

September 3, 2013

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

# FASB File Reference No. 2013-270 and IASB Reference ED/2013/6, Exposure Draft Leases

Dear Mr. Golden and Mr. Hoogervorst:

The Mortgage Bankers Association<sup>1</sup> ("MBA") appreciates the opportunity to comment on the joint Exposure Draft, *Leases* ("Proposed Update"). The stated objective of the project is to require preparers of financial statements to recognize in the statement of financial position assets and liabilities arising from leases. MBA is the national association that represents the broad spectrum of the real estate finance industry. MBA's commercial real estate members are concerned about the potential implications of the Proposed Update on lessors and lessees and on the commercial real estate market in general. Additionally, as MBA members are also lessees of office space and

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<sup>&</sup>lt;sup>1</sup> The Mortgage Bankers Association ("MBA") is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

equipment, we have additional concerns relative to the impact the proposed changes will have on our members.

# **Background**

Leasing is an important activity for most reporting entities. Leases give reporting entities access to equipment and buildings without many of the risks of asset ownership. In the United States, accounting for leases is governed by Statement of Financial Accounting Standards No. 13, *Accounting for Leases* (FAS 13) (ASC Topic 840). FAS 13 has been around since 1976 and, for lessees, distinguishes between operating lease and capital leases based upon four criteria:<sup>2</sup>

- a. The lease transfers ownership of the property to the lessee by the end of the lease term:
- b. The lease contains a bargain purchase option;
- c. The lease term is equal to 75 percent or more of the estimated economic life of the leased property; or
- d. The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased property at the inception of the lease.

An entity accounts for a lease as a capital lease if it meets any of the above attributes. Under FAS 13, the lessee shall record a capital lease as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of the minimum lease payments during the lease term. Operating leases are not put on the balance sheet, but minimum payment commitments under operating leases are disclosed, by year, in the notes to the financial statements.

Some users of financial statements believe the FAS 13 model is not faithful to the true essence of leasing transactions, and users frequently make pro forma adjustments to financial statements to put lease assets and liabilities derived from operating leases on the balance sheet.

In 2010, the FASB and the IASB issued a joint exposure draft ("2010 ED"). For leases within the scope of the 2010 ED, this meant that:

- (a) a lessee would recognize an asset representing its right to use the leased ("underlying") asset for the lease term (the "right-of-use" asset) and a liability to make lease payments.
- (b) a lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either:

<sup>&</sup>lt;sup>2</sup> FASB, Statement of Financial Accounting Standards No. 13, *Accounting for Leases,* November 1976, paragraph 7.

- (i) recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or
- (ii) derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach).

Assets and liabilities recognized by lessees and lessors would be measured on a basis that:

- (a) assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- (b) uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- (c) is updated when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

Respondents to the 2010 ED were critical of the complexity and operational aspects of the proposal, the front-loading of expenses, the inclusion of optional lease periods, the inclusion of contingent rent and moving away from a well-understood, long-standing accounting principle towards a regime that would place a significant burden on the financial and human resources of most companies.

On May 16, 2013, the FASB and the IASB issued the Proposed Update which made significant changes from the 2010 ED. Under the Proposed Update, the core principle is that an entity should recognize assets and liabilities arising from a lease. However, to improve the operational aspects, the Proposed Update allows lessees to exclude leases with a maximum possible term of 12 months. A new guiding principle inherent in the Proposed Update is that the accounting is driven by the amount of consumption of the economic benefits embedded in a leased asset. For most leases, other than property leases, a lessee would classify the lease as a Type A lease because the lessee consumes more than an insignificant portion of the economic benefits of the leased asset. For such leases, the lessee would account for the lease in much the same manner as originally proposed in the 2010 ED:

- 1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments.
- 2. Recognize the unwinding of the discount on the lease liability as interest separately from the amortization of the right-of-use asset. This would result in an acceleration of lease expense recognition for the lessee.

For most leases of real property (land and/or buildings), the lessee would classify the lease as a Type B lease and would:

- 1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments.
- 2. Recognize a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, on a straight-line basis.

Lessor accounting would be consistent with the principles underpinning lessee accounting. For Type A leases, the lessor would derecognize the underlying asset and recognize a right to receive lease payments and a residual asset. The lessor would recognize the unwinding of the discount on both the lease receivable and the residual asset as interest income over the life of the lease and recognize any profit at the commencement date.

For Type B leases, the lessor would continue to account for leases in generally the same manner as under current operating leases, which requires the lessor to continue to recognize and depreciate the underlying asset and recognize lease income over the lease term on a straight-line basis.

Leveraged lease accounting would be eliminated.

The following are MBA's general comments on the Proposed Update. Appendix A contains MBA's response to specific FASB and IASB questions.

#### **MBA's General Comments**

#### 2013 Proposed Update Is Vastly Improved

MBA continues to believe the existing FAS 13 (Topic ASC 840), in effect for 37 years, continues to work well and needs little, if any, update. With that said, however, MBA recognizes the vast improvements FASB and IASB have made from the 2010 ED, and we thank you for listening to respondents to the 2010 ED on many important issues. We especially appreciate the recognition in the Proposed Update of the significant difference between property leases and equipment leases. MBA agrees with the principle that accounting for a lease should be driven by the amount of consumption of the economic benefits embedded in a leased asset during the leased period. MBA also believes the continued carve-out for leases of 12 months or less in duration will make the accounting more operationally efficient. MBA further agrees that eliminating contingent rent based on sales volume and other metrics will reduce the operational complexity of the proposed accounting. Lastly, MBA believes the new principles related to the treatment of option periods represent a significant improvement over the 2010 ED.

# **Exorbitant Costs to Implement the Proposed Update**

One of FASB's guiding principles states:

To issue standards only when the expected benefits exceed the perceived costs. While reliable quantitative cost-benefit calculations are seldom possible, the FASB strives to determine that a proposed standard will fill a significant need and that the perceived costs it imposes, compared with the possible alternatives, are justified in relation to the overall expected benefits.<sup>3</sup>

MBA members believe the costs to implement the Proposed Update will be exorbitant. Lessees do not have the infrastructure and systems necessary to initially and on an ongoing basis account for these off-balance sheet assets and liabilities on-balance sheet. Excel spreadsheets, which are used by many preparers to account for operating leases, will no longer be sufficient. MBA believes the benefit, if any, of the Proposed Update to users of financial statements will be small relative to the costs preparers will incur to implement the Proposed Update. MBA remains unconvinced that FASB and IASB can demonstrate the quantitative benefits of the Proposed Update. After all, the future minimum rental commitment information in the notes to the financial statements has provided sufficient information for 37 years for users to create a pro forma balance sheet that includes right-of-use assets and related liabilities. Further, many users do not believe the Proposed Update will improve existing accounting. For example, Mark LaMonte, managing director of Moody's Investors Service, at a May 2, 2013 financial reporting conference, argued that it is possible under current accounting rules, with all the disclosures required for off-balance-sheet operating leases, for analysts and investors to get a full understanding of a company's lease obligations. His personal view is, "I would not mind seeing the proposals go away."4

Prior to moving forward with a final standard, MBA recommends the FASB and the IASB conduct a robust cost/benefit analysis for the Proposed Update, in accordance with the guiding principle cited above.

#### **Transition Rules Will Be Difficult**

The Proposed Update calls for either a "full" or a "modified retrospective approach" for transition to the new standards. As stated above, preparers will have to design and implement new software and infrastructure and then analyze thousands of leases, set them up on the new accounting software, and aggregate leased asset level information for transition accounting and disclosures.

Likewise, many reporting entities lease personal computers, printers, copiers, phone equipment, modular office furniture and other furniture and equipment using master leases that cover hundreds or thousands of individual items. Pages 29 and 30 of the

<sup>3</sup> FASB, Guiding Prinnciples, Rules of Procedure, amended and restated April 15, 2013, page 4.

<sup>&</sup>lt;sup>4</sup> Andy Thompson, Rating Agency Head Attacks Lease Accounting Proposals, Asset Finance International, May 8, 2013.

Proposed Update (ASC 842-10-15-17) would require each individual item to be set up as a separate right-of-use asset:

After determining that a contract contains a lease in accordance with paragraphs 842-10-15-2 through 15-16, an entity shall identify each separate lease component within the contract. An entity shall consider the right to use an asset to be a separate lease component if both of the following criteria are met:

- a. The lessee can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events).
- b. The underlying asset is neither dependent on nor highly interrelated with the other underlying assets in the contract.

Disaggregating the costs and other information on individual assets covered by a master lease agreement and setting them up on a new right-of-use accounting system will be a major time- and cost-consuming project.

Further, MBA also notes that loan covenants and regulatory capital ratios are based upon existing GAAP or IFRS. It will take preparers significant time and effort to change loan covenants and for regulators to amend capital rules, and it is not a stretch to say some lenders may find this an opportune time to exact further guarantees/covenants from the borrower.

MBA recommends a minimum transition period of at least three to four years for changes contemplated in the Proposed Update.

## Lease Liability Disclosures Should Be Scaled Back

Page 62 of the Proposed Update (ASC 842-20-50-4) states:

A lessee shall disclose a reconciliation of opening and closing balances of the lease liability separately for Type A leases and Type B leases. Those reconciliations should include the periodic unwinding of the discount on the lease liability and other items that are useful in understanding the change in the carrying amount of the lease liability, for example, the following:

- a. Liabilities created due to leases commencing or being extended
- b. Liabilities extinguished due to leases being terminated
- c. Remeasurements relating to a change in an index or a rate used to determine lease payments
- d. Cash paid
- e. Foreign currency transaction gains and losses
- f. Effects of business combinations.

MBA notes this proposed disclosure will require asset-level lease liability accounting and the ability to roll-up by Type A and Type B activities affecting the liability during the reporting period. This is much more onerous than the reporting required for other liabilities. MBA recommends the disclosure for lease liabilities be limited to disclosures required for long-term debt.

# **Operational Challenges of Periodic Reassessment**

Page 8 of the Proposed Update states:

A lessee would reassess the measurement of the lease liability, and a lessor would reassess the measurement of the lease receivable, if either of the following occurs:

- 1. There is a change in relevant factors that would result in a change in the lease term (as described in paragraph 842-10-55-5).
- 2. There is a change in an index or a rate used to determine lease payments.

MBA notes that the Proposed Update does not state the frequency of such periodic reassessments; however, for public companies presumably the updates would be required quarterly. MBA notes that most leases for commercial properties contain a Consumer Price Index or other escalation clause to allow protection to lessors against inflation on multi-year leases. For lessees that lease hundreds or thousands of stores or offices, this reassessment requirement and accounting related thereto will be extremely time consuming and costly. MBA believes this requirement may be so burdensome that it could drive future lessee behavior and increase potential costs to lessees. MBA also points out that whatever you do on the liability side should have a corresponding adjustment on the asset side. MBA further points out that there is no requirement in GAAP or IFRS to assess and write up fixed assets to fair market value based on future CPI or other changes in value.

MBA recommends that the FASB and the IASB adjust the requirements of this section so that a reassessment is not required. This would result in rent increases from inflation being treated as a period expense as is the case with a net lease. If FASB and IASB leave the reassessment provision in the final rule, MBA requests that reassessment be required for only material changes.

## **Potentially Significant Changes to Market Landscape**

Page 36 (ASC 842-10-25-7) indicates several attributes to consider in determining if a lease is a Type A vs. Type B lease:

- a. The lease term is for the major part of the remaining economic life of the underlying asset.
- b. The present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

These tests appear to be similar to the existing 90 percent of present value of future lease payments or 75 percent of the economic life tests in GAAP. However, MBA notes there is no specific percentage definition of "insignificant." MBA recommends that the final rule contain more implementation guidance and illustrations.

In the absence of additional guidance, MBA believes that lessees may be inclined to shorten lease lives for future leases of real property. This will add more risk and uncertainty to lessors, resulting in price increases to businesses and ultimately to consumers. MBA further notes that long lease durations served to stabilize the commercial real estate market during the recent economic downturn.

## **Guidance on Options to Extend Lease**

Page 8 of the Proposed Update states:

This revised Exposure Draft would require that a lessee and a lessor measure assets and liabilities arising from a lease on a basis that:

- 1. Reflects a lease term determined as the noncancellable period, together with both of the following:
  - a. Periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option
  - b. Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option.
- 2. Includes fixed lease payments and variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate) but excludes other variable lease payments unless those payments are in-substance fixed payments. The lessee and lessor would measure variable lease payments that depend on an index or a rate using the index or rate at the commencement date.

MBA notes that it will be difficult at the outset of the lease for preparers of financial statements to project the extent that various factors may be important 5 to 10 years out relative to the decision to exercise a renewal option. Further, the significant burden this requirement places on lessees to continually assess whether a significant economic incentive exists, or ceases to exist, to exercise an option is not realistic from a cost/benefit perspective. MBA points out that this is neither a productive nor a beneficial use of time and money well spent under the disguise of benefiting shareholders, the ultimate users of financial statements.

## **Enigma in Measurement of Lease Assets and Liabilities**

Page 64 has a hierarchy of rates the lessee uses to discount the cash flows in a lease for purposes of valuing the right-to-use asset and related liability. First, the reporting entity must attempt to determine the "rate the lessor charges the lessee." If that cannot be determined, then the reporting entity must use the "lessee's incremental borrowing rate."

Assuming the reporting entity ends up using its own incremental borrowing rate, a reporting entity that is more creditworthy would end up with a lower borrowing rate and higher amount capitalized than a borrower who is less creditworthy. This could especially happen for leases where the lessor is well-protected by the underlying collateral, as in the case of property leases. There is likely little difference in the amount charged per square foot to a high creditworthy lessee vs. a medium creditworthy lessee because the underlying asset loses its value slowly. In the case of property leases with a straight-line expense recognition, the more creditworthy company will be penalized by having to report a larger right-of-use asset, while at the same time reporting essentially the same annual lease expense as the less creditworthy company.

# Specifically Scope Out Financial Assets and Leases Carried at Fair Value

Page 5 of the Proposed Update defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration." We find that intangible assets are scoped out of the Proposed Update on pages 232 and 233. However, we don't see where financial assets are scoped out.

Further, there are a number of reporting entities that must carry leases at fair value under various accounting rules. As a result, lease (rental) income is recorded on an accrual or as-earned basis.

MBA recommends that FASB and IASB specifically scope out of the final standard financial assets and leases carried at fair value under other accounting topics.

MBA appreciates the opportunity to share its observations with you. Any questions about the information provided herein should be directed to me, Vice President Financial Accounting and Public Policy and Staff Representative to MBA's Financial Management Committee, at (202) 557-2860 or jgross@mortgagebankers.org.

Sincerely,

James P. Gross

Vice President of Financial Accounting and Public Policy

# Appendix A – Responses to Select FASB and IASB Questions

**Question 1:** Do you agree with the definition of a lease and the proposed requirements in paragraphs 842-10-15-2 through 15-16 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

**MBA's Response:** See MBA's general comment above titled *Specifically Scope Out Financial Assets and Leases Carried at Fair Value.* 

**Question 2:** Do you agree that the recognition, measurement, and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

**MBA's Response:** See MBA's general comment above titled *2013 Proposed Update Is Vastly Improved.* MBA believes that leases of real property consume the economic life and value slowly relative to leases of furniture and equipment.

**Question 3:** Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

**MBA's Response:** MBA agrees.

**Question 4:** Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 842-10-25-5 through 25-8, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

**MBA's Response:** MBA agrees with the proposed accounting based upon the lessee's expected consumption of the economic benefits embedded in the underlying asset.

**Question 5:** Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

**MBA's Response:** See general comments above titled 2013 Proposed Update Is Vastly Improved and Guidance on Options to Extend Lease.

**Question 6:** Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

**MBA's Response:** See general comment above titled *Operational Challenges of Periodic Reassessment.* 

**Question 7:** Subparagraphs 842-10-65-1(b) through (h) and (k) through (y) state that a lessee and a lessor would recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the Boards should consider? If yes, what are they and why?

MBA's Response: See general comment above titled *Transition Rules Will Be Difficult*.

**Question 8:** Paragraphs 842-10-50-1, 842-20-50-1 through 50-10, and 842-30-50-1 through 50-13 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments, reconciliations of amounts recognized in the statement of financial position, and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

**MBA's Response:** See general comment above titled *Lease Liability Disclosures Should Be Scaled Back.* 

**Question 9:** To strive for a reasonable balance between the costs and benefits of information, the FASB decided to provide the following specified reliefs for nonpublic entities:

- To permit a nonpublic entity to make an accounting policy election to use a risk-free discount rate to measure the lease liability. If an entity elects to use a risk-free discount rate, that fact should be disclosed.
- 2. To exempt a nonpublic entity from the requirement to provide a reconciliation of the opening and closing balance of the lease liability.

Will these specified reliefs for nonpublic entities help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements? If not, what changes do you propose and why?

**MBA's Response:** MBA generally supports granting relief to non-public entities, but believes that the relief suggested above would not change the significant operational and cost burdens that the Proposed Updates pose to reporting entities – public and non-public or large or small. See general comments above titled *Exorbitant Costs to Implement the Proposed Update, Transition Rules Will Be Difficult, Lease Liability Disclosures Should Be Scaled Back, and Operational Challenges of Periodic Reassessment.* 

**Question 10:** Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases (for example, to require the lease to be accounted for based on the economic substance of the lease rather than the legally enforceable terms and conditions)? If not, what different recognition and measurement requirements do you propose and why?

**MBA's Response:** MBA believes that related party leases should be accounted for based on the legally enforceable terms and conditions. To the extent that the economic substance of the lease differs materially from the terms available from third-party providers, the reporting entity should make appropriate disclosures in its related party transactions note to the financial statements.

**Question 11:** Do you agree that it is not necessary to provide additional disclosures (beyond those required by Topic 850) for related party leases? If not, what additional disclosure requirements would you propose and why?

**MBA's Response:** See MBA's response to question 10 above.

**Question 12:** The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40, Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

**MBA's Response:** The vast majority of our members report on the basis of GAAP not IFRS.