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Comment Letter No. 345

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Mr. Russell Golden, Chairman
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

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

RE: Exposure Draft ED/2013/6 *Leases*

Dear Messrs. Golden and Hoogersvorst:

The Institute of International Finance (IIF), via its Senior Accounting Group (SAG), welcomes the opportunity to comment on the IASB - FASB joint Exposure Draft ED/2013/6*,* *Leases* (May 2013). The IIF SAG supports the Boards' goal to improve the quality and comparability of financial reporting by providing greater transparency about leverage, the assets an entity uses in its operations, and the risks to which it is exposed from entering into lease transactions. In addition, the IIF SAG recognizes and appreciates that the Boards have addressed many of the comments on the 2010 ED including simplifications on such matters as proposing different treatments for short-term leases, term lease extension options, and components of a contract. However, the IIF SAG does not support the current proposals as they would create additional complexity in recognition, presentation and disclosure. As a result, the group believes that the proposals would not better meet users' needs than existing accounting for leases. Therefore, the cost of implementation would be significant without corresponding benefits for investors.

In this response, the IIF SAG decided to address three main points of particular interest to members instead of responding to the detailed questions posed in the ED as a whole:

- the continued importance of convergence in any finalized requirements;

- the lack of clarity about the nature of the Right-of-Use (RoU) asset, and possible consequences for regulatory capital treatment; and

- the costs relative to the benefits of the proposal.

Convergence

As reiterated on December 14, 2012[1], the IIF has for many years advocated international accounting convergence. The Institute advocates a global level playing field, international regulatory consistency, and mutual recognition to avoid competitive distortions and regulatory arbitrage.

The IIF SAG therefore welcomes that the proposals are on a joint basis. In the IIF SAG's view it is very important that convergence be maintained for any finalized requirements, to ensure comparability across jurisdictions in financial reporting and to encourage international regulatory consistency. Any divergence in the final requirements could undermine any benefits for investors, as well as creating differences in regulatory treatments in different jurisdictions, unless adjustments are made. Since lease accounting is currently substantially converged, it would not be an improvement in accounting for differences to emerge as a result of the finalization of the project. Furthermore, the historical response to divergence in recognition and measurement requirements by the FASB and IASB has been increased disclosure. This increases implementation costs, as well as costs for investors as they seek to understand the implications of differences between U.S. GAAP and IFRS, and the IIF SAG would not support such an approach to 'convergence'.

Likely implications of proposed approach for regulatory capital

The possible impact on regulatory capital is of obvious importance to both regulators and the financial services industry in the post-crisis environment. The IIF has for a considerable time now been concerned about the important interaction of international prudential regulatory standards articulated by the Basel Committee and accounting standards with respect to leases.

While the regulatory response to their standards is of course outside the Boards' remit, it would be unsatisfactory if the proposed standards were to create uncertainty, rather than clarifying the economic and accounting analysis on which regulators (and the industry) build prudential standards and internal risk management. In particular, the accounting description and characterization of the lessee's RoU assets and the lessors' residual value assets in the proposals is unclear.

Treatment of leases as intangible assets would greatly affect the calculation of risk-weighted assets, with regulatory deduction from capital; such an effect would be unwarranted as a result of an accounting, but not an economic, change. Treatment as a tangible asset would be less distortive, as the resulting assets would be given a risk weight, generally 100% or less. It would be helpful if the Boards would add further explanation in any finalized requirements of the nature of the assets and liabilities created by lease contracts, in particular emphasizing the similarity of RoU assets to items of 'property, plant and equipment' – which would be consistent to existing other references in the ED. Moreover, a solution that would allow RoU assets and lease liabilities to be considered on a net basis would maintain the current depiction of the economic substance and risk profile of operating leases for regulatory purposes, and therefore would be preferable.

[1] IIF Senior Accounting Group - Position on the Goal of International Consistency of Accounting Standards - December 14, 2012

This issue is important not just for the basic Basel III capital determination, but also for purposes of the leverage ratio. Recognition on the balance sheet would lead to an increase of the denominator in the leverage ratio calculation that would be inappropriate on anything other than a net basis. A substantial distortion of the leverage ratio could push the leverage ratio from a backstop measure to a binding capital constraint for affected firms. While this is a point that needs to be addressed to the Basel Committee, it is appropriate for the Boards to consider regulatory implications in their cost/benefit and impact analyses.

Cost and benefits of the proposal

The new project is intended to address issues arising from the distinction between operating and financing leases (including reducing structuring opportunities) and to address criticism of the associated disclosures.

The IIF SAG is convinced that the proposal's benefits would be much outweighed by the implied costs for both users and preparers. This perception is shared by both those members who believe that it is appropriate that all lease liabilities and associated assets be recognized on-balance sheet and those members who do not.

The IIF SAG believes that users would still want to make their own adjustments with respect to leasing transactions but would find that these adjustments are more difficult as a result of the increased complexity of the lease accounting in terms of the recognition and measurement of lease liabilities and RoU assets and in terms of presentation and disclosure. [2]

As a result of the compromises that have been made to the conceptual basis of the original model, additional complexity and potential bright line tests have been created. Rather than assessing whether there is a finance lease or an operating lease, judgment would need to be made about whether there is a lease and whether the lease is type A or type B, including judgments about whether the lease term is for a major or insignificant part of the economic life of the asset. These judgments would result in differences in presentation, which would be difficult to explain and understand for both preparers and users. For example:

1. For lessees of type B leases, the balance sheet would show financial liabilities but the income statement and cash flow would not show interest; additional disclosure may be needed to explain the interest cost of such a liability. The depreciation on RoU assets would be on a different basis to the depreciation for every other type of non-financial asset.

2. For type A leases, the lessor would have a lease receivable, which is a financial instrument, and a residual value asset. However, the income statement would show a single amount of income from leasing activity. The nature of the residual value asset would be unclear since it

[2] FASB Investors Technical Advisory Committee – Minutes of Meeting on July 24, 2012
"*Mr. Buesser began by remarking that ITAC members have diverse views on the leases project, but that ITAC uniformly agrees that the Board's decisions in this project would not be an improvement to current accounting. Some ITAC members believe that the new balance sheet information required would be helpful, but other members disagreed because of the focus on the legal lease term instead of the economic substance of the lease. On the dual model income statement approach, ITAC members were unanimously opposed. Mr. Buesser also remarked that members did not like the difference in accounting between equipment and real estate, especially for those companies that have both. He commented that a dual income statement model is not appropriate.*"

would be a discounted historic cost amount and it would accrete to the expected fair value of the asset at the end of the lease. This would complicate the recognition of impairment on both the lease receivable and the residual value asset. Again, further explanatory disclosure may be needed.

3. The notion of consumption is inconsistent between type A and type B leases and is based on concepts such as significance, which are unclear and which would have to be explained.

Equally important, the dual model approach results in inconsistencies in presentation which would make it difficult for users to develop an understanding of overall lease activities, especially for large firms. Therefore, it is doubtful whether the benefits for users would be as high as expected by the Boards. Improved disclosure under the old basis of accounting may in fact better meet their needs.

The changes would result in considerable time and effort being spent by preparers to review their entire portfolios of leases and other contracts which may contain leases, to transition to the new requirements and to continue to monitor changes in terms which result in changes to the accounting, as well as meeting the new accounting and disclosure requirements on an ongoing basis.

If the approach in the ED is pursued, some members note that the current exemption for short-term leases applies only to leases without extension options[3]. In markets where such options are generally included in lease contracts regardless of payment conditions, the exemption could no longer be applied. While the concept of the 'maximum term' is to create a straightforward exemption, it would be more practicable to apply the same criteria (of significant financial incentive) to the lease term and to the definition of a short-term lease. In addition, even though the basis of conclusion[4] states that the materiality threshold for leases is expected to be similar to items of property, plant and equipment, some members are concerned that it may be important for clarity of future interpretation to include this point in the standard itself.

The group also notes that the complex accounting and the consequences for the recognition of additional assets and liabilities would result in incentives for structuring future contracts to avoid lease accounting. This would result in less information being available about such arrangements than under the current operating lease treatment, which could be an unexpected consequence of the accounting change.

The IIF SAG believes that current lease accounting is well understood and it would be more cost effective to meet users' needs by improving the disclosure on a consistent basis for both IFRS and U.S. GAAP.

[3] **Short-term lease:** A **lease** that, at the **commencement date**, has a maximum possible term under the **contract**, including any options to extend, of 12 months or less. Any lease that contains a purchase option is not a short-term lease.
[4] BC405 In addition, the IASB expects lessees to apply a similar materiality threshold to leases as it does to items of property, plant and equipment. This would result in a lessee not applying the proposals to leases considered to be immaterial on a basis similar to that applied to items of property, plant and equipment, whereby an entity does not capitalize the costs of purchasing items of property, plant and equipment when that cost is less than a particular amount.

Conclusion

In conclusion, the required efforts - and the ongoing possible effects on capital and the leverage ratio – of these proposals would be disproportionate to any real benefits for users. Given the lack of support from users[5], the improvements the proposals still need and the expected cost for both preparers and users, the IIF SAG is of the opinion that the standard setters should consider disclosure improvements to existing accounting rather than continuing with these proposals. Such an approach would also allow time to consider feedback from users about the enhanced set of disclosures and to assess whether any further effort is needed.

Should you have any comments or questions on this letter, please contact the undersigned or Veronique Mathaud (vmathaud@iif.com; +1 202 682 7456).

Very truly yours,

Cc: Mr. René van Wyk, Chair, *Basel Accounting Experts Group*

[5] **Wednesday, August 28, 2013 - FASB News - Main Investor Panel Rejects Leases Project**
"Part of the problem with the current proposal is that you've got complexities and assumptions, and accounting constructs that muddle the economics," said IAC member David Trainer, CEO of New Constructs, LLC. Instead, the advisory committee said they want the FASB and IASB to scrap the project and draw up a package of footnote disclosures about lease terms and obligations that would allow investors to come to their own conclusions about a company's lease liabilities. "We would recommend a proposal based on a disclosure package that would give both equity and fixed-income investors the disclosures you need to understand the risks and uncertainties related to a lease," said Gary Buesser, a director at Lazard Asset Management, LLC. See also, **Investor Advisory Committee – September 9,2013 – FASB comment letter No. 102** and FASB Investors Technical Advisory Committee – Minutes of Meeting on July 24, 2012 2012.