From Peter Malmqvist
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The Association of Swedish Financial Analysts

International Accounting Standards Board 30 Cannon Street London EC4M 6 XH United Kingdom

Dear Sirs,

Re: IASB Exposure Draft ED/2013/3 Leases

I am responding to your invitation to comment on the Exposure Draft on Leases.

Summary

- I believe leases and long-term rents create assets and liabilities and should be reported on a lessee's balance sheet.
- I believe the income statement effects should include amortization on the asset, as well as interest costs on the liability. This should be reported for all leases and long-term rents.
- The liability should be recognized as financial/interest bearing.
- I do not support the dual approach for recognizing leases and renting contracts.
- I believe the disclosure requirements should be the same as for property, plant and equipment in general, unless the leases and renting agreements give rise to substantial valuation uncertainties, which requires more explanations to be understood.

Detailed comments

Examples of leasing and long-term rents

Why is this standard an important improvement? Let us look at three Nordic companies with substantial leasing agreements – the hotel operator Rezidor, the airliner Norwegian and the clothing company Kapp Ahl.

- In Rezidor the total nominal amount of future lease payments are EUR 2660mn with the bulk expiring after 2020. That compares to equity of EUR 150mn.
- In Norwegian the total nominal amount of future lease payments 2012 are NOK 15,3bn, with half of the amount expiring after five years. That compares to equity of NOK 2,4bn.
- In Kapp-Ahl the total nominal amount of future lease payments 2012 are SEK 2506mn with the bulk expiring between 2-5 years. That compares to equity of SEK 866mn.

In certain companies, as the one above, leasing and long-term renting has a substantial effect on the analysis of risk. In most companies it has not. That is why the total number of comment letters sent to the IASB will be misleading, as they will be sent by companies and organizations that has little effect from leasing. The letters will state that the costs for capitalize leasing in general cannot match the benefits.

Most of the companies with substantial effects are centered in certain sectors, namely transportation (trucks, busses, airplane, shipping), retail (rented property) and services (rented property). In those sectors the contracts are fairly standardized. Thirty years ago this was not the case. To a greater extent, companies owned the equipment and build their real estate. Since then, changes in business models, particularly when it comes to owing your property have increased. It is most likely this area will continue to grow and might in the future include other resources to the company. Therefore, to change the accounting for leasing and long-term rents is an important break through in an area of growing importance.

Discussions among Swedish analysts

The Association of Swedish Financial Analysts (SFF) has carried out discussions with its members in 2013 related to the exposure draft. The discussions included analysts at three major banks, as well as in the SFF Valuation Committee. Approximately 50 analysts attended the four meetings. The following conclusions can be drawn:

- 1. All analysts agreed that capitalizing leased of equipment was preferable to the present separation in an operating and a financial lease.
- 2. Regarding long-term renting contracts on property, a group of equity analysts had problems accepting the suggested method. The core objection was why not all long-term contracts relating to company resources? However, the credit analyst had no problems accepting future rents as a liability.

- 3. On leased equipment, all analysts agreed that the depreciation of the asset should be presented separately in operating earnings and the interest cost should be presented as a financial item. Consequently the analysts regarded the lease liability as interest bearing.
- 4. Relating to renting contracts, the views differed. A group of equity analysts did not regard the liability as financial/interest bearing. The reason was that this would increase the EV/EBIT-multiple by increasing the enterprise value (EV = enterprise value = interest bearing debt + market value of equity; EBIT = earnings before interest and taxes). The increase in the multiple would make the company look more "expensive". However, the credit analysts preferred to recognize the liability as interest bearing and to have the rent separated in an interest expense and depreciation.

The view of this comment letter

Although some of the equity analysts hesitated to have the real estate rent capitalized, the view in this comment letter is that all leases and renting contracts must be capitalized. It is the fixed stream of cash outflows that constitutes the risk in the company. Therefore the capitalized expenses must be included in the balance sheet. Whether the cash outflows are labeled interest costs, amortization payments, leasing or rents does not affect the risk, but since we use the balance sheet to measure risk, the different treatments of owing or renting resources will have a marked distorting effect. Looked upon it this way, it is quite obvious that the fixed cash outflows for equipment or premises must be treated equal to owing the resources.

The concern from the analysts – why not other contracts? – has little relevance. Other assets based on non-cancellable contracts, which give rise to fixed cash outflows, are rare. They may also be covered by other standards. For example, companies that are obliged to buy a certain quantity of goods at a certain point in time will most likely have to recognize the contract as inventory when it is signed.

The other concern - whether capitalized real estate renting should be recognized as financial or operating, must also be addressed. It is quite natural to view the capitalized item as interest bearing because the future cash flows are discounted. From this perspective the most natural way to handle the costs are separated in depreciations and interest costs. From an estimation perspective, the capitalized rents have very little in common with operational liabilities, like liabilities to suppliers. Operating liabilities are normally closely correlated to the turnover/business activity in the company. They are non-interest bearing in nature, since the "interest cost" is included in the price of the products/services. Renting contracts, on the other hand, can vary in size and length and the liability might vary substantially between the years. Therefore, from an estimation perspective it is difficult to connect the liability to the short-term business activity. From this perspective, a capitalized renting contract has much more characteristics of an investment, than an operational item.

The concern relating to the increase in the EV/EBIT-multiple is not valid. Since long-term renting is discounted and has the profile of an investment it should be included in the EV. This will increase the comparability of the key-ratio between companies. Consequently, the presentation of future cash out-flows for long-term renting must be the same as for leased

equipment. It is confusing to have two techniques covering the same sort of risk. Since the future cash outflows are discounted, the most natural label in the balance sheet is interest bearing/financial.

Disclosures

It is natural for analysts to demand disclosures relating to problematic areas in the accounts. However, relating to lease capitalization, it is not necessary to have extensive disclosures, because the area is not more problematic than other investments. Extensive disclosures are costly for the company and it burdens the financial reports, making it difficult to spot the most critical areas. If leasing and renting contracts are fairly standardized and capitalized, the disclosure requirements should be the same as for any other property, plant and equipment. However, if the contracts include substantial valuation uncertainties, like variable lease payments or substantial service payments, this must be disclosed.

I also suggest that companies with "insignificant" leasing or renting commitments should be relieved from capitalization. As this comment letter is trying to focus on, it is not the copy machine or the car leasing that are important, but the big items in certain sectors, as well as rented property. According to my study of big cap companies in Sweden, "insignificant" in this respect is up to a total nominal lease payment of approximately 2 percent of equity.

Finally – why not just go for more disclosures and leave the accounting as it is? This approach includes two problems. The first is that quarterly reports have greater significance for share prices, than the annual report. When the annual report arrives, the focus is already on the first quarter report and the problem with leasing may never be able to make the headlines of the analysis, until it is to late. Besides, substantial changes in leasing and renting contracts during the year will not be known to investors until 3-5 months after the reporting year has ended.

The other problem relates to the sources analysts use for the analysis. For a core group of companies, equity analysts dig in to details in the annual report. Those are the companies in which they issue buy and sell recommendations. However, a large part of the analysis relates to competitors to the "core" company. Those companies are analyzed on a more general level, mainly by the use of databases. For this reason "the face" of the balance sheet and income statement has become more important. The use of databases is very cost efficient and has increased to a great extent thanks to the use of IFRS, which has increased the reliability in financial reports. Replacing this standard with more disclosure requirements, will not improve the usefulness for investors.

Stockholm, September 13, 2013

Yours sincerely Peter Malmqvist

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