



The Corporate Reporting Users' Forum

International Accounting Standards Board
30 Cannon Street
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Financial Accounting Standards
401 Merritt 7
Norwalk, Connecticut 06856
United States of America

22nd December 2010

Re: Exposure Draft - Leases

Dear IASB/FASB Board Members,

The Corporate Reporting Users' Forum (CRUF) welcomes the opportunity to comment on the Exposure Draft (ED) on Leases. We regard current leasing standards as unsatisfactory and are therefore very keen to see improvements in this area. We also welcome the efforts made by IASB staff to engage with preparers and users before and after the publication of the ED.

Leasing is a controversial and complex subject and it has not been possible to get a consensus across all CRUF participants on all topics. This letter therefore includes divergent views where relevant to try and capture the breadth of opinion across CRUF participants.

Underlying principles

We support:

- The elimination of the arbitrary distinction between operating and finance leases.
- The principle of "right of use". Although some CRUF members prefer the whole asset approach (to make companies more comparable regardless of how the operating assets are



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funded), most members preferred the right of use option. There can be a real operational difference between a company that owns its assets outright and one which uses short-term leases.

- Bringing appropriate assets and liabilities onto the balance sheet.
- Addressing lessee and lessor accounting at the same time. However, we would not want the lessee standard to be delayed because of disagreements over the proposed treatment of lessors. Some members would prefer to see the standard split into separate lessor and lessee standards if the lessor debate takes longer to resolve.
- Improved disclosure. It is often impossible to extract useful information from the notes about leasing assets, liabilities and risks. We think it is very important that the new standard includes a high standard of disclosure, both in the statutory accounts and accompanying notes. Without clear and detailed disclosures the standard has the potential to create another layer of uncertainty for users.

Lease options and contingencies

- We have had considerable debate about this topic from both the fundamental and practical viewpoints. Generally we prefer balance sheet assets and liabilities to be as 'real' as possible otherwise they start to become less useful. We are happy to see contractual lease liabilities capitalised and put on the balance sheet. However as soon as one starts to capitalise potential liabilities such as options to extend, we get into much more subjective territory. Valuing an option to extend is by nature subjective and is also sets a strange precedent; we would be forcing companies to recognise a liability which does not actually exist. We would prefer for the liability to be limited to the actual amount that the company has committed to pay. The correct place to disclose options is in the notes, along with other contingent liabilities.
- On balance, we are nervous about requiring companies to estimate and capitalise contingent lease payments such as revenue-based payments. These contingent liabilities are really future operating expenses as the amount and timing will depend on how the business performs. From a fundamental standpoint, it is difficult to see why contingent lease payments should be capitalised when other contingent costs such as cost of goods, wages and so on are not. It would also be both onerous and subjective for preparers to estimate multi-year future contingent liabilities.



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- As users, we also ask ourselves what we would do with this information. While it would be interesting to see more information about options and contingencies, we do not see that the utility of the balance sheet would be improved by including these very subjective items as concrete liabilities. We recognise that requiring lessees to capitalise only contractual liabilities may create opportunities for structuring but this is preferable to having a potentially meaningless (and also much larger) asset and liability.
- The CRUF's guiding principles state that "the purpose of the balance sheet should be to reflect the capital invested in the business along with capital adequacy, compliance with legal covenants and stewardship". Capitalising option and contingent payments would breach this principle.
- Restricting the capitalised liability to the contracted lease payments would mean that users could treat the liability as analogous to debt. Reported leverage would on balance rise (on the assumption that most users would treat the liability as debt) but it would still be meaningful number. Including capitalised options and contingencies in total debt could (and probably would) result in a meaningless debt number and hence meaningless leverage ratios.
- However, some members argued that management's best estimates of future optional and contingent liabilities would be useful to investors and therefore should form part of the accounts. We see two possible solutions here. Uncertain future payments could be 1) capitalised and put on the balance sheet but given their own heading to distinguish them from contracted lease liabilities or 2) reported in the notes, in a similar way to other contingent liabilities. Either option would preserve the utility of debt and leverage numbers but remove a possible incentive to structure leases that produced low capitalised lease liabilities at the expense of onerous future optional/contingent costs.

Changes to the income statement

- Under the current proposals, lease costs as charged to the P&L are higher at the start of the lease and fall as time passes. We are concerned that 1) there may be a mismatch between cash costs and P&L expenses, which is inherently undesirable and 2) there will be a temptation for some managers to use the slope to massage profitability. There is a valid theoretical reason for the lease costs to fall over time but whether the theoretical purity is better in practice than simple straight line expensing is debatable.



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- A minority of members felt strongly that the front loading would distort reality, particularly for long term leases. For example, under a 20 year lease with a 6% discount rate, the P&L charge at the start of the lease would be twice as high as the charge at the end. Shortening the lease term to 5 years would reduce the year 1 expense by 13%. This will make comparisons between companies more difficult and create possibilities for companies to influence reported profitability without affecting cash flow.
- Under the current transition plan, most if not all lessees will experience a sudden and temporary fall in profitability as the new standard is implemented, followed by a steady increase as the P&L lease cost falls. Quite apart from the theoretical issue of whether lease costs should be flat or declining over time, introducing a major new standard which causes the profitability of all lessees to fall and then rise will almost certainly cause widespread adverse comment from both professional and casual users. This is both undesirable and avoidable and we would encourage the boards to adopt smoother transition methods.
- It will be important that the lease component of interest and amortisation be broken out. Amortisation is traditionally considered a non-cash charge and under the ED lease amortisation would have both cash and non-cash elements. Without appropriate disclosure, analysts will be unable to determine the relative component of each. A detailed note to the accounts would be appropriate.

Lessor accounting issues

- One of our main complaints about current lessor accounting is that it is impossible to penetrate and analyse the inherent residual value risks. This is best addressed by more thorough disclosure. It is not clear whether the new standard would adequately address this.
- We generally prefer the derecognition model for all leases as we believe that the lessor should have assets that are symmetrical to the liability of the lessee plus the present value of the residual asset at the end of the lease term (or using a fair value of the residual as an alternative).
- We agree that there should be an exemption for short term leases (such as car hire) where we see no benefit in forcing the lessor to capitalise future lease receipts and derecognise a portion of the underlying asset. However, we are not convinced that lessors should have this treatment available as an option on a lease by lease basis.



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- A minority of CRUF members support the proposed hybrid model for lessors. Whilst they agree that a single accounting model for lessees is desirable, they believe that differences in the economics of lessor business models are too great to support a 'one size fits all' approach. They agree with the boards that the derecognition approach is appropriate where the lessor's business model is primarily the provision of finance while the performance obligation approach is appropriate where the lessor's business model is primarily to generate a return from management of the underlying assets.

Scope and service contracts

- Whilst we do not believe that service contracts should fall within the scope of this standard, we are not convinced that a robust definition is presented in the standard to allow preparers to consistently present their accounts. One example cited in discussions within the CRUF was the use of a ship – if the owner provides the captain then it may be a service contract but if the client provides the captain then it is a lease.
- Where any bundled service is material it will be important for analysts to understand the integrated nature of the contract. If, for example, it was not clear from accounts that a mining company relied on a single contractor for both the mining service and equipment, the financial and contract risk could be understated.

Disclosure

- As mentioned above, we would like to see better disclosure in the notes about a company's overall leasing policy and structure where relevant. Similar companies in the same sector often make very different use of leasing. As users, we want to understand the business implication of a company's leasing arrangements. A company that uses short-term renewable leases can be a different investment proposition to one that uses fixed long-term leases. The former will have lower financial risk but greater business risk. The notes should provide enough information to enable users to understand the financial and business dynamics.
- It is currently very difficult (and frequently impossible) to trace the impact of leasing arrangements in the cash flow. This should be addressed, especially for lessors. As many investors will treat future capitalised contracted lease payments as debt, a reconciliation



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between the cash flow and movement in net debt becomes even more important. The lack of a cash flow / net debt reconciliation is a long-standing CRUF complaint and we would hate to see the leasing standard make the current situation even worse.

- It is important that there is a clear reconciliation of the charge, cash impact and balance sheet movements. This could be structured along the line of the current PP&E note but with additional information on cash / non-cash charge and any revaluations. Key assumptions on terms (e.g. duration of lease contract), options and contingencies also need to be disclosed.

Impact of fair value¹ accounting.

- The standard already moves further away from cash accounting which in itself creates additional concerns for analysts. In particular we believe the revaluation of capitalised assets could create the potential for further distortion of the reported earnings. As the majority of PP&E is now in accounts at cost, the potential for the revaluation of leased assets could impact the future leasing charges and provide one off earnings adjustments. We believe these should be limited as much as possible and where revaluations are deemed necessary, the changes should be detailed in the notes.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB and FASB.

CRUF participants come from all around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views,

¹ This note does not fully reflect the richness of CRUF view on fair value. To understand more fully the nature of the debate within the CRUF community on this topic, we recommend that the reader review the comment letters on www.cruf.com.



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though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

We sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum (www.CRUF.com) and not as representatives of our respective organizations. The views expressed are those of individual CRUF participants and do not necessarily reflect the views of the respective organizations where we are employed.

The participants in the Forum that have specifically endorsed this response are listed below.

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