

**American Accounting Association’s Financial Accounting Standards Committee
Response to FASB Invitation to Comment on the G4+1 Special Report
Leases: Implementation of a New Approach**

Stephen G. Ryan, Chair; Robert H. Herz; Teresa E. Iannaconi;
Laureen A. Maines; Krishna Palepu; Katherine Schipper;
Catherine M. Schrand; Douglas J. Skinner; Linda Vincent

The Financial Accounting Standards Committee of the American Accounting Association (hereafter the Committee) is charged with responding to requests for input from standard setters on issues related to financial reporting. The Committee is pleased to respond to the FASB’s invitation to comment on the G4+1 Special Report, “Leases: Implementation of a New Approach” (hereafter the Special Report). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

Our response to the Special Report is presented in four sections. The first section summarizes the Committee’s views as to the main characteristics of a conceptually sound leasing standard. The second section summarizes relevant empirical research findings. The third section discusses issues that apply broadly to the specific questions posed in the Special Report. The fourth section contains responses to those specific questions. In developing the specific responses, the Committee was guided by the discussion in the first three sections.

Characteristics of a conceptually sound leasing standard

The Committee supports development of a single, conceptually sound approach to accounting for all types of leases and believes that such an approach should have the following characteristics:

1. The approach should recognize that *all* leases, regardless of their specific terms and conditions, create assets and liabilities. In particular, the nature of the property being leased should not affect the accounting, nor should the length of the lease.
2. The approach should recognize that the accounting for leases is a special case of the accounting for contracts. The accounting for *all* contracts should be placed on a sound conceptual footing, and the principles developed for leases should be both internally consistent and generalizable, in the sense that the principles governing the accounting for leases should be suitable for application to the accounting for contracts generally.
3. The approach should be robust to shifts in the contractual details of lease contracts when such shifts do not materially alter the economic substance of the arrangements. In particular, the approach should require that substantially similar lease contracts be accounted for similarly and substantially dissimilar lease contracts not be forced into a misleading appearance of comparability.
4. The approach should take account of practical realities of the leasing market that often make measuring the assets and liabilities in lease contracts difficult. The leasing market is

characterized by customized as opposed to standardized contracts, which may make it difficult or even infeasible to identify similar lease contracts.¹ Moreover, public information about the specifics of lease contracts is often unavailable.² As a result, the market for trading lease receivables and liabilities is not well-developed. In addition, one or both parties to a lease contract may face substantial transaction costs for relocating and releasing assets under lease; such frictions may provide incentives that affect the contractual lease provisions.

While the measurement difficulties discussed in point 4 above must be considered carefully, the Committee believes that the principles governing the accounting for lease receivables and liabilities should conform to the accounting for other financial instruments. In this regard, we note that in previous comment letters to the FASB (most recently, to its December 1999 Preliminary Views “Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value”), the Committee stated its support for fair value accounting for financial instruments once the conceptual and measurement issues are resolved.

Review and discussion of empirical research

This section contains three parts. Part 1 surveys empirical research and related practice on the use of financial report disclosures of minimum lease payments for operating leases (hereafter operating lease disclosures) by investors for equity valuation and equity risk assessment purposes. This research generally finds that estimates of the lease obligation derived from the operating lease disclosures are associated with the market value of equity and market-based measures of equity risk similar to recognized capital leases and debt. Likewise, evidence indicates that practitioners treat operating leases like debt. Part 2 summarizes empirical research on the question of whether balance sheet recognition of operating leases would be more useful than the current disclosures of minimum lease payments for decision-making purposes. The research findings are mixed but suggest that the usefulness of lease information to decision-makers would not be reduced and might be improved by recognition rather than disclosure of all leases. Part 3 surveys empirical research that describes how leasing behavior has changed over time in response to changes in accounting rules.

1. Existing research indicates that operating leases are similar to capital leases and debt for valuation and risk assessment purposes.

Academic accounting research generally finds that leases, regardless of whether they are accounted for as operating or capital leases, are treated like debt for risk assessment and valuation purposes. For example, Bowman (1980) reports that estimated lease liabilities based on ASR 147 disclosures are positively associated with market-based measures of equity risk. Similarly, Ely (1995) and Imhoff, Lipe and Wright (1993,1995) find that operating lease liabilities, estimated using SFAS 13 disclosures, are positively associated with measures of

¹ Contrast this with the market for mortgage-backed securities, which was created by entities such as Fannie Mae and Ginnie Mae. These intermediaries also facilitated the standardization of the traded instruments.

² Item 601 of Regulation S-K, which defines the exhibits to be included in SEC filings, requires in the section on Material Contracts that “any material lease under which a property described in the registration statement or report is held by the registrant” be included as an exhibit.

equity risk. Whisenant (1998) reports that the market value of equity reflects estimated operating lease liabilities based on SFAS 13 disclosures.

Finance research provides a slightly different view, in part because it focuses on attributes (such as differences in tax benefits) that distinguish lease financing from debt financing. Classical finance theory (e.g., Myers, Dill and Bautista, 1976) assumes Miller-Modigliani (essentially frictionless) markets. Assuming no taxes or that leases and debt are taxed in the same way and also that the lessor is able to finance the leased asset with 100% debt financing, leases and debt are perfect substitutes for the lessee, i.e., a dollar of economic lease liability displaces a dollar of debt. When tax differences between leasing and debt are introduced (so that leasing shifts tax benefits from lessees to lessors) or when the lessor has to finance the leased asset in part with equity, leases and debt become imperfect substitutes with a dollar of lease displacing more or less than a dollar of debt conditional on the relative tax rates of lessee and lessor and the ability of the lessor to finance the leased asset with debt.

In contrast to this classical theory, which excludes most of the frictions that characterize actual markets, recent empirical evidence examines the *observed* relations between debt and leases. Bowman (1980) and Ang and Peterson (1984) report that firms with more debt also have more leases, results consistent with debt and leases being complements, not substitutes. Extending these results, Lewis and Schallheim (1992) provide evidence that the tax advantages of leasing induce firms to increase the total amount of debt-like claims in their preferred capital structure. These results do not imply that leases are not similar to debt, but rather the results indicate that leases and standard forms of debt often have different claim priority as well as different tax, incentive, and contracting implications (Barclay and Smith, 1995).

Financial analysts also treat non-cancelable leases like debt with the nature of the analysis becoming more sophisticated over time. For example, until recently Standard & Poor's debt rating analysis estimated the operating lease liability by multiplying the annual rent by a factor of eight and adding the result to balance sheet debt. Cottle, Murray and Block (1988) state that this rule-of-thumb procedure is consistent with the approach of many security analysts. Currently, Standard & Poor's (2000) converts all operating leases to capital leases as described below:

The debt-equivalent value of operating leases is determined by calculating the present value of minimum operating lease obligations as reported in the annual report's footnotes. The lease amount beyond five years is assumed to mature at a rate approximating the minimum payment due in year five.

Cottle, et al. (1988) and Copeland, Koller and Murrin (1990) both advocate that security analysts treat operating leases in much the same way as Standard & Poor's current approach.

2. Empirical research on disclosure versus recognition of leases finds mixed results, but suggests that the usefulness of lease information to decision-makers would not be diminished and might be improved by recognition of all leases as proposed in the Special Report.

Wilkins and Zimmer (1983) find that a group of loan officers treated all leases as debt-equivalents, regardless of whether the lease information was recognized or disclosed, consistent

with disclosure being sufficient for credit decisions. However, loan officers are presumed to be sophisticated decision-makers who are particularly conscious of leverage, and the results might not generalize to equity investors. Imhoff, Lipe and Wright (1993, 1995) find that market-based equity risk measures appear to reflect simple estimates of operating lease liabilities. Specifically, Imhoff et al. explain a greater proportion of equity risk when they estimate operating lease liabilities using the rule-of-thumb procedure described by Cottle, et al. (1988) (8 times the recognized annual rent expense) than they when they use the more sophisticated approach of estimating these liabilities as the present value of the minimum lease payments.

Finnerty, Fitzsimmons and Oliver (1980) compare estimates of systematic risk across three periods (pre-ASR 147, when little lease information was required; during the period of ASR 147 footnote disclosures; and during the post-SFAS 13 period, when capital leases became recognized on the balance sheet). They find no change in systematic risk across the three periods and conclude that investors used information about leases from sources other than financial reports to assess risk. Their study, however, does not control for shifts in financing associated with SFAS 13, as described in part 3 below.

3. Empirical research finds that leasing behavior changes when lease accounting rules change.

Imhoff and Thomas (1988) find that many lessees restructured their existing capital leases in response to the adoption of SFAS 13 and that the most common effect of SFAS 13 was the substitution of operating leases for capital leases, presumably in order to avoid liability recognition. They also find evidence that firms substituted equity financing for leases. Debt covenants, managerial compensation, and taxes have all been identified as influencing lessees' choice of lease type under SFAS 13 (El-Gazzar, Lilien and Pastena, 1986; Morsfield, 1999).

The recent development of the synthetic lease provides another example of leasing behavior affected by accounting rules. Synthetic leases take advantage of differences in the criteria for capital leases under SFAS 13 and IRS tax rules to provide operating lease treatment for financial statement purposes and capital lease treatment for tax purposes.³ Synthetic leases are typically so complex and costly to structure that they are rarely used for leasing transactions under \$10 million. Synthetic leasing has been studied both by academic researchers (Morsfield, 1999; Weidner, 2000) and practitioners (Holmes, 1996; Sandler, 2000).

General issues raised by questions posed in the Special Report

In this section, we discuss two related issues that apply generally to the questions posed in the Special Report on leasing as well as to the accounting for contracts. The first issue is whether the signing of a contract is a transaction that should be recognized in financial statements. The discussion on this issue is based in part on accounting theory research regarding leases and other

³ Law (1999) states that synthetic leasing is largely restricted to U.S.-based entities or entities with lease obligations reported under U.S. GAAP. He notes, however, that non-U.S. entities using IAS 17 may also be eligible for synthetic leasing but that few synthetic leases have closed outside of the U.S.

executory contracts. This literature does not generally distinguish the two kinds of contracts.⁴ The second issue is whether payments that are optional but probable because of the terms or context of a contract should be reflected in recognized assets and liabilities.

The Committee believes the goal for lease accounting is to represent the underlying economics of the contracts. The Committee also believes this goal is better served by accounting standards that rely on expert judgment based on all facts and circumstances than by standards that establish bright line rules. Although the Committee recognizes the potential problems of a judgment-based approach, particularly with respect to measurement issues and the perceived reliability of the reported results, we believe that the importance of economic relevance outweighs such concerns. In addition, the Committee reiterates that the accounting for lease assets and liabilities should reflect the value of the rights and obligations conveyed by the lease, not the value of the physical assets.

1. Is the signing of a contract a transaction that should be recognized in financial statements?

The accounting theory literature (e.g., Rappaport, 1965; Vatter, 1966; Wojdak, 1969, and Ijiri 1980) discusses when leases should be recognized on the balance sheet – at the signing of a contract or at delivery – and whether leases are logically different from other executory contracts. Regarding the timing of lease recognition, Vatter states “[t]he lease is a complete transaction. The relations established by the contract are positive and specific; even though certain acts are unperformed, the arrangement is incomplete only in the sense that it involves future time.” Consistent with this argument, Wojdak likewise defines a transaction as an exchange of service potentials, not as the immediate availability of service potentials. Rappaport, Vatter, Wojdak, and Ijiri each argue that the *signing* of leases yields expected benefits and incurs obligations, and therefore should result in balance sheet recognition of both assets and liabilities.⁵ Wojdak and Ijiri both extend this conclusion to other contracts that can be characterized as firm commitments.

Consistent with the notion that firm commitments should yield recognized assets and liabilities, the Committee believes that the signing of a contract constitutes a transaction whenever it is probable that the signed contract will be executed. The Committee also believes that virtually all signed leases are probable of being executed because it seems unlikely that a lease would be signed by both parties without the expectation of mutual execution. In addition, the Committee concludes that the question of whether a contract is non-cancelable is less economically meaningful and thus less relevant as to the appropriate recognition of the transaction than is the question of whether the contract will probably be executed, insofar as the

⁴ Three of the four papers we discuss below pre-date the development of conceptual frameworks as a basis for standard setting. The fourth, Ijiri (1980), was sponsored by the FASB during the development of the conceptual framework in the U.S.

⁵ Ijiri (1980) includes an appendix that surveys the entire literature on executory contracts. He states that “the bulk of the articles surveyed here agree” that a “lease is not different from other commitments. All commitments should be capitalized.”

two questions yield different answers.⁶ Therefore, we conclude that virtually all leases should be recognized at signing.

The Committee also believes that, unlike delivery, the probability of execution is a meaningful concept upon which to distinguish leases from certain other executory contracts. In particular, for some executory contracts, such as personal performance contracts, it is often difficult to assess the probability of execution or the probability of execution may be low.

2. Should payments that are optional but probable because of the terms and conditions of a lease contract be reflected in recognized assets and liabilities?

Contracts may include features designed to influence subsequent decisions by the contracting parties. Specifically, contractual terms may affect the likelihood of lease renewal and cancellation as well as the probability of legally optional payments. Example 2 of Chapter 4 of the Special Report illustrates this point. In this example, a firm leases equipment for a 3-year term at 5000 per year. The lessee has the right to extend the contract for 2 additional years at the same 5000 cost per year. If the lessee does not renew it must pay a penalty of 4000. Effectively, the 4000 penalty is the cost of the option to renew the lease for two additional years at an incremental cost of 6000 (10000 less a refund of the 4000 penalty). Because of contracting frictions, the renewal option may not be separable from the lease contract, so the 4000 cost need not be the amount at which the option could be purchased separately.

The main purpose of the cancellation penalty in Example 2 is to increase the likelihood of lease renewal for two years. The probability of renewal increases with the magnitude of the penalty and the corresponding decrease in the payments in the renewal period. A sufficiently large penalty (how large depends on the market for the leased asset, the lessee's non-contractual costs of non-renewal, and other attributes of the lessee) may make renewal highly probable. On the other hand, renewal remains the lessee's legal choice regardless of the size of the penalty.

The Committee takes the position that optional or conditional future lease payments should be recognized when the probability that such payments will be made is determined to be sufficiently high. We do not attempt to define sufficiently high, but we believe that the definition of this threshold should reflect a balance between moving towards the theoretically desirable goal of fair value accounting for leases and practical issues such as financial report auditability and clarity. Specifically, under pure fair value accounting, lease assets and liabilities would be recognized at the expected discounted value of the future lease payments, regardless of the probability of these payments. On the other hand, practical issues may suggest a high probability threshold. We believe that there should naturally be an evolution over time towards a lower probability threshold as fair value accounting for financial instruments in general and leases in particular becomes established practice, and as managers and auditors become more expert in making these probability judgments.

⁶ The Committee also believes, however, that legally minimum lease payments are important for some sorts of analyses or in some situations, and so recommends that material differences between minimum and expected lease payments be disclosed.

In assessing the probability that lease payments will be made, all pertinent facts and circumstances should be considered. This position results from acknowledging the wide variety of lease types and the difficulty of specifying conditions for recognition that would be applicable to even some subset of available lease types. Returning to Example 2 of Chapter 4 of the Special Report, the Committee believes that the initial value of the lease liability likely should be 19000, the minimum contractual payments, because it is in general difficult to assess at the time of lease initiation the probability that renewal options will be exercised and there is no additional information on which to base a probability estimate in this example. However, 19000 is the minimum; if renewal is probable then the initial value of the lease liability should be increased above this amount by the expected incremental payments under the renewal option. Regardless of the amount recognized, we recommend that the terms of the renewal option be disclosed in the notes (e.g., the two additional years at 5000 instead of the 4000 penalty).

Our position goes further than the literature on leases and executory contracts surveyed above and implies that firm commitments are not always required for recognition. For example, with respect to contingent rentals, renewal options and residual value guarantees, our goal is to recognize the expected value of probable future cash flows. Probability of execution and expected cash flows must be estimated based on all facts and circumstances. Contingent rentals, renewal options and residual value guarantees may be included in the original recognition of the lease asset and liability if the probability of exercise is sufficiently high.

The Special Report does not appear entirely consistent in its treatment of probable, optional payments that are not firm commitments. For example, the Committee would recognize lease assets and liabilities for probable usage-contingent rentals whereas the Group would not. The Group and Committee come to the same conclusion on the renewal option example (Example 2 of Chapter 4 for which the Special Report also argues that the lease asset and liability should be 19000) but for different reasons. Specifically, the Group's criterion is that renewal options are not firm commitments, whereas the Committee's criterion is that the probability of renewal option exercise usually cannot be reasonably assessed at lease initiation. The Committee believes that consistency dictates that the probability criterion be applied to renewal options as well as other contingent payments.

The Committee stresses the importance of disclosure of the key terms and conditions of the lease contract. Specifically, payments that are not capitalized, such as renewal options that are not considered sufficiently probable, as well as contingent payments that are capitalized, such as usage contingent rentals and residual value guarantees, should be described appropriately in the notes.

Finally, although the Special Report does not propose that lease assets and liabilities be subsequently fair valued, the Committee considers lease assets and lease liabilities to be financial instruments for which subsequent fair valuation should be considered. As noted above, however, our proposal to recognize assets and liabilities only for probable lease payments does not go as far as pure fair value accounting because of practical considerations. We also note that fair valuation could result in asymmetric accounting treatment by lessee and lessor, contrary to our general support of symmetric accounting treatment. An example of such asymmetric treatment would be lessors that write homogeneous leases that could be accounted for on a portfolio basis

(similar to banks' accounting for homogeneous credit card loans). Such lessors assess probabilities of contingent payments at the portfolio level and such assessments likely differ from the probability assessment of the individual lessee.

Responses to questions posed in the Special Report

Part I - Introduction and Scope

Q1 Chapter 1 sets out the deficiencies of existing accounting standards for leases and the problems associated with an arbitrary distinction between different types of leases.

Do you agree that standard-setter should aim to develop a single accounting method that can be applied to leases of all kinds?

Yes. Unless it can be shown that two or more economically distinct types of leases exist, comparability demands a single method for all leases. The empirical accounting research discussed in a previous section of this response indicates that users of financial reports appear to act as if both operating and capital leases are similar to debt, providing no support for a continuation of any distinction between operating and capital leases.

Q2 Chapter 2 discusses the scope of any revised accounting standards for leases. It distinguishes contracts that would fall within the scope of leases and other contracts, in particular executory contracts, that would not.

(a) Do you agree that the distinction has been made appropriately in Chapter 2? If not, what other factors do you think are particularly relevant?

We do not agree. The Committee believes that the accounting for leases should be considered in the context of the accounting for contracts generally, and that the development of lease accounting methods should be grounded in concepts that are applicable to the accounting for contracts generally. The distinction made in the Special Report between leases and executory contracts relies heavily on delivery. The Committee views the distinction between leases and executory contracts based on delivery as both strained and not grounded in concept, particularly when, as noted in paragraph 2.26, contracts are written so as to make performance probable. A contract written so that performance is probable imposes both rights and obligations on the contracting parties and should yield recognized assets and liabilities. The Committee views a *conceptual* distinction between leases and executory contracts as problematic if the distinction later places obstacles in the path of obtaining a coherent and internally consistent approach to the accounting for contracts generally.

The Committee believes that the Special Report relies on delivery in order to limit the scope of the project as a pragmatic device and not as a concept. If the G4+1 standard setters wish to consider leases before, or separately from, other contracts, this

decision can be justified in terms of practical constraints on the resources that can be devoted to any one project. Elevating delivery to the status of a concept (that is, using it conceptually to distinguish leases from executory contracts) could create additional work, or the potential for inconsistencies, when the accounting for contracts other than leases is considered.

(b) Do you agree that leases of intangible assets (including agreements to explore for or use natural resources) should not in principle be excluded from the scope of revised standards?

Yes. The Committee believes that the nature of the asset leased should not affect the accounting for a lease.

What practical problems might arise if the proposals were applied to leases of intangible assets?

The Committee believes that the practical problems associated with applying the proposals to the leasing of intangible assets would be problems of measurement and problems of relating the leasing standard to the standards governing the accounting for intangible assets. For example, the current accounting for the costs to develop certain intangible assets requires immediate expensing. If a lease for an intangible asset were to allow the lessee access to and use of, say, an element (e.g., a formula, a piece of software, a process) of an in-process R&D project, the property being leased would not be accorded asset status on the lessor's balance sheet. These issues should not impede the development a consistent and comprehensive leasing standard, however. In particular, the Committee does not believe that the current non-recognition of most internally developed intangibles in many countries should lead to non-recognition of leased intangible assets for lessees.

(c) Do you agree that no specific exemption should be proposed for short leases and that reliance should instead be placed on the principle of materiality?

Yes. The Committee believes that the term of the lease should not in principle affect the accounting treatment, and that the determination of when a (short) lease is not material should be based on judgment and not some numerical rule. The Committee also agrees in principle with reliance on a materiality-based judgment. In practice, given jurisdiction-specific implementations of materiality judgments, it is possible or even likely that a lease accounting standard which requires a materiality judgment as a basis for recognition would lead to noncomparable results across jurisdictions. A second practical consideration is the possibility that managers who wish to avoid balance sheet recognition might structure a lease with immaterial accounting measures of assets and liabilities, even though the lease creates economically material rights and obligations, say by structuring short leases with renewal options. The Committee believes that our probability-based approach reduces the potential for this problem to occur compared to the Group's approach.

Q3 Do you agree that leases of land and buildings, as accounted for by lessees, should not be excluded from the scope of revised standards (see Chapter 13)?

Yes. The Committee believes that the nature of the asset leased should not affect the accounting for a lease. Contracts providing for the use of land and buildings (or any other contracts) should be excluded only if they do not fit within the scope of a lease (as defined in paragraph 2.3 of the Special Report).

Part II - Lessee Accounting

Q4 Do you agree with the Group's recommendations related to lessee accounting in Chapter 3 that:

(a) Assets and liabilities should be recognized by a lessee in relation to the rights and obligations conveyed by a lease when the lessor has substantially performed its obligation to provide the lessee with access to the leased property for the lease term?

The Committee agrees that lessees should recognize assets and liabilities in relation to the rights and obligations conveyed by the lease. As noted earlier, the Committee disagrees with the emphasis in the report on delivery as the point of recognition in the case of leases. When a lease, or any other contract, is structured so that performance is probable, then the point of recognition should be the signing of the contract.

(b) The objective should be to record, at the beginning of the lease term, the fair value of the rights and obligations that are conveyed by the lease?

Yes. Consistent with the perspective taken by this Committee in previous response letters, and also with the perspective on fair values of financial instruments taken by the Financial Accounting Standards Board and the International Accounting Standards Committee, rights and obligations conveyed by leases should be viewed as financial instruments and measured at their fair values at the point of recognition, subject to measurement considerations.

The Committee also notes that leases can be structured in ways that *appear to* shift rights and obligations without actually doing so, depending on what stream(s) of payments are included in the measurements. For example, real estate leases can be structured net or gross of operating costs. Net leases offer smaller minimum lease payments but the lessee is contractually required to pay real estate tax, insurance and maintenance costs. Gross leases include these operating costs in the lease payments. Unless the operating costs are explicitly accounted for, the measured obligation of the lessee will be different under a net lease than under a gross lease.

The Committee favors capitalizing the estimated equivalent gross lease payments for net leases in order to maintain accounting comparability between economically equivalent gross and net leases. The difference between the equivalent gross and net

lease payments are essentially payments on executory contracts for services, although these amounts are usually paid to third parties such as local governments, insurers and maintenance firms rather than to the lessor. The Committee believes these payments have the same probability of being paid as do the payments on the net lease, however, and so are economically identical from the lessee's perspective and so should be accounted for as such.

- (c) *The fair value of the rights obtained by a lessee cannot be less than the present value of the minimum payments required by the lease (assuming that the lease is negotiated on an arm's-length basis)?*

Yes.

Q5 Chapter 4 discusses the treatment of optional features of leases and contingent rentals. It proposes that the rights that are reflected in the initial lease asset (and liability) that is recorded by the lessee will comprise the rights to use the property and also options, for example, to extend the lease to purchase additional usage of the property in exchange for usage-related rentals, or to purchase the property itself (in those cases where such options can be measured reliably).

- (a) *Do you agree with the proposal that leases containing lessee options to renew or cancel leases should not be accounted for on the basis that renewal options will be exercised, even if that is thought to be the probable outcome?*

The Committee takes the position that the recognition of optional or conditional future lease payments should depend on the probability of such payments, insofar as such probability can be determined. In assessing the probability, all pertinent facts and circumstances should be considered. This position results from acknowledging the wide variety of lease types and the impossibility of specifying conditions for recognition that would be applicable to even some subset of available lease types. In general, we believe that it is unlikely that the probability of renewal can be reasonably assessed at lease initiation, precluding recognition of optional future lease payments.

- (b) *Do you agree that, except in those circumstances where it can be demonstrated that an option has significant value (and assuming its value can be ascertained with sufficient reliability), the payments required by the lease should be deemed to relate to the right to use the property for the lease term?*

The empirical accounting research reviewed in a previous section of this response is silent on this measurement issue. While this research typically has used capitalized measures of minimum lease payments disclosed for leases under SFAS 13, there is no research on whether or when the capitalized amounts should include the portions of minimum lease payments associated with renewal options because these amounts are not separately disclosed.

The Committee agrees with the Group in principle, but we think that it may be often be difficult to determine whether the option has significant value. Here and elsewhere the Special Report refers to comparisons between the terms of leases with and without specific features to measure the lease asset and the optional feature separately (for example, paragraphs 4.10, 4.15). The Committee questions whether this measurement approach is consistent with the practical realities of the leasing market where many leases are customized, the overall quality and quantity of information about leases is low, and there may in fact not exist sufficient leases with and without a given optional feature to support measurement using the Special Report's comparison approach.

Q6 Chapter 4 discusses (paragraphs 65-77) the treatment of contingent rentals that are a proportion of the lessee's revenues or profits derived from the leased property.

The Group's view as reflected in the Paper is that if the minimum payments required by the lease are clearly unrepresentative of the value of the property rights conveyed by the lease, assets and liabilities of a greater amount, reflecting the fair value of such rights, should be recognized. The fair value of the property rights conveyed by a lease might be determined by having regard to the payments required by a similar lease that had no provision for contingent rents.

An alternative view that the initial asset and liability should reflect only the present value of the minimum payments required by the lease.

Which of the two approaches do you support, and why?

In general, we support the Group's view. However, the Committee raises again the potential impracticability of measurements based on comparisons of leases with and without a given feature in its response to Q5(b).

The Committee also notes that the Group's position with regard to contingent rentals is not entirely consistent with its position not to recognize optional but probable payments associated with renewal options. The Group appears to distinguish sales-contingent rentals, which are only partly controllable by the lessee, from renewal options that while probable of being exercised are legally fully under the control of the lessee. The Committee does not believe that this distinction is economically meaningful as a general rule. However, in this situation, the Group states that the minimum lease payments are "clearly unrepresentative of the value of the property rights conveyed by the lease" prompting us to agree with the Group's view that the greater fair value of such rights should be recognized.

Q7 Chapter 4 discusses (paragraphs 78-88) the treatment of contingent rentals that vary in line with prices.

The Group's view as reflected in the Paper is that estimates of future price changes should be reflected in the amount of assets and liabilities recorded at the beginning of the lease.

An alternative view is that only the existing level of rentals should be reflected in the amount of assets and liabilities recorded at the beginning of the lease.

Which of the two views do you support, and why?

We agree with the Group's view. Specifically, the Committee believes that initial expectations of probable contingent lease payments, which reflect expected future prices, should be included in initial lease assets and liabilities. Subsequent uncertain changes in lease payments from unexpected price changes should result in remeasurement of the asset and liability conveyed by the lease as uncertainty is resolved (that is, as the price to which payments are linked becomes known).

Consistency of measurement supports the same treatment for future changes in lease payments that are partly⁷ (as in the case of payments linked to turnover) or wholly (as in the case of price-level-indexed payments) out of the control of the lessee.

However, the empirical accounting research reviewed in a previous section of this response is silent on this measurement issue.

Q8 Chapter 5 discusses various arrangements where the lessee has rights and obligations relating to the residual value of the leased asset, such as those arising from a residual value guarantee.

The Group's view as reflected in the Paper is that an asset and liability should be recognised at the beginning of the lease term measured at the present value of the payments the lessee is required to make during the lease term and the fair value of guarantees or other residual value agreements (if it is practical to quantify them).

An alternative view is that in circumstances where in substance the lessee has exposure to risk on substantially all of the property's value, it should record an asset and liability at the beginning of the lease reflecting the full fair value of the property, regardless of the cash flows that are specified in the lease contract. (Those who hold this view believe that Examples 4 and 5 in Chapter 5 are economically similar and therefore the accounting treatment should be similar.)

⁷ While it is true that the lessee can take actions to affect turnover, as long as there are economy and industry effects on the lessee's operations, turnover is not entirely under the lessee's control. An exception, of course, would occur if the lessee were to cease operations at the leased facility (turnover would be zero, entirely due to the lessee's actions).

Which of the two views do you support? If you support the alternative view, how would you define the circumstances in which gross asset and liability amounts should be reported?

In general, the Committee agrees with the alternate view. The Committee considers Examples 4 and 5 in Chapter 5 of the Special Report to be economically identical in terms of net payoffs to the parties, although differing in contractual details. Therefore, the Committee (applying the third element of the characteristics laid out in the first section of this response) believes that Examples 4 and 5 should be accounted for in the same way. Because the lessee receives the value of the asset with certainty in both examples, it should record the gross value of the asset (18000) in both examples. In Example 5, this approach requires uncoupling the residual value guarantee into a fixed payment of 3000 and the receipt of the asset.

The Committee believes that when payments are probable the lessee should record the expected value of those payments as assets and liabilities. Only when there is no material difference between recording the full value of the asset and the expected value, as is the case in Examples 4 and 5, do we favor full gross recognition of lease assets and liabilities.

Q9 Chapter 5 (paragraphs 35-39) also discusses the accounting treatment of subsequent changes in the value of the lessee's obligations in relation to residual value guarantees.

The Group's preferred view is that the carrying amount of both the lease liability and the lease asset should be increased or decreased (subject to the carrying amount of the asset not being increased above a value that would cause an impairment write-off), and that the asset's revised carrying amount should be depreciated over the remainder of the lease term.

An alternative view is that the difference between the remeasured liability and its previous carrying amount should be recognised immediately as a loss or gain in income.

Which of the two treatments do you support?

The Committee is concerned about the incompletely fair value accounting nature of both the preferred and alternative views. Why should residual value guarantees be fair valued while other lease assets and liabilities are not? Compared to either of these views, we would prefer either a consistently historical cost or fair value accounting proposal that accounts for residual value guarantees in the same way as other aspects of the lease. As discussed above, we favor a consistently fair value accounting proposal subject to measurement concerns. We think that a consistently fair value accounting proposal would naturally require immediate recognition of gains and losses on the remeasurement of the lease assets and liabilities associated with each aspect of the lease contract, again consistent with the Group's alternative view.

Q10 Chapter 5 (paragraphs 61-66) discusses the accounting where a renewal option is accompanied by a residual value guarantee. The Group's view as reflected in the Paper is that the concurrent existence of these two features in a lease should not give rise to the recognition of additional assets and liabilities (that is, by anticipating the exercise of renewal options). An alternative view is that additional assets and liabilities should be recognised. What is your view?

Consistent with our prior statement about the difficulty of assessing the probability that renewal options will be exercised, in general we agree with the Group's view. In addition, we suggest that the Group consider carefully how combinations of contractual features should be disclosed to indicate as clearly as possible the nature and implications of those features.

Q11 Do you agree with the recommendation in Chapter 6 relating to the discount rate that should be applied to the rental payments?

The Committee believes that the approach taken to discounting in lease accounting should be consistent with FASB Concepts Statement 7, which advocates exchange or transaction values, not values-in-use as the basis for fair value measurements. To the extent the discount rates advocated in chapter 6 would conform *in practice* to the FASB Concepts Statement 7, the Committee agrees with the recommendations. The Committee also advocates disclosing the discount rate.

Q12 Chapter 7 discusses two approaches to accounting for sale and leaseback transactions. Do you agree with the Group's view as reflected in the Paper that a sale and leaseback should be accounted for as one transaction, with any gain restricted to that which relates to the rights that have not been retained by the lessee?

Yes.

Part III - Lessor Accounting

Q13 Do you agree with the general principle (Chapter 8) that a gain should be recognised at the beginning of the lease term if (a) there is evidence that the value of the lessor's assets (less its liabilities) has increased as a result of its performance in entering into the lease contract, and (b) the increase can be measured reliably?

Yes, subject to reservations about measurability. One measurement difficulty is that partitioning based on fair value measurements can differ from partitioning on risk retained versus sold. There can be considerable difficulty in arriving at reliable measures. (The Committee points to the measurement difficulties experienced by the sub-prime lending industry in the United States in applying a similar model.) When measurement is problematic, the Committee recommends that gain recognition be deferred, even if this requires deferral to the end of the lease.

Q14 Do you believe that accounting standards should specifically restrict the recognition of a gain by a lessor at the beginning of a lease to the circumstances described in paragraph 18 [note typo in question, which says paragraph 22] of Chapter 8?

Yes.

Q15 Do you have any comments on the recommendations in Chapter 9 relating to disclosure of separate components of the lessor's assets?

No. However, the Committee refers the Group to its response to Q13 concerning measurement issues.

Q16 What practical problem, if any, do you foresee with the recommendations in Chapter 10 relating to the initial measurement of receivable and residual interest assets?

The Committee believes the discount rate (discussed in paragraphs 10.5 and 10.6) should be consistent with the FASB's Concepts Statement 7, and reflect exchange values in a hypothetical arms-length transaction. The Committee believes that the approach in paragraph 10.6 is more nearly consistent with Concepts Statement 7 than is the approach in paragraph 10.5. In practice, moreover, the expected cash flows associated with lease payments and residual values may be difficult to estimate, leading to significant measurement error.

The Committee also notes that certain leased assets (such as real estate) are often characterized by increasing values (the economic value of the asset at the end of the lease exceeds the economic value at the beginning). This feature of real estate is not directly associated with leasing activities per se (it is not leasing that causes the value of real estate to increase over time) but the Committee believes that balance sheet measurements that take account of this increase will be more informative to users of financial statements than those that do not. Examples of such measurements are cited in note 47 of the Special Report.

Q17 Chapter 11 discusses the treatment of optional features of leases and contingent rentals from the lessor's perspective. The Group's view is that it should be presumed that if a lease contract gives rise to a liability for the lessee (as discussed in Chapter 4) it will give rise to a corresponding receivable asset for the lessor.

In general, we favor symmetry in the accounting for lessees and lessors. However, as noted above, there may be exceptions such as when the lessor accounts for a portfolio of homogeneous leases. The issue here is whether part of a leased asset, already accorded recognition status on the lessor's balance sheet, should be reclassified as a financial asset, with the possibility of gain recognition. This issue is in part one of revenue recognition, and authoritative accounting guidance for revenue recognition differs across jurisdictions. Therefore, in some jurisdictions the lessee might have a liability but the lessor might not be permitted to recognize a gain (because one or more revenue recognition criteria were not met).

(a) *Where contingent rentals are a proportion of the lessee's revenues or profits derived from the leased property, the Group's view as reflected in the Paper is that if the minimum payments required by the lease are clearly unrepresentative of the value of the property rights conveyed by the lease, the lessor's initial receivable asset (corresponding to the asset and liability that is recognised by the lessee) should be a greater amount, reflecting the fair value of such rights.*

An alternative view (corresponding to the alternative view of the appropriate lessee accounting noted in Question 6) is that the lessor should recognise a receivable asset of only the present value of the minimum payments required by the lease.

Which of the alternative approaches do you support, and why?

Consistent with our response to Q6, we agree with the Group that if the lessee recognizes the fair value of such obligation (an amount greater than the minimum lease payments), that the lessor likewise should recognize the greater amount of rights.

(b) *Where contingent rentals vary in line with prices, the Group's view as reflected in the Paper is that estimates of future price changes should be reflected in the receivable asset recognised by the lessor at the beginning of the lease.*

An alternative view (corresponding to the alternative view of the appropriate lessee accounting noted in Question 7) is that only the existing level of rentals should be reflected in the receivable asset that is recognised by the lessor at the beginning of the lease.

Which of the alternative approaches do you support, and why?

In responding to Q17(b), the Committee refers to its answer to Q7. The Committee believes there to be no basis for asymmetric accounting by lessor and lessee regarding price-contingent rentals.

Q18 Chapter 12 discusses three alternative views on how a lessor's residual interest asset should be measured and accounted for during the lease term. Do you agree with the Group's view as reflected in the Paper that the initial carrying amount (measured at the present value of the estimated residual value at the end of the lease) should be accreted over the lease term by "unwinding" the discount?

Please see the response to Q19.

Part IV - Other issues

Q19 Do you agree with the recommendation in Chapter 13 that lessors of land and buildings should report as separate assets in their balance sheets the amount of their investment that represents lease receivables, and that which represents their interest in the residual value of the property, and that the finance income for the lease receivables and changes in the interest in the residual value should be reported separately? If not, what alternative treatment would you favour and why? Do you agree that information on fair values should be preserved?

The Committee agrees with the proposal for separate reporting (receivables and interests in residual values separately, and finance income separately from changes in the interest in the residual value). Referring to the specifics of measurement for residual values, the Committee refers to its response to Q16. Given the alternatives discussed in the Special Report, the Committee believes that the approach described in paragraph 13.20 (report finance income on the lease receivable and fair value the leased real estate) would be preferred.

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