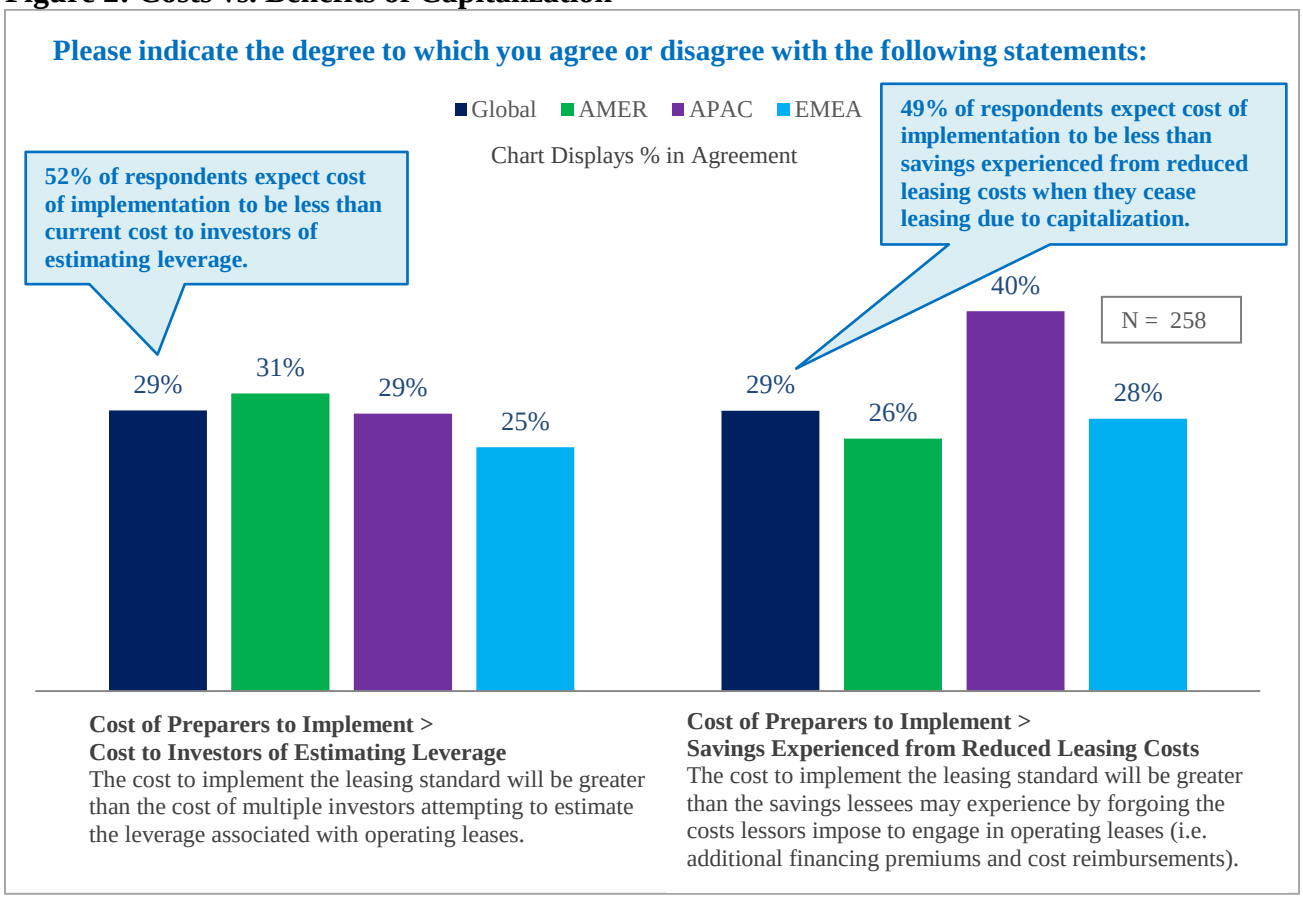
As the survey results in **Figure 2** illustrate, respondents expect that the benefits of capitalization would exceed any resulting costs faced by lessee and lessor companies. The findings from survey respondents were as follows:

- 52% expected that preparers' cost to implement the standard will less than the cost incurred by investors/analysts in attempting to determine the analytical adjustments necessary to estimate leverage. Only 29% expected the lease standard implementation cost to be greater than the analyst cost of estimating leverage.
- 49% expected that the cost to implement the standard will be less than savings lessees will experience from leasing costs (i.e. additional financing premiums and cost reimbursements) they will forgo if they cease engaging in operating leases because they are required to capitalize leases. Only 29% expected the cost of implementing the standard to be greater than the savings that lessees will experience from leasing costs.

Also interesting is that 67% of respondents (**Figure 3**) expected companies to continue engaging in operating leases regardless of these proposed updates to lease accounting. The comments below from one respondent casts doubt about reservations related to adverse impacts on the leasing industry:

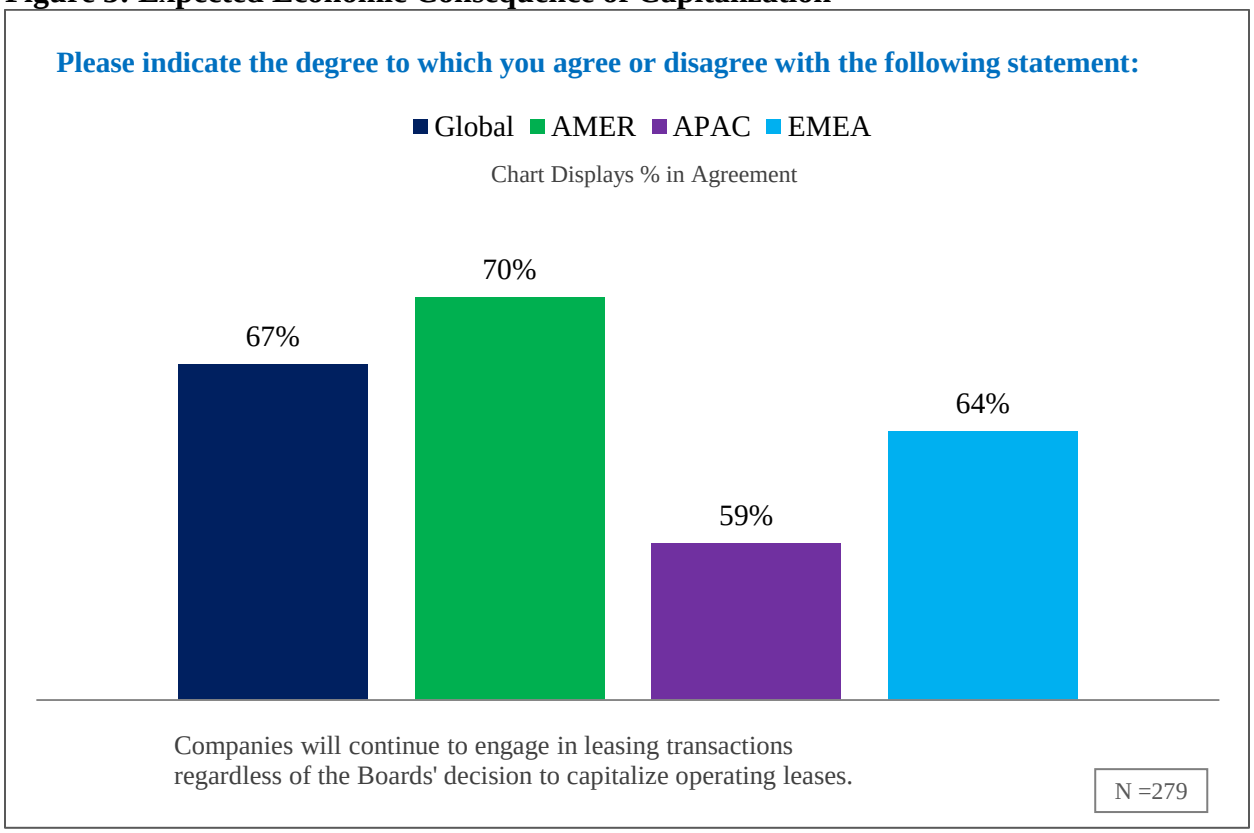
> *"If leases are economically relevant, then accounting standards simply requiring their capitalization will not result in the demise of the leasing industry. Those who make the argument that it will, are simply making the argument that the leasing industry exists to disguise leverage and provides no other productive economic reason for existing."*

Figure 2: Costs vs. Benefits of Capitalization



Bar charts represent percentage of respondents that agreed with the statement while side-box annotation represents those that disagreed. The percentage responses of those who had no view on the matter are not reflected in the chart.

Figure 3: Expected Economic Consequence of Capitalization



As one respondent commented:

> *"This is a no-brainer. These are real borrowing obligations, almost all analysts capitalize them, and they reflect real leverage. I don't see why it kills the leasing business as it is predicated on favorable tax treatment more than favorable financial statement treatment. And if it does, so what, the point is to reflect reality not to bend reality because that is how it has been done. All the lease accounting tricks exist as a way to shrink the balance sheet, jack up Return on X, Y, Z type numbers etc. Just do it please – it would be a great step towards having financials actually reflect reality."*

Overall

Our survey results reflected what we have heard from investors over the many years this standard has been under development. Investors do not believe capitalization of leases will result in the end of the leasing industry as capitalization is simply requiring preparers to perform an adjustment to accurately reflect the leverage of lessees which has been estimated for decades by investors. Sophisticated investors recognize this leverage in their analysis and don't assign higher valuations to those who manage the perception of leverage by engaging in leasing arrangements.

Further, investors dismiss the notion that the costs of implementing the proposed leasing standard will be a net negative to the companies in which they invest. They believe that when

performing the cost benefit analysis many who argue against capitalization fail to include in their analysis the costs incurred by many analysts making adjustments to estimate the underlying leverage (i.e., the cost of capital increases due to uncertainty over adjustments).

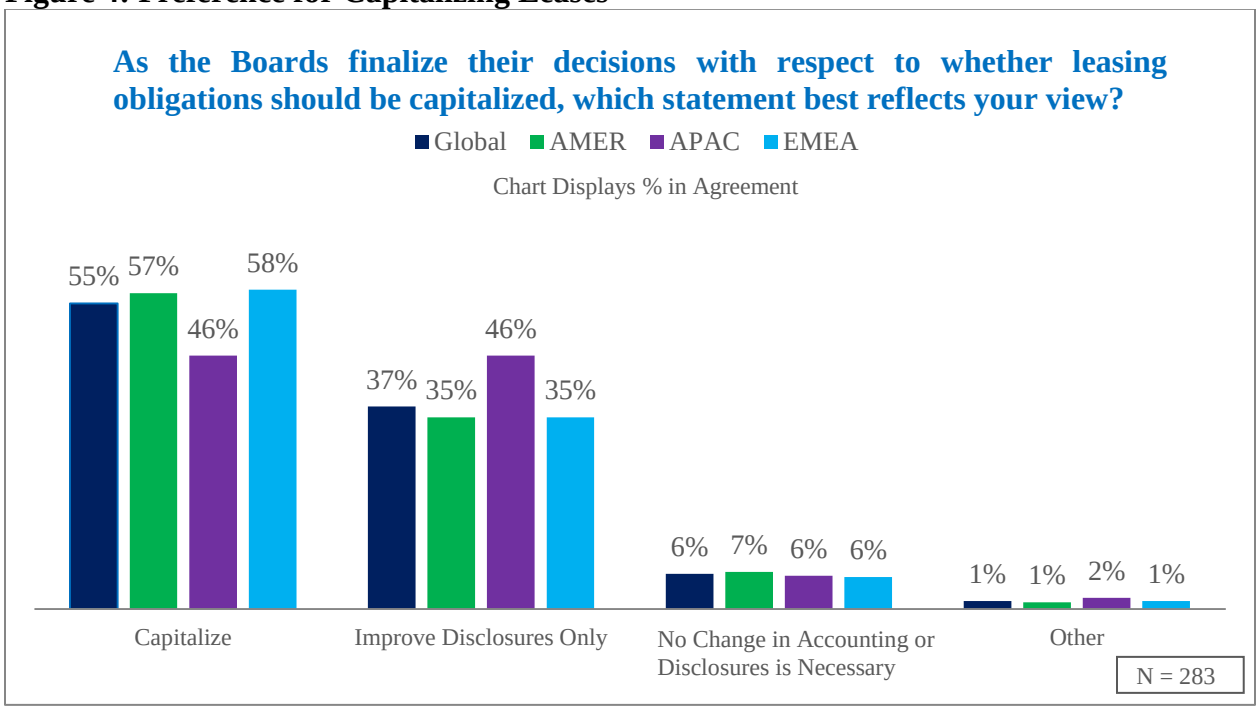
Capitalization of Leases

Investors Support Capitalization Over Simply Improving Disclosures

Consistent with the charts above, respondents support capitalization. **Figure 4** shows their preference relative to improving only disclosures or retaining existing accounting guidance:

- 55% of the survey respondents favored capitalization;
- 37% favored improvement in disclosures (i.e. no capitalization); and
- Only 6% supported making no changes to current lease accounting requirements.

Figure 4: Preference for Capitalizing Leases



Representative respondent comments include the following:

"Capitalize all leases (including short-term leases to prevent strategy of rolling-over short-term leases to create effectively long-term leases)"

"Capitalize ALL forms of leases, including short-term leases."

"This change is long overdue."

"This is a great and much needed initiative."

"All financial obligations should be reported as a liability on the balance sheet. All leases, even ones with a term less than one year, should be included on the balance sheet as a liability. We record accounts payable, why would we not record a lease payable? These

off balance sheet financing arrangements have been off balance sheet for too long. If all obligations were reported on the balance sheet, you could get rid of the "other obligations" footnote. I think there may be some benefit to listing lease expenses, operating or capital, as a separate line on the income and cash flow statements as some analysts may want to separate operating costs from financing costs."

The objection to capitalization of leases, as reflected by those who favored only improving disclosures, arises in large part due to measurement related concerns. Such measurement concerns have been expressed by some investors including the FASB Investors Advisory Council (IAC). We have also expressed similar concerns related to measurement in our 2010 comment letter on the Original ED.

In our survey background (**Appendix**), we highlighted the existence of measurement concerns as one of the reasons for opposition to leases being capitalized. Our survey background included opposing and supporting views so as to inform respondents of both perspectives. Accordingly, the support for capitalization by 55% of the respondents is a reflection of the views of the broad sample of respondents, after considering the supporting and opposing reasons for these proposals. The below comments from a respondent to the survey encapsulates the anticipated benefits of capitalization for investors and casts doubt about reservations related to adverse impacts on the leasing industry

"From the perspective of a user of financial statements, leases longer than one year should be capitalized to increase transparency and facilitate communication between users and operating companies. Analysts are still free to make subjective assumptions regarding assets values and discount rates, but they will have a common basis of discussing inputs to valuation models. I find the objection to capitalizing leases on the basis of harm to the leasing industry to be questionable."

Investors Anticipate Capitalization Will Be Beneficial

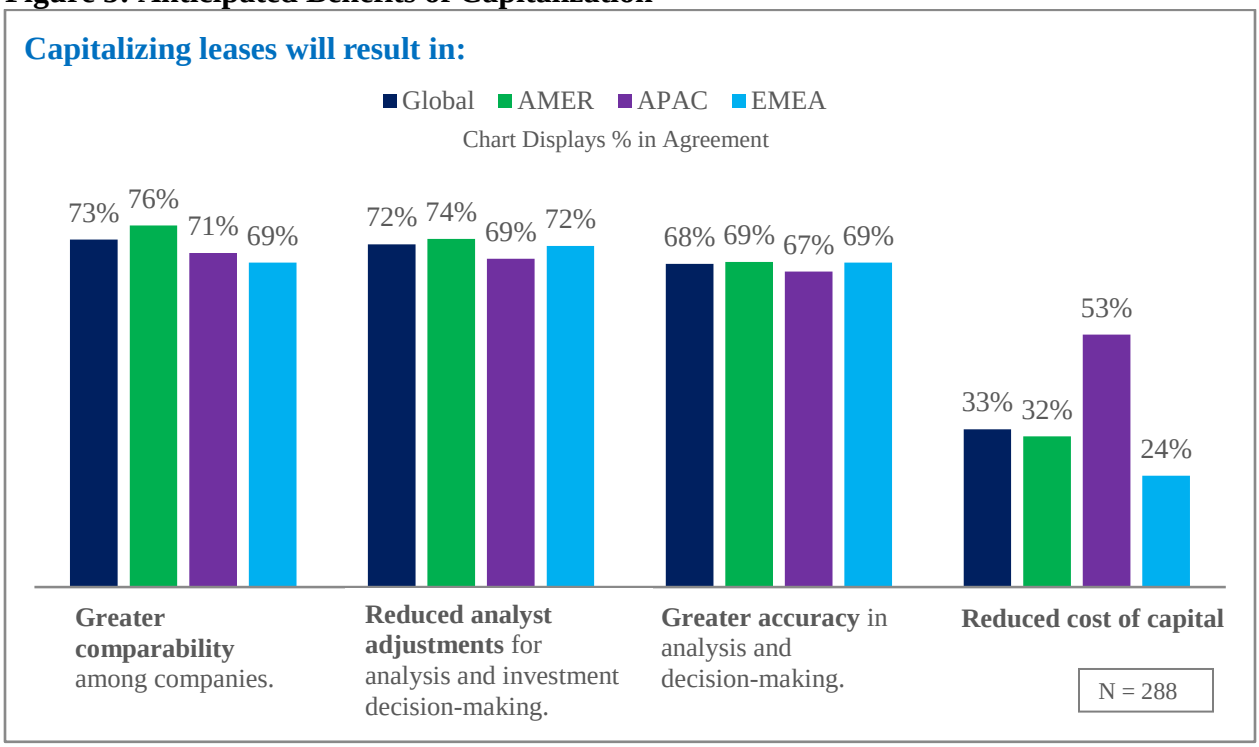
As the survey results in **Figure 5** illustrate, respondents expected several benefits to inure from the capitalization of leases. The findings from survey respondents were as follows:

- 73% expected greater comparability among companies;
- 72% expected reduced analytical adjustments for analysis and investment decision making;
- 68% expected greater accuracy in analysis and decision-making.

In the words of one respondent:

"This is one area where the comparability of financial statements is poor."

Figure 5: Anticipated Benefits of Capitalization



As noted, the survey results reveal that investors anticipate the overall benefits to investors will outweigh any direct or indirect implementation costs. Correspondingly, the following survey respondent comment pinpoints the need for standard setters to act in the interest of investors.

> ***"****At the end of the day, for as long as corporations continue to source capital from third party institutional and retail investors, the welfare of investors should be of paramount concern of accounting standards. Standard-setters should reduce the complexity of accounting standards. Reduce the opportunities of corporations to hide things in the financial statements.****"***

Capitalization of Leases:
Essential Step Towards Greater Transparency & Improving Analytical Adjustments

As reflected in the survey results, investors support capitalization of lease obligations. Regardless of the accounting regime, investors and analysts will still end up estimating lease obligations and grossing up their balance sheets – as leases clearly represent economic obligations.

As we cited in a previous comment letter, a paper reviewing archival academic research[8] related to leases shows that both operating and capital leases are treated as debt for risk assessment and valuation purposes by capital market participants. Further, there is nearly universal acknowledgement among stakeholders to the standard-setting process (investors as well as preparers and members of the leasing industry) that leases are recognized as obligations by investors. Furthermore, 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 as shown by a Credit Suisse study[9].

The Credit Suisse study 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 estimate is 71% higher than the one derived from the 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.

The support for capitalization evidenced in the study is consistent with our view that capitalization will convey management's view regarding the value of the lease obligation and provide a platform for more accurate subsequent analytical adjustments by investors. Effectively, capitalizing leases will provide the best starting point for the required analytical adjustments to the balance sheet.

Our overarching observation is that the proposal to capitalize leases, coupled with the practical expedient of exempting short-term leases, would be a significant first step (i.e. necessary but not sufficient step) towards enhancing the transparency of leases. Even if there are differences of opinion with respect to the elements of measurement, the existing measurement errors are likely to be greater in magnitude than those under the proposed standards.

As such, we strongly encourage the Boards to adopt this proposal to capitalize all leases which is long overdue. We argue that anything short of requiring the balance sheet recognition of lease-

[8] 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.

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

related assets and liabilities, will amount to forgoing an opportunity to meaningfully enhance the transparency of lease contracts. A respondent to the survey says it best:

> *"Unfortunately, the IASB and FASB have been forced into the new lease standards by issuers creating lease contacts that stay just on the right side on the bright line tests to report leases as operating. It appears the solution is to capitalize everything. To properly analysis a financial statement and make it comparable, it is necessary to capitalize leases. It is sometimes hard to know if you are getting it right based on the Company's disclosure. This will be an improvement if the issuer does it properly."*

Required Disclosures

Differing Perspectives on the Measurement of Lease Obligations

As the survey results in **Figure 4** illustrate, the most significant objection to the recognition of lease obligations has stemmed from differing perspectives regarding the measurement of lease liabilities (e.g. measurement of options).

During the development of these proposals, there have been varied viewpoints expressed by different stakeholders regarding the following aspects:

- *Economic Nature of Leases* – The economic nature of the leasing contracts and the underlying assets and liabilities (e.g. whether lease contracts are always a *de facto* form of ownership of the asset, or whether some leases are simply service contracts or financial instruments).
- *Economic Objectives of Leases* – The economic objectives of companies entering into leasing contracts (e.g. influence perception of leverage and risk profile of companies, banks minimizing regulatory capital etc.).
- *Best Representation on Financial Statements* – The optimal financial statement representation of lease contracts (e.g. representation of right-of-use asset as proposed by the Boards versus 'whole asset' approach where there is a depiction of the entire asset on the balance sheet by the lessee during the lease term).

These, and other often mentioned, diverse perspectives regarding the nature and purpose of lease contracts and how to best depict these on the financial statements has led the Boards to settle on two different methods of classifying leases – Type A and Type B which result in a dual income statement approach.

High Quality Disclosures:

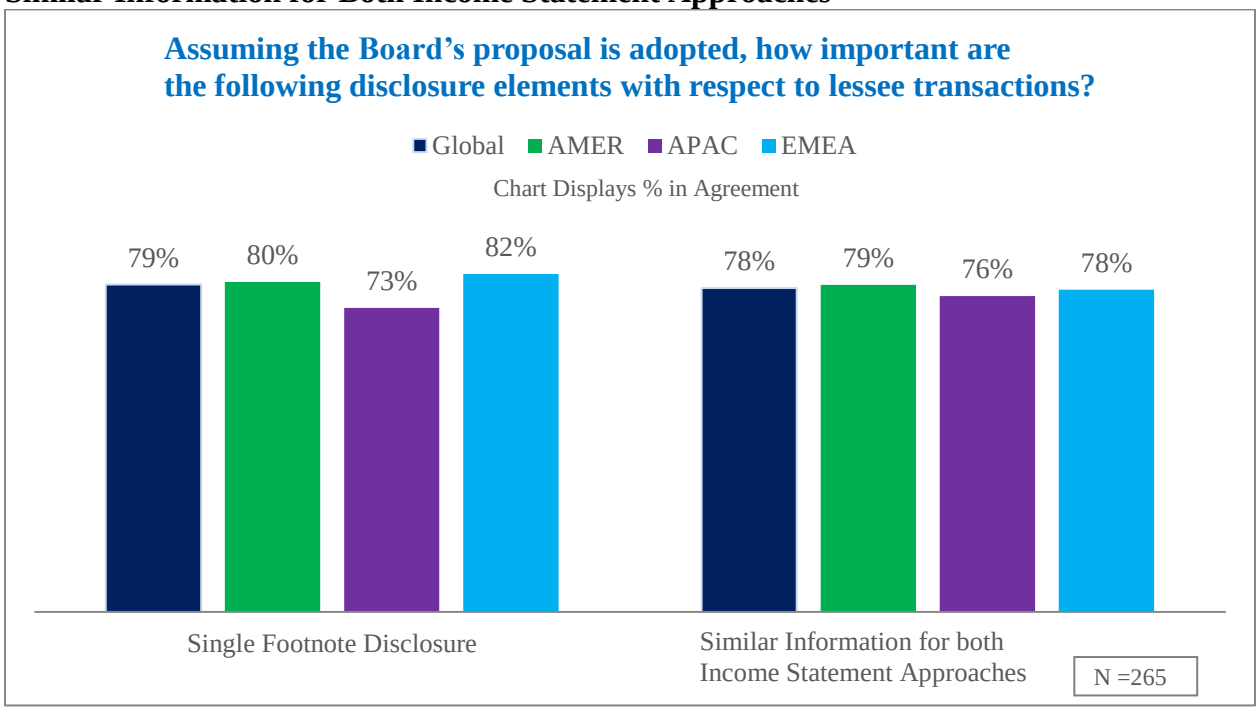
Necessary to Address Differing Perspectives & Alleviate Measurement Concerns

Because of these differing perspectives on the nature of lease obligations – and the two different methods of classifying leases now being proposed – we expressed in our 2010 comment letter on the Original ED the need for comprehensive, easy to access disclosures to meet the analytical requirements of different users of financial statements. Comprehensive disclosures will also be required to assuage the measurement concerns that we, and others, have expressed at different junctures.

Comprehensive disclosures will allow investors to make the analytical adjustments that they deem appropriate to address differences in perspective on the underlying economics, create comparability in approaches and adjust for measurement concerns they may perceive exist within the Boards' decision with respect to measurement.

We asked our members whether such disclosures should be located in a single footnote as has been proposed in the alternative view by the FASB's Marc Siegel to facilitate easy access by investors when making analytical adjustments. A single footnote disclosure with similar information for both income statement approaches would be consistent with the preferences of our survey respondents as shown in **Figure 6**. 79% of respondents considered single footnote disclosure to be important and 78% considered similar information for both income statement approaches (i.e. amortization and interest expense for Type A leases and expenses for Type B leases) to be important.

Figure 6:
Single Footnote Disclosure &
Similar Information for Both Income Statement Approaches



Lessee Disclosures: Opportunity to Enhance Remains

We support the proposed requirements to disclose maturity analysis of lease payments and the roll-forwards of right-of-use asset and liability to pay rentals. That said, there should be symmetry in the requirements of the roll forward for both the ROU asset and lease liability, in respect of foreign currency translation adjustments and business combinations made during the year. This does not seem to be the case under the proposed requirements.

In our previous comment letter[10] (pg. 23) we requested disclosures of the following elements to provide a reasonableness check and convey to users the measurement uncertainty, if any, associated with reported statement of financial position numbers:

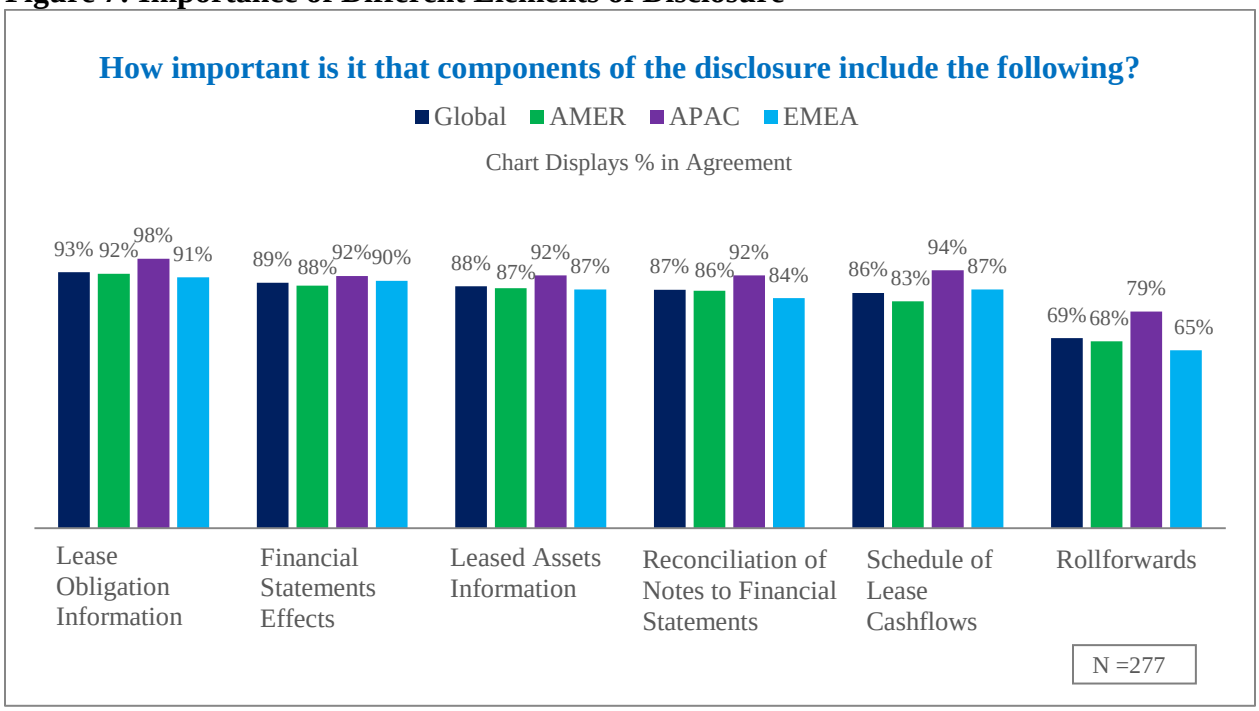
- *Nature of Lessee Arrangements* – Details regarding the nature of the lessee arrangements
- *Measurement of Performance Obligation (Lease Obligation Information*) – Details on the measurement of the lessee obligation including information on the lease term, lease payments, details of base lease payments versus options disaggregated, capitalized costs, discount rates and any reassessment of the performance obligations.
- *Right-of-Use Asset (Leased Asset Information)* – Details of the ROU asset including amortization method, average life, and details of any revaluation or impairment made to the asset.
- *Roll-forwards* – Rollforward of right-of-use asset and lease performance obligation.
- *Reconciliations (Reconciliation of Notes to Financial Statements & Financial Statement Effects)* – Reconcilation of the disclosures to the amounts presented in the basic financial statements such that investors can understand the financial statement effects of the disclosures.
- *Maturity Analysis (Schedule of Lease Cash Flows)* – A schedule of the cash flow requirements of leasing transactions, sufficiently disaggregated by maturity.
- *Sensitivity Analysis* – Sensitivity analysis of reported liability to pay rentals.
- *Fair Value* – Fair value of lease liability consistent with the requirements to provide fair value disclosures for financial instruments.

It remains a missed opportunity for the Boards not to have required the above disclosures. We believe a 'half-way' approach towards specifying required disclosures will negate the usefulness of the overall package of disclosures. The relevance of the disclosures that we have previously requested is evident from our survey results as shown in **Figure 7** below. The results show that investors consider disclosures of the following lease elements to be important:

- *Lease Obligation Information (93%)* – The nature of the lease obligation recognized including the cash flow requirements of the leasing transaction, the term of the lease, discount rates utilized in measuring the obligation and the amortization expense recognized.
- *Financial Statement Effects (89%)* – A summary of the effects of leasing transactions on the balance sheet, income statement and statement of cash flows;
- *Leased Assets Information (88%)* – The nature of the leasing asset recognized including its amortization method, period and income statement effects as well as any impairments recognized;
- *Reconciliation of Notes to Financial Statements (87%)* – Reconciliation of the amounts disclosed in the footnotes to the amounts recognized on the balance sheet, income statement and statement of cash flows.
- *Schedule of Lease Cash Flows (86%)* – A schedule of the cash flow requirements of leasing transactions, sufficiently disaggregated by maturity.
- *Roll-forwards (69%)* – Roll-forward of the leasing asset and obligation.

[10] Ibid 4.

Figure 7: Importance of Different Elements of Disclosure



The majority of respondents viewed all of the disclosures in **Figure 7** as necessary disclosures for purposes of improving lease accounting. Several respondents provided additional comments regarding disclosures mostly surrounding the need to disclose lease terms, renewal options, percentage rents, cancellation provisions, purchase options and greater detail on maturity analysis. Below are several representative comments:

"Disclosure of purchase option(s) provided in the lease agreement is also important."

"Lease term and renewals should also be disclosed."

"I believe comprehensive disclosures are important. It is easy for me to disregard information about which I am not interested, so there is no harm done in providing too much detail."

"Each required lease payment should be disclosed, even in out years (i.e, eliminate the lump sum for year 6 and thereafter). Lease cancellation provisions and penalties should also be fully disclosed."

False Choice: Capitalization vs. Enhanced Disclosures

Both Necessary & Disclosure Is Not an Appropriate Substitute for Recognition & Measurement

As noted, comprehensive disclosures are required by both investors who believe leases should be capitalized and those who do not. As **Figure 4** illustrates, only 6% of respondents believed no change in recognition, measurement or disclosures was necessary and that current lease accounting or disclosures should be retained unaltered. Our survey results in **Figure 4** above have shown that respondents who either supported capitalization (i.e. 55%) or who supported only enhanced disclosures (i.e. 37%), required the enhancement of disclosures on lease contracts. For example, this was evident from the number of respondents that considered the disclosure of lease obligation information (i.e. 93%) and other elements of disclosure to be important as shown in **Figure 7** above.

Thus, choosing between either capitalization or only enhanced disclosures, amounts to a false choice. Regardless of the differing perspectives on lease contracts from different stakeholders, it is widely acknowledged that in practice most investors and analysts are making analytical adjustments to the balance sheet, implicitly recognizing that there is an obligation to pay rentals. In other words, investors bear the cost of having to make the analytical adjustment as well as the costs associated with capital misallocation due to information uncertainty.

A Disclosure Only Change to Lease Accounting: Unlikely to Result in Improvement for Investors

An academic paper[11] which reviewed the disclosures of 57 of largest U.S. equipment lessors, highlights how poor companies are at providing disclosures, even when some of these disclosures are required and these companies have material investments in leasing. Apart from comprehensive disclosures being unlikely in practice, there are many other limitations that would arise from a 'disclosure only' solution including the following:

- *Leverage Forgone in Making Longer-Term Improvements* – Experience over the years has shown that there is greater imperative to enhance disclosures whenever items are recognized on the balance sheet and income statement than when they are not. If the Boards choose not to recognize lease obligations on the balance sheet, the disclosures are unlikely to provide the degree of quality necessary to make the necessary analytical adjustments and there will be little, if any, leverage to improve the disclosures over time. The existence of the obligation on the balance sheet brings greater attention to the appropriate measurement of the liability. As we have seen in pension accounting and stock-based compensation accounting subsequent revisions to standards are made to improve measurement and disclosures once amounts are recognized in the basic financial statements.
- *Forward-Looking Information: Common Refrain Against Necessary Disclosures* – If lease obligations are not recognized on the balance sheet, investors worry about the likelihood of the debate then shifting towards assessing whether the most important lease disclosures would be considered "forward-looking information" and thereby being considered inappropriate for disclosure in the financial statements. There are salutary lessons to be learnt from the debate that occurred in the U.S in the context of the promise to provide liquidity and interest rate risk disclosures as an alternative to fair value recognition of all financial instruments.

[11] Bauman, M.P.; and Francis, R.N; 2011; *Issues in Lessor Accounting: The Forgotten Half of Lease Accounting*; Accounting Horizons; Vol.25, No.2; pp. 247-266.

- *Incomplete Disclosures* – Apart from companies failing to provide the required disclosures, the notion of comprehensive disclosures being an alternative to capitalization is challenged by the Boards decision not to require disclosures of the following due to preparer cost concerns cited in Paragraph BC 210 of the Basis of Conclusion :
  - Discount rate used to calculate the lease liability;
  - Fair value of the lease liability;
  - Initial direct costs capitalized as part of ROU asset; and
  - The existence and principal terms and conditions of any options to purchase the underlying assets.

  If such disclosures are too costly to provide when included – in certain circumstances – in the measurement of the lease obligation and ROU asset, there is little probability that a disclosure only solution will result in their inclusion in the financial statements.
- *Incomparable Disclosures* – Investors are concerned that there is a high likelihood of companies providing disclosures for leases which are not comparable under a disclosure only solution. Consequently, investors would be heavily constrained to fully estimate the initial and subsequent value of the underlying asset and liability regardless of what they assume to be the economic nature of these assets or liabilities (i.e. right-of-use asset, executory contracts or financial instruments). Investor analytical practices show that there is wide variation[12] in estimates of the leasing obligation, even among those who share similar assumptions about the economic nature of the lease contract (i.e. always a form of ownership) and who should therefore make comparable analytical estimates of the lease obligation. This variation in analytical estimates can be explained by the partial information provided through off-balance sheet disclosures. The poor quality and lack of comparable analytical estimates are unlikely to be remedied by the 'disclosure only' enhancement approach.
- *Lower Levels of Assurance* – There is likely to be a lower threshold of audit assurance for information that is only disclosed as compared to the audit assurance on amounts recognized in financial statements.

For the above reasons, we agree with the need for enhancement of disclosures, but emphasize that disclosures are not a substitute for capitalization of leases.

[12] Ibid 9 – The Credit Suisse study shows that estimates of the lease obligation could vary significantly across the spectrum of users depending on whether investors use multiples based guesstimates (e.g. 8x annual lease rentals) or a discounted cash flow estimation of value based on partial information within disclosures.

OTHER SPECIFIC COMMENTS

In the below section we address selected issues related to the following:

- Lease Definition;
- Lessee Recognition and Measurement
  - Dual Income Statement Approaches;
  - Other Measurement Concerns;
- Presentation; and
- Transition and Effective Date.

Lease Definition

Service Definition: Required to Complement Lease Definition

In our previous comment letter, we highlighted the need for the improved definition of a lease, alongside the need to respectively provide independent definitions of 'a sale' and 'service contract.' These definitions would facilitate the consistent application of the lease accounting requirements by preparers and contribute to greater comparability of financial statements for users. These definitions would also effectively allow the distinction between:

- *Lease vs. Sale* – This distinction was important under the previously proposed performance obligation approach for lessors. The Revised ED no longer requires the performance obligation approach for lessors and therefore this distinction is less critical.
- *Lease vs. Service* – This distinction remains important because lease contracts could contain service elements that are required to be accounted for differently under the proposed requirements. Preparers are likely to be incentivized towards having contracts being categorized as services in order to apply the more 'favorable' accounting treatment (i.e., not on balance sheet). In addition, many stakeholders have asserted that certain types of leases (e.g. current operating leases) are simply 'services'. The latter point shows the need for a definition that will help to avoid the use of lease and services interchangeably. Needless to say, the blurred boundaries in stakeholders' minds between these terms could be shaping their expectations of the suitable accounting treatment of what are currently considered to be operating leases.

The Revised ED updates have clarified that a lease relates to specified assets and incorporated both power to direct activities and entitlement to benefits from use of an asset as criteria for judging lessee control of the asset. The proposed definition will allow a desirable consistency in evaluating the transfer of control across the leases, revenue recognition and consolidation standards. However, the Revised ED has still not provided an explicit, independent definition of a service. There are only implied definitions or indicators of service (e.g. substitutability of assets; the use of a portion of capacity; and lack of separability from the primary leased asset), which are discussed in the evaluation of different fact patterns in the basis of conclusion document – Paragraphs BC 105 and 106 – even then it is not clear whether these examples will be a part of the codification under US GAAP or application guidance under IFRS. Effectively, under the proposed requirements, classification of contracts as services could inappropriately occur, as this is a residual, loosely defined category. In addition, preparers could more readily structure contracts to avoid the definition of a lease (and accordingly, the recognition of an obligation) when there is no explicit definition of service that allows an evaluation of whether the contract is a service contract. It could also result in a push by preparers in certain industries for eligibility for leases accounting treatment. For example, software providers who prefer ratable revenue recognition would likely prefer to have their contracts with customers to be

treated as Type B leases. Effectively, there could be pressures to cherry pick what part of an arrangement is a service versus a lease.

As highlighted by Tom Linsmeier in his alternative view, the lease definition needs to clarify the nature of a right-of-use asset (i.e. whether it is a service, intangible asset, or unique asset subject to a lease). Our view of leases is that a lease contract creates a long-term financial obligation, which should result in a recognized liability that creates (at inception) an equivalent asset – the ROU. We view the ROU is a different class of asset and, for that reason, believe that standard setters should not simply analogize this unique asset with other asset classes.

Hence, we still recommend that the Boards provide an explicit definition of a service as this will be complementary to the definition of a lease. Such a definition will be relevant across several projects. For example, the need for the explicit definition of a service was also evident in the revenue recognition project in situations where performance obligations are satisfied over time. The definition of a service is a cross-cutting issue that needs to be addressed by the Boards.

Lessee Recognition and Measurement: Dual Income Statement Approaches

Single Income Statement Recognition Approach: Our Preferred Option

In our liaison meetings and in the response to staff member outreach we communicated our preference for a single income statement approach and expressed our concerns regarding a dual income statement recognition approach that depends on the classification of leases into Type A and Type B based on the economic consumption principle. In the sections below we highlight several of these concerns.

Significant Economic Consumption Threshold: Remains Unclear & Is Highly Subjective

The determination of significant consumption, or more than insignificant consumption, of the underlying leased asset seems to be based in certain instances on the dimension of time (i.e. lease term as proportion of either the full or remaining economic useful life) as well as being based purely on the extent of value diminution in other cases as cited in Paragraph BC 56 where occupancy of property for 15 of 50 years would still be seen as a Type B lease.

In general, it remains unclear what the threshold of 'more than insignificant' means. This lack of clarity could contribute to inconsistent application of the requirements. While we understand the need to avoid bright-line definitions or thresholds, we believe that the Boards still need to strengthen and provide application guidance around the threshold of 'more than insignificant' consumption of assets.

We reiterate our previously expressed need for the strengthening of guidance on economic consumption to enable consistent application of the requirements by preparers who have entered into similar lease contracts. Without such strengthening, we believe there is a strong likelihood of subjectivity in judgments regarding the notion of significant consumption of leases. Furthermore, there is need for the guidance to clarify if/when the consumption principle could result in asymmetrical judgments by the lessor and lessee regarding the level of consumption of the leased asset (i.e. where lessee concludes significant consumption in a specific lease whereas the lessor reasons that the consumption is insignificant or vice versa).

Significant Economic Consumption Threshold: Robust Disclosures of Judgment Required to Mitigate Concerns about Dual Income Statement Recognition Approach

Notwithstanding the above concerns, our principal requirement is that both Type A and Type B leases are capitalized. As such, we recognize that the Boards have adopted a dual income statement recognition approach as a compromise to accommodate the diversity of views regarding the nature of lease contracts. The uncertainty around how consistently these judgments of significant economic consumption of asset will be made necessitates more robust disclosures than proposed that convey how these judgments have been made.

Type B Leases: Raise Questions Regarding Usefulness of Financial Statement Balances

The creation of Type B leases raises a question regarding the usefulness of the financial statement balances created by the implementation of this approach. We outline our concerns below:

- *Type B Expense*: *Limited Predictive Value* – A level expense pattern has limited information content and predictive value of future cash flows. The smoothed expense does not reflect the underlying cash flow effects and represents an accounting rather than economic construct.
- *Type B Asset & Liability Link: Insufficient Conceptual Justification* – There is no conceptual justification for inextricably linking the subsequent measurement of the right-of-use asset and liability to pay lease rentals for Type B leases.
- *Type B ROU Asset: Diminished Economic Meaning* – The proposed impairment approach that inextricably links the ROU asset and liability to pay rentals diminishes the economic meaning of Type B lease ROU assets reported on the balance sheet. The value of the ROU asset is plugged to accommodate the level income statement expense.

Interest vs. Amortization Split: Disagree With Conclusion Only Relevant For Type A Leases

Basis of Conclusion Paragraphs BC 50 to 63 articulate that lessor pricing and expected return on lease contracts is comprised of the following elements:

- The consumption of asset, ostensibly represented by the value diminution or decline in fair value.
- Expected yield from the consumed asset portion.
- Forgone yield from residual asset during the lease term.

These elements highlight that there are different reasons for engaging in lease contracts and that there are cases where leasing arrangements could be entered into solely for lessor yield-searching purposes. In other words, where there is no significant economic consumption of the asset.

A corollary of the Board's reasoning is that asset consumption is expected to only occur for Type A leases but not for Type B leases and that it is therefore less meaningful for lessees to separately present the amortization of Type B leases. The Boards' reasoning seems to be that the economic consumption of the leased asset should dictate the appropriateness of the lessee representing the amortization or impairment as a separate line item on the income statement.

We agree that there should be consistency between the lessor and lessee in their assessment of expected economic consumption of the leased asset. However, the amortization or impairment could still be relevant regardless of whether the lease has a high residual asset value (i.e. minimal consumption of asset from lessor point of view). For example, where there are residual value guarantee arrangements.

In addition, income statement related metrics such as earnings before interest and tax (EBIT) and earnings before interest, tax, depreciation and amortization (EBITDA) are widely used by various users as performance and valuation measures. These users assume that there is an interest component for all leases (i.e. Type A and Type B). Without an interest versus amortization disaggregation for Type B leases, users will be unable to obtain comparable EBIT and EBITDA across all companies. These will also introduce a distortion to the performance analysis and valuation of companies that have Type B leases.

Reassessing Classification after Commencement Date: Disagree With Decision Not To Reassess

The economics of the lease arrangement can change during the lease term. Consequently, reassessment during the lease term ought to provide a sanity check of the reasonableness of the initial judgment and reflect changes in the economics of the arrangement. Hence, we disagree with the decision not to reassess classification.

Lessee Recognition and Measurement: Other Measurement Concerns

In our previous responses to the Original ED and DP, we stated that our preferred measurement approach would be a fair value measurement of the underlying ROU asset and lease obligation liability. We recognize, however, that it would be challenging to determine such fair values for the ROU asset. We have several outstanding concerns with the measurement of the ROU asset and the lease obligation.

Amortisation of Type A Lease ROU: Guidance Remains Inadequate

Amortisation guidance for Type A leases remains inadequate. Reference to other asset literature avoids resolving questions regarding the underlying nature of ROU asset. In our response to the Original ED, we stated that the the amortization should reflect the actual economic utilization of right-of-use asset and requested that the Boards strengthen the guidance and be more specific on the amortization approaches for different types of right-of-use asset.

Variable Lease Payments: Disagree With Partial Recognition in Lease Obligation Measurement

We do not support with the exclusion of variable payments linked to sales or use as proposed in the Revised ED. This approach is inconsistent with the recognition threshold for other standards related to liability recognition. It is also not clear whether this approach is consistent with the revenue recognition approach in the recognition and measurement of contingent and variable revenue.

It is important that there is separate disclosure of the variable lease payments, regardless of whether these are included in the measurement of the lease obligation.

Options: *Disclosures Necessary to Assuage Concerns on Measurement*

In previous commentary, we supported the recognition of options where the expected lease term would be determined using a probability-weighted approach as this would be the most objective measurement approach. Though we still prefer the probability-weighted approach, we recognize that in adopting the determination of lease term based on there being a significant economic incentive to exercise the options, the Board was responding to preparer feedback regarding complexity and cost constraints. Nevertheless, we remain concerned that the proposed approach of presence of a 'significant economic incentive to exercise' as a basis of option recognition, simply grants preparers the discretion to understate the economic obligation. To assuage these concerns, there will need to be comprehensive disclosures regarding:

a) options that have been excluded for measurement; and
b) how the judgment of there being a significant economic incentive to extend lease term is made.

Presentation Requirements

The guiding presentation principle should be disaggregation and cohesiveness across balance sheet, income statement and statement of cash flows such that investors can adjust for accounting impacts as necessary for their analysis**.** We have several observations in respect of the required presentation of the lease asset, liability, expenses and cash flows in the main financial statements.

Balance Sheet

We support separate presentation of the right-of-use asset and lease liability. We also support separate presentation or disclosure of owned assets, Type A and Type B leases. That said, there is need to clarify the requirements of Paragraph 55 of the IASB ED, which seems to make allowance for non- disclosure of the ROU asset and lease liability.

Income Statement

We support separate presentation of Type A (amortization and interest expense) and Type B (lease expenses) expenses.

As noted previously, we also support separate presentation of amortization and interest expense for Type B leases so as to allow comparison of EBITA and EBIT measures across companies. See also the discussion below regarding the impact on analysis of cash flows.

We also agree with Marc Siegel's alternative view that variable lease payments should always be part of lease expenses and preparers should not have discretion to classify this under any other expense category. We reiterate a portion of one respondents comment noted previously:

> *"I think there may be some benefit to listing lease expenses, operating or capital, as a separate line on the income and cash flow statements as some analysts may want to separate operating costs from financing costs."*

Statement of Cash Flows

We propose that there should be separate presentation of short-term leases, Type B leases and Type A lease interest and amortization, and variable lease payments within the cash flow statement.

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 related to Type A lease interest expense (i.e. whether it is an operating or financing cash flow). The boundaries between operating and financing cash flows would be blurred for financial companies, but the same is not the case for non-financial companies. Thus the guidance should be strengthened such that there can be comparable classification across similar business models. Removing the discretion and requiring consistent classification of interest expense will contribute to the reporting of comparable statement of cash flows.

Furthermore, as noted earlier, not disaggregating Type B expenses into amortization versus interest components will distort EBITDA and EBIT measures for Type B leases and lead to incomparability of these key metrics across companies. This incomparability will be compounded in the statement of cash flows because interest may or may not be included in cash

flow from operations for Type A leases but will be implicitly always included in the cash flow from operations for Type B leases. We emphasize that it is essential for the income and cash flow statement to be disaggregated such that investors can determine the actual cash paid in respect of the leases.

Transition & Effective Date

Transition

In our previous comment letter, we expressed our support for the 'full retrospective' application of standards and concerns about a 'simplified retrospective' approach. As such, we welcome that the Boards no longer allow a 'simplified retrospective' transition approach. That said, we also expressed concerns about allowing transition alternatives – as is the case with lessees in the Revised ED.

The Revised ED allows a choice between 'modified retrospective' (e.g. apply information available to the lessee at the date of transition and portfolio discount rate can be applied as opposed to the discount rate for each lease) and 'full retrospective' application of the standards for lessees, and a 'full retrospective' approach for lessors.

The presence of such transition alternatives reduces the quality of new accounting standards to investors as they reduce comparability – not only in the year of transition, but for many years to come – and they reflect a lack of understanding regarding the importance of comparability in financial reporting data between organizations when making investing decision.

Multiple accounting choices are not investor-friendly and should not be promulgated by the Boards.

Early Adoption

We do not support the choice to early adopt as it results in a period of incomparability between organizations – especially when the transition is dependent, as in the modified retrospective approach which is dependent upon conditions in existence at the date of initial application.

Given the transition provisions of this Revised ED – which are heavily dependent upon assumptions at initial application – we strongly object to any early adoption option as differences will exist between companies due simply to differences is market conditions at dates of application.

As it relates to first-time adopters of IFRS, our comment letter[13] on effective dates and transition addressed this issue.

Effective Date

We do not object to an effective date which allows companies to plan for adoption and improve the quality of retrospective application. However, we 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[14] on effective dates and transition we addressed our views on proposed effective dates.

[13] CFA Institute (2011), *Comment Letter on Effective Dates and Transitions*, http://www.cfainstitute.org/Comment%20Letters/20110221.pdf
[14] Ibid.

CONCLUDING COMMENTS

In conclusion, we encourage the Boards to promptly issue the proposal requiring capitalization of leases. The transparency and improvement to the integrity of financial statements that this standard will bring is long overdue as implied in our investor survey results. Historically, the Boards have made similar decisions to recognize obligations, transactions or instruments (e.g. pensions, stock options, derivatives) because their underlying economics – as in the case of leases, were not properly reflected in the financial statements. Further, we would highlight in each of these instances, measurement and disclosure aspects of these standards were subsequently revised. We encourage the Boards to concurrently require comprehensive disclosures to assuage the differences in perspectives regarding the underlying economics of certain leasing arrangements, to facilitate more accurate and comparable analytical adjustments and to address the measurement concerns that many investors including ourselves have with the proposal.

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Thank you again for the opportunity to comment on the Proposals. If you or your staff have questions or seek further elaboration of our views, please contact either Vincent Papa, PhD, CFA, by phone at +44.207.330.9521, 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/ Sandra J. Peters

Sandra J. Peters, CPA, CFA
Head, Financial Reporting Policy
Standards & Financial Markets Integrity Division
CFA Institute

/s/ Ashwinpaul C. Sondhi

Ashwinpaul C. Sondhi
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council

SURVEY BACKGROUND

The CFA Institute global member survey referred to in the body of this letter was conducted in May 2013 at around the same time the Revised ED was issued. The survey questions were focused on investor expectations related to capitalization, disclosures and economic implications of using operating leases. In the background to the survey, we also highlighted the salient aspects of the Revised ED including the dual income statement approach.

We did not, however, evaluate user views of the proposed dual income statement approach, except on the question of whether they would like similar information for both income statement approaches. We considered the capitalization on the balance sheet and required additional disclosures to be the principal changes, which warranted validation from users of financial statements. We considered that the adopted approach of specifying two leases for income statement recognition is simply a practical expedient to retain aspects of existing income statement treatment.

To avoid leading the respondents and thereafter generating biased responses, the survey background outlined the principal arguments for supporting and being against the proposals that have been expressed by different stakeholders. This background was articulated without stating CFA Institute's position within the questionnaire in any manner that could bias respondents.

The reasons cited for support towards the proposals were:

i. Better Representation of Economic Leverage and the Economics of Lease Transactions – Leasing arrangements are being considered as equivalent to the financed ownership of assets. Capitalization of leases thereby better reflects the underlying economics of the asset and related obligation.
ii. Enhanced Transparency of Leases – Capitalization is expected to provide greater transparency for investors regarding the contractual obligations emanating from leases than is provided by disclosures alone.
iii. Reduced Need for Analytical Adjustments and Reduced Likelihood of Errors Associated with Analytical Estimates of Lease Related Leverage – Capitalization of all leases is expected to eliminate the need for investors to have to make analytical adjustments to quantify the obligations associated with operating leases, as tends to be the common current analytical practice. Investors currently tend to make analytical adjustments and this can be based on varied guesstimates of obligations to pay rentals.

The reasons for opposition to progressing with the project as stated in the background were:

i. Expectations of Prohibitive Costs – Assertions regarding the prohibitive cost of implementing the new proposed new standard.
ii. Conceptual Questions – Questions have been raised regarding the conceptual basis of all leases being capitalized given that not all leases are effective ownership arrangements. That said, through the Revised Exposure Draft, the standard-setting bodies propose to distinguish between effective ownership leases versus non-ownership leases via differences in their income statement treatment.
iii. Adverse Economic Consequences to the Leasing Industry – Concerns have been voiced regarding the potential adverse economic consequences of the proposed standard. For example, potential increased capital requirements for the banking sector. Some anticipate adverse secondary effects including killing of the leasing industry, should lease financing cease to be seen as a viable option for companies.
iv. Economic Representation of Measurements – The initial and subsequent measurement of the asset (i.e. right-of-use asset) and liability of leases (i.e. obligations to pay rentals) may yield amounts that would not represent the real economic value of the respective asset and liability.

The survey had 288 respondents representing a response rate of 3% and implying that a margin of error of +/-5.8% would exist whilst making inferences about the characteristics of the full sample.

Valid Inferences Can Be Drawn From the Survey

After taking into account the margin of error for this particular survey and thereafter deducing the upper and lower bound response levels to different questions posed, the conclusions made regarding the relative support on key questions related to capitalization versus disclosure, would remain unchanged. In other words, this survey does validly inform on the relative support by investors for different potential lease accounting approaches.

Survey Successfully Elicits Broad Based Investor Input

The absolute numbers of responses obtained through this survey is comparatively higher than the number of responses typically elicited through many other investor related surveys (e.g. those conducted by standard setter, accountancy firms). Thus, this survey provides standard setter feedback based on eliciting broad based investor input. In general, broad based investor input for accounting updates tends to be difficult to obtain and the attainment of 288 responses achieves this and enhances the overall value of this survey.