# AMERICAN INTERNATIONAL GROUP, INC.



December 15, 2010

Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Re: File Reference No. 1850-100 – Proposed Accounting Standards Update, Leases

American International Group, Inc. ("AIG") appreciates the opportunity to comment on the proposed Accounting Standards Update, *Leases* ("Proposed ASU"). AIG is engaged in a broad range of insurance, insurance-related and financial services activities globally. AIG also is involved in the aircraft leasing industry through its wholly-owned subsidiary, International Lease Finance Corporation ("ILFC").

We recognize and appreciate the overall objectives of the Boards in improving financial statement transparency, establishing a principals-based set of accounting standards and aligning lease accounting with the Boards' conceptual framework as it applies to the definitions of assets and liabilities. We agree with the Boards' objectives to report relevant, useful and consistent information to users of financial statements about the amounts, timing and uncertainty of cash flows arising from leases. While we agree with the conceptual changes that would ensure all the rights and obligations arising under leases are recognized on the financial statements, we are concerned with the practical application of the Proposed ASU. Additionally, we do not believe the Proposed ASU fully meets the Boards' objectives in a number of key areas, which should be reconsidered by the Boards as we summarize below. Refer to our complete responses in the Appendix for our supporting rationale.

• We believe that operating leasing, which allows for the use of an asset for a specific period of time with no transfer of rights or risks of ownership, is more similar to a service agreement than a financing. However, we recognize that some leasing transactions are in-substance sales and should be accounted for as such.

For example, aircraft are long-lived assets with lives extending to 25 years and beyond that will have multiple lessees over the life of the asset. The aircraft lessor remains exposed to the asset's value throughout the life of the asset. It is not unusual in the aircraft leasing industry to restructure a lease agreement to change the lease term (shorten or extend), the type of aircraft, the term options, or the payment terms. This flexibility is one of the essential reasons airlines lease rather than own aircraft. Airlines want the flexibility to add, change, or revise routes and change capacity as their business evolves without the need to commit critical capital to the acquisition of long term assets that may not fit their business needs in the future. In short- and medium-term planning, airlines view lease costs as a fixed, determinable cash flow similar to fuel or air crew costs needed to support a specific operational strategy. ILFC provides that flexibility through its operating lease activities.

Additionally, we believe it is inappropriate to treat the leasing of investment real estate assets as financing transactions because this treatment ignores the true economic characteristics of leasing real estate. Real estate leases are not financing transactions because these leases are generally for a small percentage of the underlying real estate property and for lease-term lengths well below the useful life of the asset. There are also no residual values to lessees associated with leases of investment real estate. Rather, lessees choose to lease certain investment real estate assets to obtain advantages such as ample space for their personnel and the location and comfort of the property. For the most part, tenants do not have the expertise to own and manage real estate and the business model for investment real estate assets is clearly one providing a service of property and asset management, rather than financing.

The performance obligation model for lessors in the Proposed ASU will not properly present the economics of an operating lease because the model assumes the transaction is a financing in which a portion of the asset is given permanently to the lessee. The economic substance of the transaction is the rental of the asset for a specific period of time. We propose the Boards allow for a leasing model that reflects the true economics of the lease transaction, which is not the financing of a sale of an asset, but is more similar to a service agreement that would result in a constant yield over the lease term. We view the asset as the means by which we deliver the service over the service period for a periodic payment (i.e., the airline is entitled to receive the service (i.e., use of the aircraft) only to the extent lease payments are made). Therefore, like current service agreements, revenue should be recognized on a straight-line basis, which is reflective of providing that service. When lease transactions become more like ownership of the underlying asset, current finance lease accounting would provide virtually the same result as the proposed derecognition method, which reflects the accounting as a financing.

• Front-ended lessee cost patterns do not reflect the true economics of the lease. We conceptually support the recognition of leases on balance sheet and recognize that a lease contract obligates the lessee to make payments and provides a lessee with future economic benefits. However, we are concerned the proposed changes add further complexity for users of financial statements by replacing rent expense with a combination of asset amortization and interest expense. We understand the Boards believe reporting a lessee's costs, as proposed, more appropriately reflects the purchase and financing of a right-of-use ("ROU") asset. However, because the economics of a lease transaction for a lessee are based on the cash payments made and because the transaction components may not be separated, we

believe it is more appropriate for a lessee to recognize expense equal to the lease payments, preferably as lease rental expense.

- The current lessor lease accounting is well understood by preparers and the users of their financial statements and does not require users to make adjustments to the financial statements for unrecorded contractual commitments. Since its issuance in November 1976, the lessor accounting guidance in Statement of Financial Accounting Standards No. 13, Accounting for Leases ("SFAS 13"), has remained substantially unchanged with mostly minor amendments. We believe changing lessor accounting to create symmetry with the proposed lessee accounting model would "fix" what is not broken. We encourage the Boards to exclude lessor accounting from the current leases project.
- The proposed lessor accounting model creates unneeded complexity. Current accounting treatment for lessors is transparent and provides users with decision-useful information related to the operating leasing activity in a concise method. The Proposed ASU discusses four possible methods of accounting (five under International Financial Reporting Standards ("IFRS")) for lease transactions, which significantly complicate the accounting for lessors who lease longer-lived equipment to multiple lessees. For example, lessors in the aircraft industry may have to employ all methods (i.e., short-term lease exception, performance obligation, derecognition, sale exception and fair value measurement (under IFRS)) to an asset over its life cycle or its lease term if used in a short-term lease. In determining which accounting methods to employ, the proposed guidance will require lessors to exercise significant judgment in their assessment of whether they retain exposure to significant risks or benefits associated with the underlying asset.
- The use of two methods of lessor accounting for very similar assets complicates the financial statements for both preparers and users. The two methods would inevitably result in some economically similar arrangements not to be accounted for similarly. The Boards' proposal to allow the use of two primary methods for longer-term operating leases attempts to provide the means for lessors to report lease transactions in accordance with the economics of a lease. While we agree with this in principal, if implemented, choosing the appropriate method needs additional guidance. Applying the term "significant risks" to a single transaction may be achievable given a limited number of variables; however, application to a large pool of leases with differing terms would be extremely challenging, if not impossible.

If the Boards change lessor accounting, we believe the Boards should consider the use of one model for all operating-type leases. While we do not believe a change to current lessor accounting is required, we believe the performance obligation model is the one that should be applied if changes are adopted to lessor accounting. In conjunction with that decision, we recommend the Boards expand the sales criteria exception specified in paragraph 8(a) of the Proposed ASU to instead state "a contract that results in an entity transferring control of substantially all the risks and benefits..." This change would cause leases that are similar to sales to be accounted for as sales rather than as leases.

• Implementing the Boards' proposed lease guidance will not lead to more decision-useful information. The proposed accounting will often distort the income statements of both

lessees and lessors. Under the proposed lessee model, expense amounts (including both asset amortization and interest components) will be unrepresentatively high early in the lease term and unrepresentatively low late in the lease term. Lessors' income patterns would change significantly under both the performance obligation and derecognition models. Under the performance obligation model, lessors' income in early periods of the lease would be greater than it would be if the lease were classified as an operating lease under current accounting rules and lower than operating lease income in later periods. Under the derecognition model, lessors' total income over the lease term would be lower compared to finance or sales-type leases under current accounting rules. Lessees and lessors will not be reporting financial results that reflect the true economics of lease contracts nor a fair presentation of the risks and rewards of the business model. Additionally, the elimination of "rent" and splitting revenue and expense between two components is a concept that does not make economic sense and will not be understood by many users of the financial statements.

- Significant volatility will result in financial results due to the effect of lease options, contingent payments, and the periodic reassessment of these items. The Proposed ASU entails the use of significant estimates and judgments, resulting in the recognition of amounts on the balance sheet for contingent rents and option renewals with a great deal of measurement uncertainty and would result in initially recognizing amounts for events that may not occur. Periodic reassessments of these lease terms will require a significant amount of judgment from management that could change dramatically from one reporting period to the next thereby reducing comparability in financial results and providing little objective, decision-useful information to users of financial statements. The volatility that will be created is the result of the highly-speculative nature of forecasting future events of various factors over extended periods.
- An accounting-driven change in leasing strategies may have a negative economic effect unintended under the proposed rules. We are concerned there will be unintended consequences to leasing transactions due to the proposed changes to lease accounting. Financial statement metrics (i.e., EBITDA, return on assets/equity ratios and leverage ratios) will be inappropriately impacted by the additional assets and liabilities recorded by lessees and lessors. The unintended breaching of debt covenants due to an increase in liabilities can cause borrowers (lessees and lessors) and lenders to enter into costly negotiations to cure such breaches. Additionally, lessees will likely begin to negotiate lease terms in such a way that additional assets and liabilities required under the ROU model would be minimized. Such strategies may result in shorter lease terms than currently witnessed in today's leasing market and a reduction in future variable rent components, which could have an adverse impact to leased property valuations.
- Implementing the new accounting guidance will be costly, in particular due to the need to include the effects of lease options and contingent payments and periodically reassess such items for their entire lease portfolio. Each lease will need to be evaluated individually due to its unique aspects. With thousands of leases from both a lessor and lessee perspective to assess initially and reassess on a quarterly basis, this process will be extremely time consuming and costly for AIG, with little, if any, perceived benefit. The adoption and maintenance of two separate lessor accounting models by ILFC would also increase the

amount of effort required to comply with the proposed accounting rules if adopted as currently proposed.

• The Boards have not fully exposed the accounting for lessors with the user community. Lessor accounting was only briefly addressed in the Joint Discussion Paper, Leases: Preliminary Views issued by the Boards and only fully unveiled in the Proposed ASU. Significant discussions consumed many of the meetings of the Boards with inconclusive consensuses on lessor accounting issues. If the Boards decide to go forward with the lessor component of the joint project, we recommend a separate project be added to the Boards' agenda to address specific concerns of the lessor community.

We welcome the Boards' outreach activities relating to this Proposed ASU, however, we believe they should be further extended to explore the lessor model, which has not been sufficiently evaluated. As we have noted, we believe that significant changes to the Proposed ASU are warranted. The development of a comprehensive accounting model for all leases that will be operational for preparers and understandable to users will require additional outreach and may require field testing. We believe these efforts will take more time than the Boards have currently allotted to the project, particularly given the many demands on the Boards and the number of projects currently underway.

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Our responses to certain questions raised by the Boards of importance to AIG are included in the Appendix to this letter. Thank you for the opportunity to present our views. Please do not hesitate to contact me at 212-770-8997 if you have any questions or need clarification with respect to any matters addressed in this letter.

Very truly yours,

/s/Tom Jones Director and Global Head of Accounting Policy American International Group, Inc.

cc: Anthony Valoroso Vice President and Chief Accounting Officer American International Group, Inc.

# **Appendix**

# **Question 1: Lessees**

- (a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?
- (b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We conceptually support the recognition of leases on the balance sheet and recognize that a lease contract obligates the lessee to make payments and provides a lessee with future economic benefits. We agree with the Boards' proposed lessee accounting for simple leases; however, we are concerned with the proposals on the measurement of the right-of-use ("ROU") asset and liability for more complex leases that contain options and contingent rents. The model proposed would entail the use of significant estimates and judgments, resulting in the recognition of amounts on the balance sheet with a great deal of measurement uncertainty and would result in recognizing amounts for contingent rents and option renewals that may not occur. Additionally, we believe circumstances could arise where the ROU asset recorded by the lessee would exceed the fair value of the underlying leased asset.

We are concerned that the proposed changes add further complexity for users of financial statements by replacing rent expense with a combination of asset amortization and interest expense. Current accounting, which requires operating lease payments to be recognized as straight-line rent expense on the income statement, is at the core of analyzing the true economics of leases. Under the proposed accounting, expenses would be accelerated or front-loaded compared to the straight-line expense recognition associated with most operating leases under current accounting rules. As a result, the reported costs would bear no relationship to the revenue/benefits generated by the leased asset. We understand the Boards believe that reporting a lessee's costs, as proposed, more appropriately reflects the purchase and financing of a ROU asset. As we have noted, we believe that operating leasing, which allows for the use of an asset for a specific period of time with no transfer of rights or risks of ownership, is more similar to a service agreement than a financing. Therefore, like current service agreements, revenue should be recognized by a lessor on a straight-line basis, which is reflective of providing that service. Because the economics of a lease transaction for a lessee are based on the cash payments made, we believe it is more appropriate for a lessee to recognize expense on a straight-line basis, preferably as lease rental expense.

#### **Question 2: Lessors**

- (a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?
- (b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

The Boards' proposal to allow the use of two primary methods for longer-term operating leases for lessors attempts to provide the means for lessors to report lease transactions in accordance with the economics of a lease. While we agree with this in principal, if implemented, choosing the appropriate method needs additional guidance. The Proposed ASU does not provide sufficient guidance (i.e., the existence of one or more indicators is not conclusive) in determining the approach to use for each lease. We do not agree with the proposal for lessors to determine the appropriate approach to apply based on an assessment of whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term because this is inconsistent with the Proposed Accounting Standards Update, Revenue from Contracts with Customers (the "Proposed Revenue Recognition Model").

The performance obligation model does not reflect an improvement over current accounting guidance for operating leases. The concept of a constant yield over the term of a lease embedded in SFAS 13 will be lost. For operating lessors, the prospect of profitable, high front-end revenue followed by decreasing profitability, lower revenue and, finally, possible losses versus the current straight-line revenue recognition will not reflect the true economics of the lease transaction. We believe users likely will attempt to adjust lessor financial statements to give a straight-line effect to revenue to more fully understand the quality of revenue and the related cash flows. Additionally, the performance obligation approach is not consistent with the principles in the Boards' proposals on revenue recognition. Under the Proposed Revenue Recognition Model, the lessors' delivery of the leased asset (i.e., giving of control) would trigger all revenue under the contract whereas the performance obligation method requires revenue to be recorded over the life of the lease. We believe the proposed accounting model inappropriately penalizes lessors for being flexible in their leasing activities in certain situations (i.e., where the aircraft is taken back early or an option to renew is not exercised). In these situations, a loss will result for the lessor because the lease receivable will always be greater than the performance obligation.

The derecognition model does not reflect an improvement over current operating and non-operating lessor accounting. The existing guidance for finance/sales-type leases provides the lessor/lessee accounting symmetry the Boards desire, is simple to employ and is well understood by users of financial statements. The partial derecognition model in the Proposed ASU essentially ignores the physical nature of the assets leased, converts the physical assets into a patchwork of financial and other assets and ignores the fact that the asset itself is not "owned" by the lessee. We note in such circumstances the lessee does not enjoy full rights of ownership to the asset, but rather has a right to use the asset for a specific and intended purpose over a limited period of time.

Additionally, multiple lease transactions for an individual asset likely could cause a change from one accounting method to another over the life of the asset. The effects of these changes on the assets, liabilities, revenues and expenses in the financial statements of lessors will make comparability difficult, if not impossible. Our concern is that the multiple accounting methods available under the Proposed ASU provide a greater probability that similar transactions will not be accounted for in a similar manner. This would be contrary to achieving the Boards' primary stated objective that economically similar leasing arrangements be accounted for similarly. That is, assets with the same configuration and monthly lease rates (i.e., identical or similar assets and cash flows) will generate different accounting results depending on the method of accounting employed. Without additional guidance we believe the potential to use two methods for essentially the same leased asset will cause confusion for the users of the financial statements. As a result, financial statements of lessors will not be readily comparable to their peers nor easily understood by users.

#### **Question 3: Short-term leases**

This exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:

- (a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).
- (b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65).

(See also paragraphs BC41-BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

We agree with the Boards' proposal that a short-term lease is one with a maximum possible lease term of twelve months or less. We also agree with the proposal for lessor treatment of short-term leases. We believe, however, that lessees should have the same elections for short-term leases as those provided to lessors. Lessees should be able to choose on a lease-by-lease basis not to recognize assets or liabilities arising from a short-term lease. In lieu of the proposed option to record the undiscounted ROU asset and related liability, lessees should be able to recognize the cost of short-term leases on a straight-line basis consistent with current accounting guidance. This would align expense recognition with cash flows on the short-term lease. It also avoids the significant effort and costs associated with accounting for and measuring such short-term assets and liabilities.

## **Question 4: Definition of a Lease**

- (a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?
- (b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?
- (c) Do you think that the guidance in paragraphs B1-B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

We generally believe the definition of leases and the criteria specified for distinguishing between a lease and a purchase or sale included in the Proposed ASU is appropriate.

We agree with the proposed criteria for distinguishing a lease from a contract that represents a purchase or sale. The transfer of title or a bargain purchase option at the end of a lease contract generally are proper indicators that a sale has essentially occurred on the leased asset. We believe, however, that further indicators of a sale would exist when a lease term comprises a significant amount of the leased asset's estimated useful life because this would result in an economically similar position to a lessee as a transfer of title of the leased asset. This is also consistent with the discussions in the Proposed Revenue Recognition Model, indicating that control exists when an entity has the right to use the asset for its remaining economic life. In this regard, we recommend the Boards expand the sales criteria exception specified in paragraph 8(a) of the Proposed ASU to instead state "a contract that results in an entity transferring control of substantially all the risks and benefits..." This change would cause leases that are more similar to sales to be accounted for as sales rather than as leases. This change would essentially eliminate the partial derecognition model and leave one model for non-sale leases.

The guidance provided in paragraphs B1-B4 identifies factors to be considered in determining whether a lease contract exists, which we agree with. Additional guidance should be provided to identify a service contract and the differences between a lease and service contract. See further discussion in our response to question 6 below.

#### **Question 5: Scope Exclusions**

This exposure draft proposes that a lessee or a lessor should apply the proposed guidance for all leases, including leases of right-of-use assets in a sublease except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33-BC46).

Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

We generally agree with the scope of the proposed guidance. We urge the Boards, however, to exclude lessor accounting for leases of real estate held for investment purposes as the application of the proposed lessor accounting models for these properties is not practical. We believe more complete and comprehensive accounting requirements for leases related to investment property should be developed and exposed prior to finalizing a standard on leases. We understand the FASB also is considering a convergence project for measuring real estate investment property at fair value for certain types of reporting entities, which presumably would

result in a scope exception from the proposed guidance for leases for those real estate investment properties measured at fair value. In particular, convergence of US GAAP with IAS 40, Investment Properties, would result in a consistent and informative basis of accounting for investment properties. Consistent with the current proposal under IFRS, lessors that report investment properties at fair value under GAAP should be exempt from applying the proposed ROU lease accounting model and should be permitted to continue to record rental income on a straight-line basis. Fair value accounting for an investment property would reflect both gross contractual rental income and managed expenses that are directly correlated with the property's day-to-day operations, reflecting the true value of the investment property.

# Question 6: Contracts that contain service components and lease components

This exposure draft proposes that lessors should apply the guidance to proposed Accounting Standards Update, *Revenue Recognition* (Topic 605): *Revenue from Contracts with Customers*, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5-B8 and BC47-BC54). If the service component in a contract that contains service components and lease components is not distinct:

- (a) The FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.
- (b) The IASB proposes that:
  - (i) A lessee should apply the lease accounting requirements to the combined contract.
  - (ii) A lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
  - (iii) A lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We recognize the Boards' attempts to separately identify and account for service components within leases with the overall objective to preclude recognition of income from a service before the service is delivered. We note, however, that there is not clear guidance in the Proposed ASU on how to determine if a service component is distinct. The Proposed ASU points to the guidance in the Proposed Revenue Recognition Model. This guidance, however, is not clear with respect to the interpretation of whether certain leasing fees would be considered distinct because the most objective factor specified is when the service is sold separately by the lessor. If not sold separately, the service can be considered distinct if it has a utility on its own or with other non-leasing goods and services and if it has a distinct profit margin. This concept would not be applicable to property lease components that are considered cost pass throughs, such as property insurance and property taxes. However, it is unclear whether maintenance fees would qualify under this concept.

AIG's property leases contain components relating to executory costs (i.e., property insurance, property taxes and maintenance fees). The maintenance fees cover upkeep of the building housing the leased property, security and janitorial services and the operation of common utilities such as heat and water. These fees often are based on a predefined calculation in a lease subject to yearly changes and sometimes are paid in full for the year at the beginning of the year. Inclusion of these fees in the measurement of a lessee's ROU asset may cause that asset to be valued at an amount that is higher than the fair value of the underlying asset. Additionally, evaluating or predicting the likely changes in these fees at each reassessment period would add unnecessary volatility to the probability analysis used to determine the ROU asset and related liability. We believe that service components representing maintenance fees within leases should be treated as a distinct service and therefore be accounted for as a separate component of income as the service is provided.

Varying interpretations of what is considered a distinct service will lead to inconsistency in application of the proposed guidance, which is moving further away from the FASB's goal of achieving consistent accounting and disclosures for leasing activity among constituents. We urge the Boards to provide additional guidance on distinguishing lease components from components that should not be treated as part of the lease, such as building services that are covered by maintenance fees. This guidance also should address treatment of these fees by landlords. In most leases involving building services provided under these maintenance fees, the lessee reimburses the landlords for these fees. In these situations, these fees should be recognized as a separate component from lease income and should be recognized as an expense reimbursement by the lessor.

# **Question 7: Purchase options**

This exposure draft proposes that a lease contract should be considered terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or lessor should account for the purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

We conceptually agree that a purchase option should only be recognized when exercised as a lessee or a lessor does not have any obligations or rights until such exercise. However, if the Boards retain their position that the term of a lease should include consideration of options to renew/terminate a lease, the Boards should provide a sound basis for not including consideration of purchase options as part of the measurement of the most likely lease term. A decision to exercise a purchase option involves consideration of the same factors as a decision to exercise a renewal/termination option. We are concerned that if the final standard contains different treatment for purchase options from that for renewal/termination options, significant structuring opportunities for leases would result.

#### **Question 8: Lease term**

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or lessor should determine the lease term and why?

The Boards' proposed lease accounting specifies that the lease term should be determined as the longest possible term that is "more likely than not" to occur, taking into account the effect of any options to extend or terminate the lease. However, we do not agree that the longest possible term is the appropriate solution. This approach may result in recognizing the effect of an option to extend or terminate a lease when such option may not be exercised. Options are generally given to create flexibility on the part of the lessee to, in essence, grant a right-of-first-refusal to the lessee and to encourage the lessee to discuss the lease and potential renewal early. The exercise of an option is the event that creates the rights and obligations associated with the option period. Recognizing the effect of such options can result in recording assets and liabilities before they exist. Additionally, this recognition is not consistent with the Boards' definitions of assets and liabilities and gives users unrealistic expectations of the future of the company's business. If the Proposed ASU is to go forward as described, we recommend that the Boards provide guidance in the Proposed ASU about how such options meet the Boards' definitions of assets and liabilities.

The decision to exercise an option to extend a lease term is often based on the economics involved in the option. If the option is economically attractive at the time to extend the lease, it will usually be exercised. The attractiveness of the option will depend on the rental market of the leased property at the time of renewal to see if it will be attractive to extend the lease based on the economics involved in the renewal option. This will often reside with the lessee because it is the lessee that has the power to exercise the renewal option. It likely is also in the best interests of the lessee to incorporate this extension into its most likely lease term as it will result in a profit if the option is not exercised at the end of the lease term. The lessor will not have as much information available to determine if the option will be renewed because the power to exercise the option to renew resides with the lessee. However, if the renewal is incorporated into the lessor's most likely lease term and the option to renew is not exercised, the lessor likely will incur a loss on the lease. Due to the inherent uncertainty in determining whether the renewal option will be exercised and differing levels of information available to the lessee and the lessor, inconsistencies will result in the most likely lease term for the same lease.

The accounting for options becomes even more problematic for aircraft lessors. For long-lived assets there may be multiple options extended to lessees. Inclusion of these options in the calculation of the lease receivables creates significant estimation risk around the probability of exercise of the option to the lessor. Aircraft lessees typically evaluate these options at each option exercise date when they determine their equipment needs and other available equipment and financing alternatives. At ILFC, the historical trend of its lessees is not to exercise above-market options and to renegotiate lease terms at option-termination. It appears that similarly-situated aircraft or long-term equipment lessors face this same problem and will find it difficult to reach the "more likely than not" criterion unless they clearly offer below-market options in the lease.

The financial effect to the lessor for an incorrect estimate is severe and difficult to assess under either the performance obligation or derecognition methods. The exercise of these options will be based on market conditions when the option can be exercised, which is not in the lessor's control. For example, there were significant changes in lease rates after September 11, 2001 and again from the middle of 2008 to the present. If options are to be considered in the lease term, a higher threshold than "more likely than not" should be considered. The inclusion of options adds to the inappropriate "up front" recognition of interest income that may not be realized at option expiration, and therefore we suggest the threshold for recognition should be at least "reasonably assured." We suggest that the Boards revert to the concept of the minimum lease term as provided for in the current standard.

# **Question 9: Lease payments**

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured? Why or why not?

We do not agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included using an expected outcome technique. These amounts are contingent and do not become contractual rights or obligations until the occurrence of the event upon which a contingent payment is based. Because a contractual right/obligation would not exist until the occurrence of the contingent event, we recommend the Boards remove inclusion of contingent payments in the lease calculation until it is reasonably assured that the contingency will be met.

We have significant concern regarding whether entities would be able to appropriately and accurately assess the probability of individual outcomes when measuring lease payments under the proposed expected outcome approach. For example, ILFC typically signs a lease agreement several years before the aircraft is delivered to the lessee. During the period from lease signature to lease commencement and through the initial lease term plus lease options, if any, the number of contingent payments triggered plus the estimate of the valuation of the payments presents a large number of possible outcomes. To arrive at the expected outcome, to obtain a reasonable estimate for the contingent payments, and to provide for periodic changes will be a significant operational challenge and will be highly speculative, which brings into question the reliability of the accounting information produced.

Additionally, this analysis would need to be performed for each lease on an individual basis due to the unique nature of each lease and as a result, this process will be very time consuming. This process will be made even more complex if the requirement to reassess these probability-weighted estimates when facts or circumstances change. We believe that including contingent payments will lead to significant volatility in, and lower reliability of, the financial statements

without providing decision-useful information. The volatility will be principally based upon management's ability to forecast contingent payments many years into the future. Alternatively, forecasted contingent payments could be disclosed within the footnotes to the financial statements.

Should the Boards decide to include contingent payments in the measurement of lease assets and liabilities, we believe the Boards should provide improved and simplified guidance, consider recognition of the contingent payments when it is reasonably assured the contingency will be met, and align such guidance with current accounting guidance in the Proposed Revenue Recognition Model.

# **Question 10: Reassessment**

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

We support the Board's attempt to reflect current market conditions and provide more relevant information to the users of financial statements through the proposal to remeasure lease assets and liabilities for significant changes arising since the previous reporting period. We believe, however, more guidance should be added to determine what constitutes significant changes. The proposed language could be interpreted to incorporate a continual reassessment of contingent rental periods and lease terms that are already based on a high level of subjectivity to determine the amount. Reassessments at each reporting period for these items would result in tremendous efforts that would outweigh any potential benefits in providing more current information, particularly when the lease term has renewal options that span several years. AIG has thousands of leases from both a lessee and lessor perspective and a reassessment of lease terms at each reporting period would require a tremendous level of effort because this reassessment would require a manual, lease-by-lease assessment due to the unique nature of each lease.

Additionally, the updated information may not be more relevant or reliable due to the high level of subjectivity involved in determining the most likely lease term as proposed. Periodic reassessments of these lease terms will require a significant amount of judgment from management that could change dramatically from one reporting period to the next thereby reducing comparability in financial results and providing little objective, decision-useful information to users of financial statements. The volatility that will be created is the result of the highly-speculative nature of forecasting future events of various factors over extended periods.

We believe remeasurement should be performed based on revised contractually binding lease terms (i.e., early termination, executed lease renewal, formal change in lease terms). FASB Concepts Statement No. 3, Elements of Financial Statements, states that one of the essential characteristics of a liability is the presence of an obligation with "little or no discretion to avoid future sacrifice...". Reassessment of lease terms based on contractually binding changes would fit this definition and would provide consistency in when to reassess and record changes due to revisions in binding lease terms.

## **Question 11: Sale and leaseback**

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

We generally agree with the criteria for a sale and leaseback transaction. We do not agree, however, that the lessor/buyer who qualifies for a sale and leaseback transaction should be required to account for the lease as a performance obligation as outlined in paragraph 68(a). The lessor/buyer should be able to determine whether the lease transaction should be accounted for under the derecognition or performance obligation method based on their analysis of the transaction and application of the proposed guidance.

# **Question 12: Statement of financial position**

- (a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment but separately from assets that the lessee does not lease (paragraphs 25 and BC 143 BC 145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?
- (b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totaling to a net lease asset or lease liability (paragraphs 42, BC 148 and BC 149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?
- (c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial asses and should present residual assets separately within property, plant and equipment (paragraphs 60, BC 154 and BC 155)? Why or why not? Do you think that a lessor should disclose the information in the notes instead? What alternative presentation do you propose and why?
- (d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC 150 and BC 156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

#### Lessee Presentation

We support the Board's proposal to present liabilities to make lease payments separately from other financial liabilities because it represents a unique class of liabilities that is linked to a corresponding asset in which the values of both the liability and the asset require a high level of subjective assessment from management. Additionally, because the obligation to make lease payments under a lease may warrant different treatment from other financial liabilities in certain situations (i.e., imminent contingencies), separate presentation of the liability to make lease payments is warranted. We also support the Board's proposal to separately present right-of-use assets from owned assets within property, plant and equipment. We believe the presentation of ROU assets based upon the nature of the underlying leased item provides users of financial statements with useful information regarding the nature of the leased asset. We believe, however, that the ROU asset and the related liability should be separately presented on the face of the

financial statements if material. Otherwise, disclosure within the footnotes would be adequate in providing decision useful information to the reader of the financial statements.

#### Lessor Presentation

In general, we do not support the use of two methods of accounting for very similar assets because it complicates the financial statements for both preparers and users. The two methods would inevitably result in some economically similar arrangements to not be accounted for similarly.

If the Boards decide to proceed with the two methods, under the performance obligation approach, we believe separate presentation of the performance obligation liability and the underlying asset within the financial statements should be allowed if material, but not required. We believe presentation of these amounts separately as both assets and liabilities could result in a significant increase in the total assets and total liabilities of the lessors. This could potentially dilute the asset base in situations where the appearance of a liquid asset results when the lease receivable exceeds the performance obligation liability. We believe it is important for the Boards to define these assets as intangible assets to mitigate the risk to unsecured creditors of borrowers attempting to leverage these assets, which are not liquid assets. Covenants within most loan agreements are based on "GAAP" assets, and generally exclude intangible assets in most cases. As an alternative to the separate gross presentation of the asset and liability, we believe that presenting the unamortized performance obligation as an offset to the underlying asset provides a clear picture of the financial position of the lessor. We also believe that presentation of the net lease asset or liability on the lessor's financial statements, with supporting information included in the footnotes, would provide users with useful information on the financial position of the lease during the reporting period. In addition, we believe the Boards also should clarify the manner in which net lease assets and net lease liabilities should be required to be presented in the current or non-current section of a classified statement of financial position.

Under the derecognition approach, we believe the presentation of the rights to receive lease payments separately from other financial assets should be allowed if material, but not required. We do not believe the separate presentation of the residual asset on the financial statements should be required. Disclosure within the footnotes differentiating residual assets from other assets included in property, plant and equipment will provide sufficient information to a user of the financial statements.

#### **Subleases**

We do not agree with the application of the proposed accounting to subleases. The application of the right-of-use accounting model can result in a substantial increase to amounts recorded on the balance sheet that do not give more insight into the leasing arrangement and causes confusion regarding the amounts recognized by the sub-lessor (the intermediate lessor). Application of the proposed model will cause the intermediate lessor to recognize two assets (the right-of-use asset for the head lease and the lease receivable from the sub-lessoe) and two liabilities, assuming the performance obligation approach is taken by the sub-lessor (the liability to allow use of the underlying asset to the lease and the liability to make lease payments under the head lease). The double recognition of these assets and liabilities relate to the same underlying leased asset and could create confusion for a reader of the financial statements of the sub-lessor. This presentation does not give any insight to the economics of the sublease either because a profit or loss often will result in sublease arrangements. Under current accounting, a

loss is recognized when the sublease is executed for subleases that will result in a loss. Under the proposed model, a loss will be recognized on the head lease if the right-of-use asset is considered impaired, which does not match the sequencing of events on the sublease (i.e., the loss is incurred upon the contractual execution of the lease).

We urge the Boards to re-evaluate the proposed accounting for subleases to more closely match the economics of the sublease arrangement. In particular, we believe disclosure in the notes will be sufficient to distinguish assets and liabilities that arise under a sublease from those that arise in other lease contracts and that separate presentation on the financial statements should not be required.

#### **Ouestion 13: Income statement**

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

We generally support the presentation of lease income and lease expense separately from other income and expense in the income statement because the income statement effects of leases are unique from the other components that would generally be captured within other income and expense. We believe, however, that a lessee should combine amortization and interest expense under the lease and present the combined amount as lease expense on the statement of comprehensive income, if material. Additionally, the components of the lease expense should be disclosed in the footnotes to the financial statements.

We are concerned with the overall impact of the recognition of interest and amortization expense in lieu of the current recognition of operating leasing activity through rent expense. Current accounting allows for the recognition of rent expense to match the economics and cash flows of the operating lease. The proposed accounting has the potential to introduce significant volatility to earnings as a result of the lease term, contingent rental payments and the reassessment provisions. This volatility would be recognized within income but may never be realized if assumptions are revised and the volatility is reversed upon reassessment.

Additionally, the proposed accounting will have a significant impact on covenants (i.e., EBITDA, return on assets/equity ratios and leverage ratios) included within certain debt agreements. These items are key components in the majority of debt agreements. The negative impact on these ratios is not a true representation of the leverage of the company because the recognition of interest expense, particularly the impact of the effective-yield method resulting in more recognition toward the beginning of the lease term, does not match the cash flows and level amounts due under most lease terms. The effect on existing covenants may lead the banking industry to restrict lending to some companies.

### **Question 14: Statement of cash flows**

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC 159)? Why or why not? If not, do you think that a lessee or lessor should disclose this information in the notes instead? Why or why not?

We support the Board's proposal to separately present leasing cash flows from other cash flows within the statement of cash flows. As we have noted, we believe that operating leasing, which

allows for the use of an asset for a specific period of time with no transfer of rights or risks of ownership, is more similar to a service agreement than a financing. As such, we believe that the current accounting treatment to reflect cash flows from operating leasing activities within operating activities generally matches the purpose of entering into leasing activities by both parties. The proposed presentation of cash flows from lessees within financing activities is appropriate when lease transactions become more like ownership of the underlying asset, which is indicative of a financing transaction.

# **Question 15**

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognized in the financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows?

(paragraphs 70-86 and BC168-BC183) Why or why not? If not, how would you amend the objectives and why?

We agree that lessors and lessees should disclose quantitative and qualitative information that identifies and explains the amounts arising from leases and describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows. We note, however, that the Proposed ASU requires a significantly increased volume of disclosures in comparison to current requirements. We do not believe all of the proposed disclosures are necessary or useful. In particular, we disagree with the Boards' proposal to disclose a tabular reconciliation of opening and closing balances, along with the amount of cash payments made during the period, for lessors and lessees. The proposed presentation of the balances related to leases to be separately presented within assets and liabilities on the balance sheet, along with the disclosure of annual maturity for the first five years of the lease term and separate presentation of lease activity within the statement of cash flows, presents sufficient information to a user of the financial statements to understand the amount of lease payments due in the first five years of the lease. The tabular reconciliation will place an undue burden on constituents to gather the information comprising the reconciliation, which consists of thousands of leases for AIG from both a lessor and lessee perspective. This disclosure will provide little in additional value to the users of the financial statements as the other disclosures provide an ample level of information for a reader to understand the economics of and amounts due on the lease.

The proposed disclosure requirements are more onerous than the disclosures currently required for property, plant and equipment in Topic 360 and debt in Topic 470 and puts leasing activity to a higher standard than the core components capturing this leasing activity. We encourage the FASB to remove the requirement for the tabular disclosures and to consider whether reconciliations of opening and closing balances are beneficial as part of the broader financial statement disclosure project.

We welcome the requirement in the Proposed ASU that an entity should consider the level of disclosure appropriate to satisfy the disclosure objectives specified in paragraph 70 of the Proposed ASU on "how leases may affect the amount, timing and uncertainty of the entity's future cash flows." We note that the Boards have proposed that entities can "aggregate or

disaggegate" disclosures in an attempt to ease the burden of preparing and providing the extensive proposed disclosures. We welcome this and encourage the Boards to be more explicit to avoid confusion. We believe the main emphasis of the disclosures should be to provide sufficient granularity about the lease portfolio to enable a user to understand the significance of the lease transactions to an entity's business and the related amount, timing and uncertainty of cash flows.

# **Question 16 – Transition**

- (a) This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88-96 and BC186-BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
- (b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?
- (c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

The Boards have proposed a simplified retrospective implementation, which we do not support. Simplified retrospective implementation will lead to reporting financial results that are not indicative of the economics of lease contracts due to the arbitrary starting date of the simplified retrospective implementation. The Proposed ASU does not provide any guidance as to the assessment of leases outstanding at the date of initial application and it is unclear whether a lessor should determine the appropriate accounting model (i.e., performance obligation or derecognition) as of the date of initial application or the date of inception of the lease. It also would lead to arbitrary decisions due to the hindsight that would inevitably be employed on outstanding leases as of the effective date. Additionally, applying these decisions to each and every lease and lease action would be extremely costly and highly speculative.

Full retrospective implementation, which we also do not support, would be consistent with the transition proposed for the Proposed Revenue Recognition Model, but would also be the most costly. The Boards should obtain feedback from roundtable discussions and users about the difficulties involved with any form of a retrospective implementation.

We believe prospective implementation would be more appropriate and cost/beneficial given the number of new accounting standards that may be or have been issued, exposed or become effective during the transition period (there are over ten projects on the FASB's agenda as of December 2010). Prospective adoption also would allow for more efficient implementation because each lease will need to be evaluated individually due to the unique aspects of each lease while providing financial statements that are no less comparative than those produced under the simplified retrospective method.

## **Question 17 – Benefits and Costs**

Paragraphs BC200-BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

We support the Board's efforts in seeking to improve existing lease accounting and increasing the usefulness of the information provided and the comparability among constituents. The proposed models for lessee and lessor accounting, however, will require significant efforts in implementation because adoption of the proposed accounting rules will require a review of lease terms for all leases outstanding. Due to the uniqueness of the terms within each lease, adoption of the proposed accounting will involve review of terms on an individual lease-by-lease basis.

The cost of assessing renewal options and contingent payments on a lease-by-lease basis at each reporting period is unduly burdensome because AIG has thousands of leases from both a lessor and lessee perspective. Additionally, the adoption and maintenance of two separate lessor accounting models also would increase the amount of effort required to comply with the proposed accounting rules if adopted as currently proposed. Compliance with the proposed lease accounting will require AIG to create a separate accounting and reporting system to monitor and continually forecast the amounts and estimates of contingent payments and evaluate each lessee's intent related to options many years in the future on a quarterly basis. This system likely will not be used to assist management to run its business (i.e., to follow cash flows, compete on lease rates, change equipment from lessee to lessee, follow possible income tax requirements or defend asset valuations for insurance or financial losses), which our current systems provide.

The current accounting model appears to reflect the true economics of leases in the distinguishment between operating and capital leases. The proposed accounting is overly complex, requires a tremendous level of effort to implement, leads to a lack of symmetry and distorts comparability among lessors and lessees due to the lack of objective measures. As such, AIG encourages the Boards to provide relief on the implementation period for the proposed accounting. A longer implementation time frame will allow enough time for constituents to develop processes and systems to accommodate proper adoption of the complex proposed accounting under the Proposed ASU.

#### **Ouestion 18**

# Do you have any other comments on the proposals?

#### Lease Incentives

We urge the Boards to consider the treatment for lease incentives (i.e., tenant work allowances, free rent periods), which was not addressed in the Proposed ASU. Cash incentives received by the lessee from the lessor should reduce the amount recognized on the right-of-use asset that is recognized by the lessee upon inception of the lease. These incentives could be viewed as an allowance provided by the lessor that would not need to be reimbursed under the lease terms. This type of arrangement could be viewed in a similar manner to initial direct costs incurred with leases. The proposed accounting treatment for these costs is to reduce the right-of-use asset by the amount of these direct costs. We propose the Board incorporate into the proposed

accounting treatment of lease incentives to be the same as those of initial direct costs (i.e., as a reduction to the ROU asset).

#### Discount Rates

The proposed accounting specifies that the incremental borrowing rate assumed on the lease will not be revised unless there is a change in circumstances. For lessees, determining an appropriate discount rate based on our incremental borrowing rate does not take into consideration the fluidity of economic conditions that may change over time and its impact on borrowing rates over time. We encourage the Boards to provide additional clarifying guidance relative to the determination of a lessee's incremental borrowing rate that preparers could apply in various circumstances. For example, borrowing for four years with a two-year extension option will be priced differently from a six-year borrowing.

The definition of the discount rate being used to value the present value of lease payments for lessors is vague and revolves around the "yield on the property" as specified in paragraph B12 of the Proposed ASU. The phrase "yield on the property" should be further defined regarding whether it consists of a gross or net property yield, and particularly how the numerator and denominator are being defined within the property yield calculation. By using a property yield calculation, FASB is implying that a company has a fair market value of each and every property. We believe that to make this assumption, the Boards must set guidelines on how frequently these properties must to be valued and what appropriate valuation procedures encompass. See further discussion on the fair valuation of investment properties in our response to Question 5 above.