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ED/2013/6 Leases

Dear Sirs

In relation to the above exposure draft I would like to comment as follows.

1. Complexity: If there is one word that could be used to describe this proposed standard it is complexity, and this applies along a number of dimensions. First, complexity arises from the concepts underpinning the proposed regulation. This includes the way it distinguishes service contracts from leases of assets, short term leases, Type A leases and finally Type B leases. Furthermore, this is exacerbated by the different accounting treatments prescribed (off balance sheet, on balance sheet, capitalization and whatever label might be applied to treatment for Type B leases). Undoubtedly firms will categorize transactions differently, apply different accounting treatments, and this will undermine comparability across firms and understandability. Second there is complexity in exposition. While experienced standard setters and those used to working with standard setters might possibly feel comfortable in reading and understanding the requirements of the exposure draft, it is extremely doubtful that many practitioners would. It is inevitable that this regulation would not be applied consistently, and this would again undermine comparability. Third, and perhaps most problematically, given the diversity of accounting treatments available it is doubtful that financial statements users would fully understand the information produced, nor the nuances that have shaped these numbers.

2. Scope / Identifying a Lease: The proposed regulation runs the very high risk of repeating history. After the existing regulation was first formulated there was a significant effort by lessees and the leasing industry to structure transactions to ensure that leases were classified as operating leases rather than finance lease. In this way the requirements of lease capitalization could be avoided (Imhoff and Thomas, Economic consequences of accounting standards: The lease disclosure rule change, Journal of Accounting and Economics, 1988, 277-310). As long as there are economic incentives to avoid leases capitalization it is inevitable that lessees and the leasing

industry will endeavor to structure transactions to avoid capitalization. Attention will likely focus on the definition of the lease and ensuring that contracts are classified as service agreements and not contingent on particular assets. I do not believe the current basis for distinction is sufficient strong. I am also pessimistic about whether it can be made sufficiently strong.

3. Categorization of Leases: It is difficult to support the categorization of leases into Types A and B. First, there seems little theoretical support for this distinction. Second, the accounting treatment for Type B is contrived to give a result consistent with the lease expenses method. In particular I am referring to the lack of any real support for the determination of the depreciation charge. Third, the categorization makes little practical difference as for short term leases the income statement effects of lease capitalization are minimal with the interest expense being small relative to lease payments. It just adds to complexity.

4. Contingent rentals: This is one area where the excessive complexity of previous versions of the proposed regulations has been addressed. It is supported on the basis of it being practical and the outputs understandable

Recommendation
It is inevitable that any regulation requiring lease capitalization will be 'gamed'. This will create a diversity of accounting practices and fundamentally undermine the understandability and comparability of financial statement information. Trying to constrain this has also contributed to the complexity of the proposed regulation. To address the diversity of practices users will again endeavor to restate financial statements for off balance sheet leases (Imhoff, Lipe and Wright, Operating leases: Impact of constructive capitalization, Accounting Horizons, 1991, 51-63). However, this requires estimation and it will be done with error.

Accordingly, I would recommend the following
1. A single accounting treatment for all lease type transactions based on current period cash flow (i.e., lease expense method).
2. Full note disclosure of the accounting outcomes of transactions accounted for with and without capitalization by asset category (i.e., a contingency table approach). This would enhance certainty with respect to how transactions are being accounted for, and allow users to accurately restate financial statements if required. It would also address the issue of assets that the firm has no legal title being reported in the balance sheet.

In summary, I have concerns about the complexity of this exposure draft, and I doubt that it will do anything to limit accounting choices for leases and ensure comparability and understandability in financial statements.

Yours faithfully

Peter Wells