17th July 2009

Sir David Tweedie,
Chair, International Accounting Standard Board
30 Cannon Street
EC4M 6XH
United Kingdom

Mr. Robert Herz,
Chair, Financial Accounting Standard Board
401 Merritt 7
P.O Box 5116
Norwalk, CT 06865-5116

Re: Comment Letter on Leases Preliminary Views

Dear Sir David and Mr. Herz,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the IASB and FASB's joint project- *Leases Preliminary Views - Discussion Paper (DP)*.

The CFA Institute Centre represents the views of its worldwide members, including portfolio managers, investment analysts, and advisors. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, Brussels and London, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

BACKGROUND

Leasing is a contractual process by which the ownership rights and the right of use of the asset are separated and can be held by different parties. The lessee acquires the right to use the asset while the lessor retains the ownership of the property. The rights of the lessee (i.e. the limits within which the lessee may use the asset) as well as the lessee's obligations to the lessor are spelled out in the lease document. The right-of-use asset can be seen as the benefit to the enterprise of being able to use assets that belong to someone else to generate revenue and profit for the enterprise.

Leasing is an important source of finance to business[3]. Therefore, it is important that lease accounting standards provide users of financial statements with a complete and understandable picture of an entity's leasing activities. This is premised on the need for balance sheets across reporting entities, to fully reflect all their assets employed to generate returns plus the financing of such assets.

Summary of DP proposals

As part of the 2006 Memorandum of Understanding (updated in 2008) between the two boards, on March 19, 2009, the FASB and IASB issued a joint discussion paper expressing their preliminary views on lease accounting by lessees, consistent with their July 2008 decision to focus an initial discussion paper and subsequent exposure draft on lessee accounting. The boards tentatively decided to adopt a new accounting model for leases that results in the lessee separately recognising:

- an asset representing its right to use the leased item for the lease term (the 'right-of-use' asset)
- a liability for its obligation to pay rentals.

While current accounting standards offer two approaches to lessee accounting - operating leases and financing (capital) leases - the DP permits only <u>one</u> method. For all leases, firms would recognize on the statement of financial position a right-of-use asset and a liability for an obligation to pay rentals. It will be similar to the financing lease treatment. The proposals by the boards effectively bring onto the balance sheet operating leases whose balance sheet impacts can currently only be inferred from the note disclosures. All leases would be treated by lessees as capital leases (or financing leases under IFRS), requiring lessees to recognize on the balance sheet an asset and liability associated with the transaction, rather than recording an expense with no balance sheet impact, as would be the case under existing accounting for operating leases.

The focus of the DP is on lessee accounting. Lessor accounting is excluded from the scope of the project. The reasons that the boards have provided for this exclusion are that they believe user concerns primarily relate to transparency and comparability of lessee operating lease accounting. Other factors stated are that lessor accounting has unresolved cross cutting issues with revenue recognition and de-recognition, it will need to address investment property accounting, and prioritization of lessee accounting will facilitate the timely improvement and convergence of financial reporting.

The appendix contains more details of the approaches by the boards

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[3] ''According to the World Leasing Yearbook 2009, in 2007 the annual volume of leases amounted to US $760 billion. However, the assets and liabilities arising from many of those contracts cannot be found in entities' statements of financial position (balance sheets).'' —Introduction of FASB-IASB Snapshot, Leases: Preliminary Views

EXECUTIVE SUMMARY OF CFA INSTITUTE POSITIONS

The DP proposes to eliminate the finance and operating lease categories and would instead require the recognition of lease assets based on the right-of-use and a liability based on the obligation to pay rentals. Overall, the proposed approach is a step in the right direction and will constitute a significant improvement from current practice as it will result in the capitalization of the hitherto off balance sheet operating leases. We agree with the articulated difficulties facing financial statement users, including the inconsistent treatment of similar economic transactions and the need for rule of thumb approximations when making analytical adjustments due to incomplete and inconsistent disclosure of related operating lease information. The proposed approach will improve financial reporting by resulting in a more accurate display of financial leverage in firms that are currently employing the operating lease method of accounting. It will also reduce structuring opportunities and opaque off balance sheet financing.

Below is a summary of our key positions

Overall approach: We strongly support the application of the right–of-use approach for all leases and consider it to be a significant improvement to financial reporting. We reluctantly support the decision to prioritize lessee accounting so as to ensure the timely enhancement to current practice. However, we believe the boards should deliberate the aspects of lessor accounting that could impact on or be influenced by the revenue recognition model. We are also concerned about divergent approaches (between the boards) in subsequent re-measurement and urge the boards to align their views and present a single approach, so as to ensure the realization of a truly converged standard.

Measurement approaches: We would prefer that the lease asset and liability be measured at fair value as this would provide users with the most decision useful information. We are cautiously optimistic that discounting rental payments would approximate fair value and, for this reason, find it to be an acceptable approach. We support the use of expected value, as applied under IAS 37, in the measurement of lease contracts with options, contingent rentals and residual value guarantees. We believe the expected value approach provides the best answer in the valuation of cash flows with significant uncertainty.

We do not support the reasoning that subsequent measurement of lease asset and obligations has to be consistent with that of other non-financial assets and non-lease financial liabilities. Such an approach can only constrain the overall improvement of financial reporting as the reference standards themselves require improvement.

Presentation of leases: We would urge both boards to separate the right-of-use from other owned assets, and the related obligation from other obligations. This is one of the areas with what would appear to be an unnecessary divergence in approach.

Disclosure: We strongly advocate that disclosure requirements be always addressed in parallel with any recognition and measurement improvements and not as an afterthought as this can influence the quality of disclosures provided. An additional factor is that the Boards should consider related disclosures when deciding on whether a particular measurement approach meets user needs.

GENERAL COMMENTS

CFA Institute surveys have consistently shown that users find off balance sheet accounting, of which the treatment of operating leases comprises a significant subset, to be one of the most deficient areas of financial reporting. Under current standards, two leases that are substantially identical may be accounted for differently because one lease has been crafted to fit on one side of the "bright line" standard. Obligations under operating leases, which may be highly significant to the enterprise (consider retailers in the current economic environment) are relegated to footnote disclosure.

We believe that the capitalization of operating leases is a significant improvement from current practice. However we would urge the boards to be a little more bold when enacting improvement approaches to both initial and subsequent measurement and not to be constrained by the goal of being consistent with existing reporting standards that bear deficiencies in their measurement basis. Consistency with these standards is often cited in the DP as one of the reasons that the boards avoided fair value measurement (and re-measurement) of the right-of-use asset and the rental obligation. Such consistency is undesirable and hampers the improvement of financial reporting. We also believe the expected value approach is most appropriate for situations with uncertainty such as the measurement of leases with renewal options, contingent rentals and residual value guarantees and that both boards should apply this approach.

Scope: Short term and 'non-core' leases
We support the broad application of the proposed approach regardless of the nature of the leased asset. We would also encourage the boards to define leases broadly, so that the standard applies to leases of natural resources and intangible assets, take or pay contracts, throughput agreements, and other contracts that effectively permit one firm to use the assets of another.

We support the view that short term leases (no longer than 6 months) do not necessarily need to be capitalized provided that there is adequate corresponding disclosure that enables both retroactive and prospective assessment of their effect on the enterprise. However we do not believe 'non-core' leases should be exempt from capitalization requirements. Aside from the difficulty of defining 'non-core', information regarding the utilization of 'non-core' assets is decision useful to users. We would concur with the view that all assets employed are 'core' and therefore of interest to suppliers of capital. We believe that there is no difference between an obligation for 'core' assets and one for 'non-core' assets since we assume that lessors have a preference for timely payment regardless of the nature of the asset. Creditors and investors should be equally cognizant of all obligations regardless of the nature of the underlying asset.

Scope: Exclusion of Lessor Accounting
We recognize that the boards seek to complete a significant number of key MoU projects including leasing before 2011. We are disappointed that the Boards have chosen not to address lessor accounting as part of this project. We agree that the benefits of a completed, implemented and improved lessee accounting standard justify the decision to avoid the risks associated with trying to develop a comprehensive lessor and lessee standard.

However, the boards should continue to bear in mind the risks associated with a partially developed lease standard. Lessor accounting has cross cutting implications across the revenue recognition, insurance and de-recognition projects. There is the expectation that revenue recognition approach will help resolve lessor accounting. Revenue recognition is a key MoU project and while we were critical of the limited

scope approach, we assumed that such an approach could be mitigated by the parallel development and cross pollination of the excluded elements such as leases. Additional risks of the deferral of lessor accounting are that it could result in asymmetrical accounting treatment, escalate the requirements for preparer implementation guidance, and this could be confusing for users of financial statements.

We note that in the May 2009 deliberations and in the DP, the boards continued to evaluate the potential approaches to lessor accounting. We would urge the Board to continue with the groundwork necessary to follow up with lessor accounting as soon as possible after the completion of the lessee accounting. Such efforts will also inform other related projects such as revenue recognition that are occurring in parallel.

Scope: Disclosure Requirements.
We strongly recommend defining disclosure requirements parallel to the recognition and measurement requirements across all projects. Disclosure requirements should not be subordinated as that contributes to the provision of insufficient, inconsistent and difficult to understand disclosures. The proposed lease accounting model calls for the recognition of a right to use asset and an obligation which, respectively, meet the definition of an asset and a liability. Given that reasonably robust disclosure requirements exist for similar assets and liabilities,it is unclear why disclosure requirements are not being developed along with the effort on recognition and measurement.

Board deliberations of accounting standards should consider the related disclosures contemporaneously as the form and content of disclosures can shed light on the appropriateness of measurement approaches. When the standard setters treat disclosures as an afterthought to recognition and measurement requirements, as has happened on this and the revenue recognition project, it can mislead investors at the time of transition to the new accounting and contribute to financial statement preparers not putting in sufficient effort to provide adequate disclosures. Similar to the de-recognition project, the boards should have a framework of identifying and deliberate user disclosure requirements and seek user feedback on these and any additional required disclosures. We outline our recommended disclosures below, under the "Presentation and Disclosures" heading.

Convergence
There are divergent approaches between the FASB and the IASB on several key areas in relation to lease accounting. These include the reassessment of likely lease term and incremental borrowing rate, capitalization of intangible assets, re-measurement of residual guarantees and contingent rentals, and the accounting for re-measurements. Convergence to the highest quality accounting standard is one of primary reasons that this project is a priority and we would hope that the Boards will align their views prior to issuing an exposure draft.

SPECIFIC COMMENTS

INITIAL AND SUBSEQUENT MEASUREMENT
Overall, we believe the boards' objective of improving financial reporting is hampered by anchoring its chosen measurement approach to that of existing non financial asset and financial liabilities standards despite their deficiency of being based on amortised cost. There is an inherent logical flaw when reporting choices are made mainly so as to ensure consistency relative to standards that also require improvement. Such an approach is antithetical to the goal of seeking aggregate improvement to financial reporting

quality. The Boards are concerned with the inconsistencies between lease obligations and other similar financial liabilities. Although the DP acknowledges that the initial measurement based on the discounting of rental payments is close to fair value, it is odd that it categorises the approach as amortised cost. This seems to be done so as to allow the subsequent measurement approach to be consistent with other non financial assets.

As a first choice, we would prefer the measurement of both the right to use and obligations to pay rentals to be based on fair value. This would be a significant and complementary improvement to the decision to require capitalization of operating leases. Fair value measurement allows investors to evaluate corporate managers' lease versus buy decisions over time. Despite the argument posed of fair value being costly and complex for preparers, we assume that managers continuously assess the economic advantages of entering into lease arrangements and that such judgments can only be meaningfully done on a fair value basis. We find it hard to believe that preparers do not know the fair value of the assets they choose to lease.

We would not, however, support allowing the fair value election of the measurement of obligation to pay rentals. Our experience thus far with the fair value option is that it provides preparers with flexibility without providing transparency to financial statement users.

The DP proposes that lease obligations will be recorded based on the present value of the lease payments, contingent rentals and residual value guarantees, discounted at the lessee's incremental borrowing rate. We agree that measurement that is based on the discounted cash flow approach is likely to approximate fair value and therefore would support it as a basis of measurement of the rental payment liability and right to use the leased asset. The DP does not present any approaches to the impairment of the right-of-use asset, and we encourage the boards to develop impairment models for the right-of-use asset.

We would prefer the re-measurement, at each reporting period through earnings, of rental obligations based on an updated estimate of the expected cash flows and a reassessment of the incremental borrowing rate. We believe that an expected value approach yields the best answer for contracts that are characterized by uncertainty due to optional future cash flows and would be proximate to fair value measurement. We support the prospective approach that adjusts both the cash flows and discount rate as opposed to the catch up rate suggested by the IASB.

We are also concerned that the boards are proposing divergent views on remeasurement and recording of re-measurement. We support the IASB use of an expected value approach rather than the most likely cash flow projection for contingent rentals and residual value guarantees. We support the recognition of these remeasurement changes each reporting period through the profit and loss account as proposed by the FASB. We believe that only the portion of the change in the rental obligation that represents a change in the expected lease term should be recognized as an adjustment to the right-of-use asset rather than through profit and loss.

OPTIONS

Consistent with our general view that all assets and liabilities should be reported at fair value, we would also prefer the separate fair value measurement of options to purchase or renew the lease. The DP makes the argument that unlike financial options, lease options are hard to value. However, we note that not all financial options are traded. Besides, the mentioned concerns overlook the advances in real option valuation theory that can enable the valuation of capital investments based on managerial flexibility. If

management is making buy or lease decisions based on underlying options, the basis of such decisions should be conveyed to users of financial statements. While measurement error and measurement difficulties may still arise, the disclosure of valuation of options will provide decision useful information on asset-liability management. For example, it is useful to know whether they exercise out of the money options and, if so, why they do so.

As an alternative to separation and fair value determination of options, the DP proposes the determination of the obligation based on the most likely lease term. The use of an expected lease term based on the contract and past practice is an acceptable alternative in the interim until the use of fair value for non-financial assets is addressed by standard setters.

PRESENTATION AND DISCLOSURES

We would support the approach that requires the separation of both the right to use the asset and obligation to pay rentals from other owned assets as proposed by the FASB.

Cash flow statement presentation is excluded from the scope of the project but it is necessary to address this as the proposed approach will have an impact on reported operating, financing and investment cash flows. We believe that the right-of-use asset should be reported as an investing cash flow at lease inception. Similarly, the rental obligation should be reported as a financing cash flow at inception; lease payments should be reported as financing cash flows, bifurcated between interest income and principal repayment.

We would propose the inclusion of the following disclosures

- Roll-forward of balances of both the right-of-use asset and the related obligation. The roll-forward should show new leases, terminations, and reassessments separately from current period operating effects
- Summarized disclosures of lease terms, renewal options, renewal history, purchase options, discount rate and sensitivity analysis.
- Discussion of factors influencing the determination of the expected lease term and the incremental borrowing rate

Short-term lease disclosures:

- Nature of assets leased
- Description of rental terms (e.g. contingent payments)
- Average lease term
- Payments made during the reporting period
- Remaining payments as of the end of the reporting period, and
- Renewal options and the extent to which the leases are expected to be renewed.

CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at vincent.papa@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht
Kurt N. Schacht, CFA
Managing Director
CFA Centre For Financial Market Integrity

/s/ Gerald I. White
Gerald I. White, CFA
Chair, Corporate Disclosure Policy Council

Cc: Corporate Disclosure Policy Council

APPENDIX

Initial measurement:
- The lessee's obligation to pay rentals should initially be measured at the present value of lease payments, discounted using the lessee's incremental borrowing rate, which should approximate fair value.

- The lessee's right-of-use asset should initially be measured at cost, equal to the present value of lease payments, discounted at the lessee's incremental borrowing rate.

Subsequent measurement:
- Obligation to pay rentals. In deciding between a fair value and amortized cost-based approaches to obligation measurement, the boards tentatively favored the amortized cost-based approach. It is more consistent with the measurement of other non-derivative financial liabilities, consistent with the initial measurement of the obligation to pay rentals, and simpler and less costly for preparers than a fair value approach.

The boards split on the issue of remeasuring the obligation for changes in the lessee's incremental borrowing rate:

FASB: tentatively decided that the lessee's incremental borrowing rate *should not* be reassessed, consistent with the amortized cost-based approach used for non-derivative financial instruments.

IASB: tentatively decided that the lessee *should* remeasure the obligation to pay rentals to reflect changes in the lessee's incremental borrowing rate, but has not decided whether the remeasurement should take place at each reporting date or only when there is a change in estimated cash flows.

- The boards tentatively decided that changes in estimated lease payments (in lease contracts with extension or termination options, purchase options, contingent rental arrangements, or residual value guarantees) should be included in the lessee's obligation to pay rentals using the catch-up approach. The

catch-up approach would revise the carrying amount of the obligation to pay rentals, equal to the present value of the revised estimated cash flows discounted at the original effective interest rate (or the revised incremental borrowing rate if adjusted to reflect current events as the IASB tentatively decided).

- *Unresolved: whether to allow preparers to elect fair value measurement, as preparers have the option of doing now for certain financial liabilities (other than lease obligations.)*

- **Right-of-use asset.** In deciding between a fair value and amortized cost-based approaches to the subsequent measurement of the right-of-use asset, the boards tentatively favored the amortized cost-based approach. It is more consistent with the measurement of other non-financial assets, consistent with the initial measurement of the right-of-use asset at cost and is simpler and less costly for preparers than fair value.

- Amortization of the right-of-use asset is to be over the shorter of the lease term or the economic life of the asset. The economic life of the asset would be used when it is expected that the lessee will obtain title of the leased asset at the end of the lease.

- *Unresolved: Views on the impairment of right-of-use assets have not been reached.*

Leases with options:
- The boards tentatively decided not to recognize lease options separately from the right-of-use asset, and also decided to address uncertainty about the lease term through recognition based on a possible lease term. For example, a 10 year lease with an option to extend for 5 years would be recognized as either an obligation to pay rentals for 10 years or 15 years.

- The lease term used to recognize an obligation to pay rentals would be the most likely lease term, or the lease term with the highest probability, determined based on reasonable and supportable assumptions. The lessee would determine the most likely outcome using contractual, non-contractual and business factors. Previous practices and the lessee's intentions would not be considered.

- The boards tentatively decided to require the reassessment of the lease term at each reporting date, with changes in the obligation to pay rentals recognized as a change to the carrying amount of the right-of-use asset.

Leases with purchase options:
- The boards tentatively decided that leases with purchase options should be accounted for the same as leases with extension or termination options.

Contingent rentals:
- The boards tentatively decided that contingent rental payments should be reflected in the liability because the lessee has an unconditional obligation to pay rentals; only the amount to be paid is uncertain.

- The boards disagreed on the method to be used to measure the contingent rental payments in the liability.

IASB: tentatively decided that a *probability-weighted estimate of contingent rental payments* should be included in the lessee's obligation to pay rentals, and should be reported as an adjustment to the carrying value of a right-of-use asset.

FASB: tentatively decided that the *most likely rental payments*, determined by considering a range of possible outcomes, should be included in the lessee's obligation to pay rentals. Lease rentals contingent on changes in an index or rate should be initially measured at the index or rate existing at lease inception, and changes in the amounts payable due to changes in the index or rate should be recognized in profit or loss.

- The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for *changes* in estimated contingent rental payments, but split on how to report changes resulting from remeasurement.

IASB: tentatively decided to require remeasurement changes to be recognized as an adjustment to the right-of-use asset.

FASB: tentatively decided to require remeasurement changes to be recognized in profit or loss.

Residual value guarantees:
- The boards tentatively decided that leases with residual value guarantees should be accounted for in the same manner as leases with contingent rentals. While a residual value guarantee meets the definition of a liability, the boards decided against separate recognition and instead decided on their inclusion in the obligation for lease payments.

- As with contingent rentals, the boards parted ways on the measurement of residual value guarantees:

IASB: tentatively decided that a *probability-weighted estimate of residual value guarantees* should be included in the lessee's obligation to pay rentals. In the IASB's view, changes in the obligation to pay rentals resulting from a reassessment of the payments to be made for residual value guarantees should be reported as an adjustment to the carrying value of a right-of-use asset.

FASB: tentatively decided that the *most likely residual value guarantee payments*, determined by considering a range of possible outcomes, should be included in the lessee's obligation to pay rentals. In the FASB's view, changes in the obligation to pay rentals resulting from a reassessment of the payments to be made for residual value guarantees should be recognized in profit or loss because such changes do not increase or decrease the value of a right-of-use asset.

Presentation:
Obligation to pay rentals. The boards differed on the presentation of the obligation to pay rentals:

IASB: tentatively decided *not* to require separate presentation of the obligation to pay rentals on the statement of financial position.

FASB: tentatively decided to *require* separate presentation of the obligation to pay rentals on the statement of financial position.

Right-of-use asset. The boards tentatively decided that the right-of-use asset should be presented in the statement of financial position on the basis of the nature of the leased item, but presented separately from owned assets.

Income statement. Reductions in right-of-use assets presented as property, plant & equipment and intangible assets in the statement of financial position should be presented as depreciation and amortization, respectively, in the income statement. If the obligation to pay rentals is presented separately in the statement of financial position (FASB view), the interest expense on the obligation should be presented separately in the income statement. On the other hand, if the obligation to pay rentals is *not* presented separately in the statement of financial position (IASB view), the interest expense on the obligation should be included in general interest expense.