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ED / 2010/9 – Leases

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### **Comments on IASB ED on Leases**

The American Accounting Association's Financial Accounting Standards Committee (FASC) is pleased to express its views in the accompanying document on Leases

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Sincerely,

### Karim Jamal

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This comment was developed by American Accounting Association's Financial Accounting Standards Committee and does not represent an official position of the American Accounting Association.

#### **Comments on IASB ED on Leases**

### American Accounting Association's Financial Accounting Standards Committee (FASC) December 15, 2010

### INTRODUCTION

The IASB and FASB jointly issued a call for comment on an exposure draft on Leases. The Financial Accounting Standards Committee (henceforth the Committee) of the American Accounting Association (AAA) is pleased to have an opportunity to express its views on lease accounting. This comment was developed by the Financial Accounting Standards Committee (FASC) of the American Accounting Association and does not represent an official position of the American Accounting Association.

The American Accounting Association promotes worldwide excellence in accounting education, research and practice. Founded in 1916 as the American Association of University Instructors in Accounting, its present name was adopted in 1936. The Association is a voluntary organization of persons interested in accounting education and research. Currently the Association has about 6,000 members in the United States and 2,000 international members. The Committee is charged with commenting on regulatory proposals on financial reporting with an aim to provide a research-based perspective on financial reporting. The AAA's membership has a diverse set of views about financial reporting and the Committee does not express views on behalf of all members. The committee has sought to focus on some key "principles" that can guide standard setting rather than just do a review of research literature. The committee hopes that this principles based approach will stimulate discussion among AAA members, regulators, and accounting practitioners regarding important financial reporting regulatory proposals.

#### **OVERVIEW**

Current accounting standards for leases, Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases*, issued in 1976, and International Accounting Standards (IAS) standard 17, *Leases*, issued by the IASC in 1982 use an "ownership approach" to determine the accounting treatment of a lease transaction. If a lease transfers substantially all benefits and risks incident to ownership of an asset, the lessee should recognize an asset and a liability on the Balance Sheet (finance lease). However, if the "substantially all" test is not met, the lessee records the transaction Off Balance Sheet (operating lease) with very clear and extensive disclosure. The major criticism of the existing lease standards is that lessees do not recognize all lease obligations on their balance sheets, based on what is now considered to be an arbitrary distinction between operating and capital leases. The current exposure draft (ED) seeks to have accounting reflect all rights and obligations arising from lease transactions as assets and liabilities. We view full reporting of all debts incurred by an organization as a desirable objective of accounting. We subscribe to the principle that a lease transaction creates a debt, and the debt should be shown on the Balance Sheet.

Taking the objective that accounting should report all debt incurred by an organization as given, it is important that the lease standard controls attempts by management to do transaction structuring. We adopt the following seven principles about current lease accounting as a guide in our response to the ED:

- 1) Knife-edged accounting, whereby small changes in a transaction lead to large differences in how the transaction is accounted for, is undesirable. Current lease accounting standards create such knife-edged accounting whereby small changes in a transaction can result in either 0% or 100% of the transaction reported on the Balance Sheet.
- 2) Bright line tests to determine accounting classifications as described above in point 1 (e.g., 75% and 90% thresholds in current lease standards) are undesirable.
- 3) Symmetry in the way a transaction is accounted for by the lessee and the lessor is desirable. Having the same transaction reported differently by the two parties to the same transaction creates lack of comparability and consistency.
- 4) We seek comprehensive scope with no exceptions. Scope exceptions create loopholes that can be used by management to defeat the intent of the standard (Jamal and Tan 2010).
- 5) All executory contracts should be considered to be part of the lease standard, otherwise management can get around the lease standard by structuring a lease transaction as a contract for services and not report any debt (See Ryan et al., 2001)
- 6) Management should not be allowed to use renewal terms, options and contingent payments to get around the intent of the standard (Jamal and Tan, 2010).

7) Management should be blocked from using special purpose entities to move leases off Balance Sheet. This means the lease standard will have to be consistent with the consolidation standard.

We now respond to specific comments posed by the ED on leases.

### Q1a: Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments?

The boards are proposing a "right-to-use" accounting model where both lessees and lessors recognize assets and liabilities arising from all lease contracts (all leases are reported on the Balance Sheet). These assets and liabilities are initially measured at the present value of the lease payments. They are subsequently measured using a cost-based method. Accordingly, a lessee would record an asset for its right to use the underlying asset, amortized over the lifetime of the lease and tested for impairment. Under IFRS, this right may be revalued in some circumstances. A lessee would further recognize a liability for lease payments, initially equal to the capitalized right-to-use asset. For contingent rentals, amounts are measured on an expected probability basis.

We support this "right -of-use" model because this model recognizes the overall principle that a lease is a financing transaction that creates debt, and gets rid of knife edge accounting since there is no critical threshold for having a transaction reported on or Off Balance Sheet. In addition, there is no need for any bright line tests in the new standard. Small changes in the lease have a small effect on the accounting, so accounting reports cannot be used to distort the economic substance of the underlying lease transaction. While no standard can get rid of all possible distortions, we believe this right to use model is a significant improvement over the current ownership model.

### Q1b: Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments?

Yes, we agree with this proposal. If a lessee recognizes an asset and a liability, then it makes sense to have an interest expense associated with the liability, and to have depreciation associated with the asset.

Q2ba: Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise?

No, we do not agree with this accounting treatment for lessors. This approach violates the symmetry between accounting for the same transaction by the lessee and the lessor. The ED proposes abandoning the performance obligation approach for the lessee, but continues to allow the lessor to use this method.

Concerning accounting for lessors, two methods are allowed according to an "ownership approach" based on retention of exposure to significant risks or benefits associated with the underlying asset (this is the standard we are moving away from for the lessee). The choice must be done once for all at the inception date of the lease. This classification and related choice of accounting method materially shapes the amounts, timing, and uncertainty of the cash flows arising from different kinds of lease. Furthermore, the impact is material for income recognition. According to the boards' basis for conclusion (ED2010/9 BC16-B22), the performance obligation approach would recognize revenue continuously during the lease term, whilst the derecognition approach allows the lessor to recognize at the date of commencement of the lease revenue that is not attributable to the financing component of the lease. In particular, (ibidem, BC27), the derecognition approach is likely to be appropriate when the entity's business model is primarily the provision of finance, because the profit of that business is derived from interest income and the principal risk associated with the business is credit risk. On the contrary, the performance obligation approach is likely to be appropriate when the entity's business model is primarily to generate (possibly variable or contingent) return from the active management of the underlying assets either from leasing these assets to multiple lessees during their life or from use or sale of the asset at the end of the lease. In that business model the principal risk is asset risk.

This qualification may actually introduce structuring opportunities to arrange operations to obtain a specific accounting outcome. In particular, application guidance (ED2010/9, §B22-B27) focalizes on asset-specific criteria to make the qualification decision, whilst financing components specific to the lease transaction - such as the credit risk of the lessee - are excluded. As far as the lease transaction deserves specific accounting requirements, it should be accounted for as a single operation including both operating and financing components bundled together under the same lease arrangement. Under the proposed accounting model, this composite economic substance is already taken into account from the lessee's side of the lease, but would be undermined from the lessor's side because of that qualification between different accounting methods. In particular, the amounts, timing and uncertainty of the cash flows related to the lease transaction should have the same accounting structure from both sides of the transaction.

A single method appears then to be preferable. Concerning the lessor, this method should recognize lease and interest incomes continuously during the lease term, avoiding recognition of

gains at the commencement of the lease. Furthermore, this method should reclassify leased asset under financial asset (or receivables) that – by definition – is no longer under the lessor's control. This latter recommendation relies on the symmetry wherein the lessee's acquisition of a property right necessarily results from the lessor's disposition of it (ARS4, p. 64). Information about the legal ownership of the lease asset should be disclosed in the notes. This symmetry is needed especially when lessor and lessee shall be consolidated in the same accounting entity for the purpose of consolidated financial statements, as it may be the case under asset securitization and structured lease finance.

The symmetry between lessor and lessee accounting is important for taxation, consolidation and other macroeconomic and regulatory purposes. Under the current proposal, the leased asset depreciation is deducted twice by the gross revenue: as part of the lease payments by the lessee, and as owned asset by the lessor. However, depreciation deduction should be either assigned -just once- to the party in the lease transaction who has an overwhelming share of the benefits and burdens of ownership control (usually, the lessee), or alternatively shared on this basis among the parties. The same problem holds with asset recognition in the balance sheet. Asset recognition should be assigned or shared in a similar way.

# Q3: The Board proposes that a lessor or lessee can apply a simplified requirement for short term leases. Do you agree that a lessee or a lessor should account for short-term leases in this way?

Yes we agree with this approach. This approach basically treats short leases the same as executory contracts for purchase of services. For such short term contracts, there is no need to report present values of cash flows.

The standard does however create a logical inconsistency. For short term contracts a lease is accounted for the same way as an executory contract (and we agree with this). However, for a longer term contract, the accounting treatment diverges between that of an executory contract and a lease (this we disagree with). We would prefer that executor contracts for services be brought into the scope of the lease standard and be accounted for like a lease (have the same income statement effect).

## Q4a,b c: Do you agree that a lease is defined appropriately? Is guidance sufficient to distinguish a lease from a sale, and from a service contract?

No, as indicated earlier, we are opposed to distinguishing between leases and executory contracts for services, and trying to partition lease components from service components.

The proposal sets out specific accounting requirements for lease features. In particular, a lease is defined as a "contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration." A lease is then distinguished from a contract that represents a purchase or sale, including sale and leaseback, or a service contract. These scope exclusions may involve structuring opportunities by structuring both lease-and-service, and sale-and-leaseback arrangements to undermine the enhanced recognition and disclosure requirements introduced by the proposed accounting model. If both contracts are bundled together in one structured operation, they should be considered as one unique operation and be accounted as such under lease accounting. However, the distinction between lease and service components (or contracts) affords the risk to allow intentional avoidance of the proposed treatment of options and contingent rentals that is expected to better represent the economic substance of the lease operation. Such structuring opportunity is especially sensitive for sale-and-leaseback contracts.

### Q5: Do you agree with the proposed scope of the proposed IFRS?

No, we are opposed to all scope limitations. The proposed scope exceptions (e.g., oil and gas, regenerative assets) involve large and material transactions and create loopholes that managers know how to use to get around the intent of the standard (see Jamal and Tan 2010). We recognize that these changes in the lease standard are being proposed before the new conceptual framework is finalized. However, these scope exceptions together with not including executory contracts for services under the lease standard open up a loophole that managers can use to circumvent the standard.

### Q7. Measurement. Initial measurement and eventual reassessment at present values

The initial measurement is at present values using a discount rate. This is like current practice. The proposal allows revaluation gains and losses to be recognized if all the assets in that class of property plant and equipment are revalued. This revaluation of the right-of-use asset at its fair value factually disconnects the lease asset from the corresponding liability, even though they are clearly linked at the inception of the lease (ED2010/9 §BC10(b)). This may undermine the overall debt exposure, even though leased assets are assumed to have features that distinguish them from other owned assets and that require then specific requirements for recognition, presentation, and disclosure. In fact, FASB would not permit lessees to revalue right-of-use assets unless to do so to recognize an impairment loss (ED2010/9 §BC76(b), p. 26).

There is considerable debate on the appropriate discount rate to use in lease accounting measurement if present values are adopted. Basically, three possibilities exist: a risk-free discount rate of reference, a company-specific borrowing rate that will reflect its credit-risk, and a lease-specific rate (implicit in the terms of the lease) that will reflect the risk involved in the contract. Concerning lessee (ED2010/9 B11), the proposed standard requires using the lessee's incremental borrowing rate (company-specific rate) or the rate the lessor charges the lessee if that rate can be reliably determined (contract-specific rate). Concerning lessors (ED2010/9 B12), the discount rate should be that the lessor charges the lessee (contract-specific) that may be equal to the lessee's incremental borrowing rate, the rate implicit in the lease, or the yield on the property (for property leases). This choice involves three main problems: it undermines comparability between companies, since the same lease contract will be valued differently; it will lead to a situation in which riskier lessees will report a lower liability for the same lease contract because they will discount at a higher rate; it will imply double-counting since expected payments are already estimated at their most probable values<sup>1</sup>. However, discounting at the riskfree level allows calculating the implicit return rate of a lease as the contract-specific return that facilitates its return-risk assessment and related profit-sharing (Biondi 2010). Recognition of discounted amounts at risk-free rates, or undiscounted amounts, appears therefore to be preferable to avoid these problematic results.

<sup>&</sup>lt;sup>1</sup> For the third problem, cf. ED2010/9 BC13, p. 46.

Q8: Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease?

Yes, we agree that management should not be allowed to use renewal options to move debt off balance sheet (Jamal and Tan 2010). One easy way for management to circumvent the intent of the standard is by adding in an option to extend the lease term. Including all lease extensions blocks this type of opportunistic behavior. Using convoluted tests like "term that is more likely than not to occur" however, creates a loophole which management can exploit. Management can argue that certain renewal options will not meet the "more likely than not" test. Experimental evidence suggest that auditors are likely to go along with these managerial judgments (Kadous et al., 2003) thus defeating the intent of the standard.

One objection to including all lease extensions is that may overstate the obligation assumed by the lessee. Our view is that if all lease extensions are counted, lease contracts are likely to contain options only for periods that are most likely to occur.

Q10. Reassessment. Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period?

No. We are not in favor of reassessments. Downward reassessments are covered under the rubric of testing for impairment. We are in favor of impairment testing since that is a conservative practice, and is consistent with the principle of recording assets at lower of cost or market. We are however, opposed to upward revaluation of assets.

Furthermore, reassessments of present values including reference discount rates, introduces structuring opportunities related to the unwinding of discounting over time (ED 2010/9, §19, p. 21). This is a difficult issue, though on balance we favor a conservative approach rather than repeated re-measurement which we view as an opportunity for managerial opportunism.

### Q11. Sale and leaseback

No. We disagree with the suggested criteria. If the contract involves a lease, then the transferor should not derecognize the transferred asset as a sale (then recognizing the profit or loss on the sale) and should recognize any amount received as a financial liability. To distinguish lease from purchase or sale, the application guidance (ED2010/9, §B9-B10) stresses the transfer of entitlement of the asset at the end of the contract term and the inclusion of a bargain purchase option. However, in both cases, the contract would cease to be a lease (to become a purchase by the lessee and a sale by the lessor) only at the end of the contract, or when such an option is exercised. This does not change the economic substance of the lease contract, which implies a financing component that should be accounted for. In particular, gains and losses that arise from a lease, including lease-and-service and sale-and-leaseback transactions, should be recognized continuously during the lease term. In sum, required distinctions between lease or service, and sale or lease contracts (or contract components) may reintroduce a classification requirement that would increase the complexity of the proposals and undermine their intended scope and purpose (comp. ED2010/9 §BC62, p. 22).

### Q 12. Statement of financial position

We agree that the lessee should recognise lease liabilities separately, but we disagree with mixing lease assets among other categories such as tangibles and investment properties. Even though the lessee has acquired the right to use those assets, it does neither own nor control them in full. Furthermore, these rights are not tangibles or properties in themselves, but merely related to them. Therefore, we recommend that leases be disaggregated and reported separately on financial statements including reporting "rights of use" as intangible assets, with details disclosed in the notes.

### Q18. Do you have any other comments on the proposals?

We feel that the proposed lease standard continues to be vulnerable to transaction structuring because the loophole of forming leases in a special purpose entity (SPE) continues to be

 $<sup>^{2}</sup>$  Comp. ED2010/9  $BC61, \, p. \, 22, \, and \, ED2010/9 \, BC164, \, p. \, 51.$ 

available to management. As long as the SPE makes the minimum initial equity investment required by the consolidation standard, the SPE can not to be consolidated by the lessee. This makes it possible to avoid the proposed lease accounting model if the lessor and the lessee agree to interpose an off-balance sheet SPE that acquires title by the lessor whilst dealing with the substantial lessee to avoid the application of either sublease accounting<sup>3</sup> or consolidation of the SPE. If the latter is the real debtor and asset substantial owner, the latter should apply the proposed model of accounting for lessee. In contrast, the standard and its application guidance pay scarce attention to synthetic leases and other structured transactions involving SPE that are of utmost importance for structuring opportunities (Weidner 2000).

### **Summary and Conclusion**

The committee members are in agreement about the importance of lease accounting for users of financial statements. Overall, we are happy to see that this exposure draft focuses on the "right-of-use" model, rather than the ownership model which has worked so poorly in practice. Unfortunately, current lease accounting is plagued by loopholes, transaction structuring and other actions by management to circumvent the intent of the standard. Preventing all transaction structuring is of course a difficult endeavor. The ED makes a good effort at dealing with the current problems of lease accounting, but some big holes (concerning especially scope, SPE and intra-group operations, definition of the lease term, and executory contracts for services) remain that need to be closed off. We prefer conservative accounting (hence use of impairment testing) but are opposed to reassessment s leading to gains since we see this as providing a loophole for managerial opportunism.

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<sup>&</sup>lt;sup>3</sup> According to ED2010/9, Appendix A, p. 40, a sublease is "a transaction in which an underlying asset is re-leased by the original lessee (or 'intermediate lessor') to a third party, and the lease agreement (or 'head lease') between the original lessor and lessee remains in effect." In our example, the third party is the lessee, whilst the SPE is the intermediate lessor.

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