

COMMENT LETTER ON THE EXPOSURE DRAFT ED/2010/9

LEASES

Submitted by: Jan Marton, Ph.D., University of Gothenburg, P.O. Box 610, SE 405 30 Gothenburg, Sweden. Phone: +46-31-773-4797. Email: jan.marton@handels.gu.se.

The responses to the Exposure Draft (ED) provided below relate to the items included in the Statement of Financial Position and in the Statement of Comprehensive Income. Therefore, responses relate to Questions 1, 2, 8, 9, and 10. Responses to other questions are not provided.

The Boards take a definition-based approach in the ED (as evident in BC5 and BC6), rather than an approach based on relevance of financial statements. An implied assumption is that consistency in the definition of financial statement items leads to relevant reporting. Consequently, an important issue is the extent to which the suggested definitions in the ED agree with comparable items in existing accounting standards. The following list, which also relates to the qualitative characteristic of Comparability, suggests consistency in definition may not be achieved through the ED.

- Lease liabilities (for lessees) and lease receivables (for lessors) are not consistent with financial assets and liabilities in IAS 39. The latter standard excludes liabilities and receivables that may be contracted in the future, even when the future contract is more likely than not to occur.
- Performance obligations (for lessors) do not correspond to any recognized liability in existing standards.
- A tangible asset is, in accordance with IAS 16, reported at a value that corresponds to future benefits (measured at historic cost), to be realized through use or disposal. In that sense, IAS 16 assets are reported at a value that corresponds to the reporting entities' right to realize future benefits from the asset, and are thus in agreement with the ED. What is not in agreement, however, is that the ED includes rights that may be obtained in contracts not yet signed. This is conceptually very different from assets reported under IAS 16.
- An additional note on the measurement of assets and liabilities is that the reassessment aspect of the ED entail lease liabilities and assets reported at values approaching fair values. Thus, the values will not be comparable to IAS 16 assets or IAS 39 liabilities. It will, however, be comparable to IAS 39 assets.

In summary, there are some issues with the definition-based approach, if the objective is to achieve consistency in the reporting of financial statement items. Returning to the issues of relevance, we will discuss it for three different users: stock market investors, lenders, and long-term principal owners. The focus is first on lessees. Note also that some issues of comparability related to relevance have already been covered above.

Stock market investors. The focus of this user group is earnings rather than the statement of financial position (SFP). However, key ratios fully or partially based on the SFP may be used, such as debt to equity, return on capital employed and return on assets. To the extent that assets and

liabilities are more comparable between entities leasing and owning assets, comparability of key ratios should increase. Retailers would be one example. In that industry, firms will probably be negative to recognizing their rental agreements in the SFP. That will, however, make retailers renting space more comparable to those entities that own the real estate used.

The ED will have two effects in the statement of comprehensive income (SCI). Rental expense will be reclassified into depreciation and interest expense, and there will be front-loading of income. The first effect will make firms renting more comparable with firms owning assets. EBITDA will, for example, be more comparable.

The front-loading of income is, however, unlikely to improve the relevance of the SCI. If relevance is defined as predictive and confirmatory value, the time series properties of earnings are important. In the case of lease agreements, accruals leading to higher expenses early in the contract period, and lower expenses at the end, are unlikely to improve relevance. Most likely, a straight-line approach (as currently used for operating leasing) will provide more relevant information to financial statement users. The accruals in the ED will be arbitrary, as they depend on the length of the contract rather than the level of consumption of resources (this is further exacerbated as the length of the lease period is subject to substantial judgment). Therefore, a straight-line approach would lead to more relevant information to stock market investors, by providing a more faithful representation of the consumption of resources.

Creditors. This user group will have a higher focus on the SFP, and will most likely benefit from the inclusion of lease liabilities in that financial statement. The user group will probably be unaffected by changes in the SCI.

Long-term principal owners. While stock market investors will evaluate financial reporting based on its usefulness in forecasts of future performance, principal owner are expected to have more of a stewardship perspective. From this latter perspective the inclusion of lease assets is beneficial, as it clarifies the resources over which management has accountability. As in the case of creditors, this user group is likely unaffected by changes in the SCI.

A few comments are made regarding accounting for lessors. The relevance of the performance obligation approach is difficult to see. It involves including benefits from the same asset twice in the SFP. First, the original asset remains in the SFP. Second, a lease receivable is included. The derecognition approach is conceptually sound, however.

Both the performance obligation and the derecognition approaches lead to higher interest revenue being recognized in early than in late periods of the lease agreement. Thus, it suffers from the same accruals effect as for lessees, which supposedly gives lower relevance for earnings forecasts.

The proposals in the ED will require substantial judgment in the preparation of financial statements. This involves estimating the lease term, contingent leases, etc. Lessors must also estimate if risks and rewards of ownership have been transferred to the lessee. This increases estimation uncertainty, and thus information risk.

Judgment by preparers provides information to users. The judgment itself is a signal from management. Research indicates, however, that the benefits of additional information are outweighed by the noise in the signal. It is precisely in situations when financial reporting matters

most that management incentives to bias judgments are strongest. Thus, in those cases judgment is unlikely to be neutral.

Below the preceding discussion is summarized in terms of answers to some of the questions in the ED.

Question 1: Lessees

We agree that a lessee should recognize lease assets and liabilities, and also recognize depreciation and interest as expenses. We think, however, that the recognition of interest on some type of straight-line basis would lead to more relevant information.

Question 2: Lessors

We do not agree that lessors should recognize performance obligations, and corresponding lease receivables. To avoid recognizing the same asset twice, a partial derecognition approach would be more appropriate.

Question 8: Lease term

Recognition of lease assets and liabilities based on lease terms not yet contracted is unlikely to give relevant information, and does not lead to overall consistency in the definitions of financial statement items.

Question 9: Lease payments

Estimating contingent lease payments could be problematic. We do not, however, see a clear alternative treatment here.

Question 10: Reassessment

The reassessment aspect lowers comparability with non-leased assets, as it makes measurement more similar to fair value. Reassessment is, however, a natural feature of estimates. Since we suggest the removal of judgment regarding lease terms, reassessment of those would no longer be relevant. It may still be required regarding lease payments, however.