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International Accounting Standards Board
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Technical Director
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Dear Sir / Madam

RE: EXPOSURE DRAFT - LEASES

We are writing to comment on the exposure draft ‘Leases’. We are a property development and investment group and so our comments are made in relation to leases of real property, focussing on the effects on lessees.

In our view the introduction of a range of complicated adjustments based on lease term and fictitious assets and liabilities would be unhelpful. We believe that the proposals would achieve the opposite of their intended effect: i.e., they would reduce the comparability of companies, necessitating significant adjustment of financial statements by users to render them useful. We also believe that the proposals would lead lessees to adopt sub-optimal behaviour which would result in economic inefficiency.

Leases as Assets and Liabilities

In our view, leases do not constitute assets or liabilities under sensible definitions of those words. Although it can be said that on signing a lease, a lessee has acquired a right to use something and an obligation to pay rent, both the rights and the obligations are very different from a normal case.

When someone owns an asset, the owner typically possesses broad rights of ownership and has exposure to residual values. That is the rationale for the
current distinction relating to finance leases. A lease of real property can contain constraints on the use of the leased asset, for example a building might be leased for a narrow permitted use. A lessee under such a lease is not exposed to residual values. And the lease might limit or even prohibit the lessee’s right to assign its interest under the lease. When one sees an asset in a balance sheet, one thinks of something that can be sold if necessary, but in the case of a lease that depends on the fine print. Rights under a lease can be lost for obscure reasons – we know of a lease in which the landlord can terminate the lease if the lessee allows gorse to grow upon the land.

A lease also makes a strange sort of liability. Under almost no circumstances, even default by the lessee, can the lessor demand full payment of rent for the remaining term of the lease. In the normal case, if someone borrows money and then an event of default occurs, the lender can demand repayment in full. In the case of a lease, however, the lessor has a duty to mitigate its loss, and in most cases the total liability of the lessee, even after default, will be substantially less than the remaining rental payments under the lease. If the market value of rent is equal to or greater than the rent payable under the lease (which is often the case) then there might not be any liability at all resulting from a default under a lease. Putting a lease into a balance sheet as a liability would ignore all of this.

Comparability Between Lessees

The Exposure Draft focuses on comparability between businesses with different approaches to ownership: for example, compare a company that owns its building with one that leases its building. In our view, it is right for the accounts of those two companies to highlight the differences – the company that owns the building with lots of debt has much higher financial risk and exposure to property values compared to the one that leases its premises. The proposal, however, could create an incentive for companies to take on more risk since long term leases would become relatively less attractive.

We would like to focus attention on comparability between companies with different lease periods. For example, imagine two companies otherwise identical except that one has a 15 year lease of a suitable building and the other occupies its building on a very short term tenancy. The proposed rules would flatter the performance of the second company relative to the first one because under the proposal expenses can exceed rental payments in the early years of a long term lease. In fact, the first company has secured its business’s position and obtained good value by negotiating for a long term lease whereas the second company is sitting dangerously exposed to the whims of its landlord and the future rental market. In our view, the proposal would create an unhelpful distortion that would lead to suboptimal behaviour by lessees. The consequence would be economic inefficiency.

We can offer an example of value destruction as follows: imagine a company that trades in the market at a certain multiple of current earnings, it has a long lease of its premises, entered into some time ago so that contracted rent is below market rent. Imagine that this company is taken private and the purchaser
agrees to shorten the lease to a two year term in exchange for a lump sum paid by the lessor (who will be able to re-lease the premises at a higher rent). Under the current proposals the purchaser could then re-sell the company at higher current earnings because occupancy costs would be lower with shorter leases and the balance sheet would not be burdened by the lease liability. In fact value has been destroyed because after two years occupancy costs will rise substantially and the company will risk being forced out of its premises. When the lease terminates the company will lose any investment it has made in fixtures in the building. If the company’s business is closely tied to the building, e.g., a hotel, the business could cease to exist at the end of the lease. How would your proposals reflect these considerations?

We believe that it is better to think of a property lease as a long term supply agreement. As a going concern, a company that requires premises will always require those premises or similar ones. That is determined by the nature of its operations, the number of staff et cetera. The annual cost of its premises will remain with the company for as long as it is in operation, regardless of the term of its lease. It is a structural cost of the business, not a liability. The cost does not depend on the term of the lease. Rent paid is the true cost of occupancy.

Alternatively, if you want to fit this analysis into your conceptual framework, you could say that the right-to-use a property is perfectly offset by the need-to-use the property, which is a structural requirement of the business. Similarly the lease liability will be mostly offset by the landlord’s duty to mitigate its loss.

Yours faithfully

Andrew Fraser