Finance & Leasing Association

Sir David Tweedie
Chairman
International Accounting Standards Board
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12 September 2002
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Dear David,

Exposure Draft of Proposed Improvements to International Accounting Standards

We are writing in response to your request for comments in respect of the above exposure draft. As the major representative body for the leasing and asset finance industry in the UK, the Finance & Leasing Association is principally concerned with those proposals relating to the accounting treatment of leased assets: IAS 17(Leases), IAS 16 (Property, Plant and Equipment) and IAS 40 (Investment Property). Consequently, we include detailed comments on each of these proposals in the attached. We have also identified some general comments on IAS I (Presentation of Financial Statements) and IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors), which we consider merit comment due to the fundamental nature of the accounting issues being raised. However, we have not set out to answer all the questions on these standards on which the IASB has sought comment, but only those matters that are of particular interest to our industry. In addition, we have identified some matters, on which the IASB has not sought comment, but which are of major concern to our industry. Our principal concern in these drafts is the treatment of the net cash investment method.

We would also like to express our support for the IASB's objectives to improve the quality of existing standards and deal with certain convergence issues as part of the Improvements Project. This inevitably means removing the conflicts between international and national standards and in some cases removing the existing choice between alternative methods of accounting.

September 12, 2002

The "Preface to International Financial Reporting", published in April 2002, affirms the newly constituted IASB's commitment to "due process" through the publication of exposure drafts, consideration of responses, field tests, public hearing and publishing within a standard its basis of conclusions. At this time there is a significant difference between the methods used by lessors to account for finance leases under the UK standard, SSAP 21, and the method required under IAS *17.* SSAP 21 requires lessors to use a "net cash investment" method, whereas IAS *17* requires the use of the "net investment method". We believe that this difference can be resolved by providing different treatments for tax-variable and other leases. Thus our proposal is consistent with the IASB's overall approach of eliminating options for the accounting treatment of the same transaction, while providing different treatments for transactions that are substantively different.

We would urge the IASB re-examine this issue, and to seek to resolve the current UK-IAS differences in respect of the way lessors recognise income. The resolution of these differences is of significant concern to the UK leasing industry given the requirement for UK listed companies to comply with International Accounting Standards from 2005. We have therefore set out our views in some detail.

We were glad that your colleagues came to meet the Leasing Summit that the FLA organised in July. It would be helpful if we could follow up by meeting the IASB to discuss our representations, especially on the net cash investment method.

I am writing in similar terms to Mary Keegan at the ASB.

Yours ever

Martin

Martin Hall
Director General

COMMENTS ON THE PROPOSED IMPROVEMENTS TO INTERNATIONAL ACCOUNTING STANDARDS

IAS 17 Leases questions

Question 1

Do you agree that when classifying a lease of land and buildings, the lease should be split into two elements a lease of land and a lease of buildings? The land element is generally classified as an operating lease under paragraph 11 of IAS 17, Leases, and the building element is classified as an operating lease or finance lease by applying the conditions in paragraphs 3-10 of IA S 17.

No. Lease accounting should reflect the substance of a lease transaction taken as a whole.

The basic principle of lease classification is that leases should be classified according to whether they transfer "substantially all the risks and rewards of ownership". Where the lessor retains significant risks and rewards the lease cannot have transferred substantially all the risks and rewards of ownership to the lessee. The amount of risks and rewards the lessor retains is a careful investment decision looking at the transaction as a whole - the land and building elements are not mutually exclusive. In practice, if the same lessor were offered a lease of only land for the same period on a fair market basis the lessor may not have the risk appetite for it. Viewed from the perspective of the lessor, therefore, the pricing of the transaction only makes sense when viewed in its entirety. The same is true of the lessee; the lessee is only concerned with the overall cost of leasing a building (including the land element), and the separate elements would rarely be subject to separate negotiation.

The practicalities of separating the rent into its land and building elements is also fraught with difficulty. In the UK, typically a property lease will be for a term of *25* years, with rent reviews to market (usually upward only) every three to five years. Commonsense would indicate these leases are operating leases as the landlord's overall return depends entirely on market conditions both throughout the term and in terms of the realisation of his residual interests. However, *if* the rental were to be separated into its land, buildings and contingent rental components, how will this be done? The exposure draft suggests that the minimum lease payments should be allocated between the land and buildings elements in proportion to their relative fair values at the inception of the lease. However, as amortising assets (buildings) and non-amortising assets (land) have very different rental rates this will produce a solution that is most certainly wrong.

Furthermore, the approach adopted in other counties, such as the US, rely on similar arbitrary rules and allocations that do not necessarily result in a split of rentals that is fair or sensible. We are therefore unconvinced that the disaggregation of the rental into separate components provides any better insight than looking at the lease as a whole.

The exposure draft also proposes to treat leases of land and buildings as finance leases where the rent cannot be reliably allocated and it is unclear that both elements are operating leases. We disagree. As with all leases, we believe the lease should be viewed as a whole.

We also disagree with the basic premise that a lease of land will always be an operating lease. Some long leases in the UK can extend to 999 years, and generally speaking the present value of the lessor's residual interest is insignificant after more than *35* years. We note paragraph 11 of IAS 17 which states that substantially all the risks and rewards will not transfer unless it is expected that title to the land will pass to the lessee by the end of the lease term. We do not believe that this should be an overriding condition and this paragraph should be redrafted accordingly. This will enable lessors to comply with the finance lease definition set out in IAS 17.

We also believe that this particular requirement t o treat land and buildings separately could have strange consequences for specialist property investment companies that would otherwise report their investment properties under IAS 40. If land and buildings were separated the buildings element may fall to be treated as finance leases under IAS 17. This in our view would be nonsensical.

Question 2

Do you agree that when a lessor incurs initial direct costs in negotiating a lease, those costs should be capitalised and allocated over the lease term? Do you agree that only incremental costs that are directly attributable to the lease transaction should be capitalised in this way that they should include internal costs that are incremental and directly attributable.

Yes. Initial direct costs should be capitalised once it is reasonably certain that the related lease will be written and they can be recovered together with a commercial rate thereon.

IAS 17 - other matters

The actuarial after-tax method of accounting

In the UK, the vast majority of finance leases, and in particular almost all 'big ticket' finance leases, are subject to clauses that vary the rent to preserve the lessor's post-tax rate of return in the event of changes in tax rates, tax depreciation and changes in the basis of tax. Such levels of protection for the lessor against domestic tax risk is quite unique to UK and competition leads to much of the tax deferral benefits of the lease being passed to the lessee by way of lower rentals. As an illustration, it is quite possible for a UK lessor to enter a finance lease over *25* years at an implicit rate of 0.7% below LIBOR, fund its net cash investment in the lease at LIBOR and still make a return of 0.3% over LIBOR. This is because the lessor only has to fund its post-tax cash flows (its net cash investment in the lease). Often in big ticket transactions, the financial schedule to the lease will set out the cash flows, the tax and funding assumptions, and any changes in these assumptions will give rise to a recalculation of rent. In other cases, the cash flows are referred to in the documentation but not spelt out to the lessee; and any disputes over the recalculation of rent is subject to an independent expert's opinion.

The method lessors developed in the UK, to account for these tax-variable leases, is the actuarial after-tax method of accounting. This method reflects both the contractual terms and the economics of the arrangements. The method is also deeply embedded in the industry's management systems and pricing making processes.

If the same lease were to be accounted for under the net investment method, as currently required by IAS, and the lessor borrowed the funds to fund its investment in the lease at LIBOR, the lessor would report cumulative losses for the first *5* years of the lease term.

In our view, reporting losses in this way does not reflect the economic and contractual profitability o ft he transaction and does meet the IASB 's basic qualitative criteria for financial statements: understandability, relevance and reliability.

By comparison, the actuarial after-tax method reflects faithfully the economic and contractual profitability of the lease transaction throughout the life of the lease and the net balance of lease receivables lease tax liabilities in the balance sheet (the net cash investment) will broadly equal the present value of future rentals and tax payments discounted at the after-tax return. Specifically, the method is consistent with the requirements of paragraph *5* of the revised draft of lAS 8, since it is an approach which results in information that is relevant to the decision making needs of users.

The arguments against the net cash investment method - at least those suggested by E56 in 1997 - were that:

(a) *"the benefits resulting from the tax attributes of a leased asset should not influence the pattern of recognition of lease income"* Such a comment ignores the fundamental economies of leasing and the nature of post-tax pricing of leases. Tax may well be an important consideration to other types of transaction, but tax-variable leases embed these features into the contractual terms between the parties. Tax-based leasing can therefore be distinguished in this way from other forms of asset acquisition.

(b) *"the philosophy of IAS 12, is that income tax is a periodic expense and not a transactional matter"*. In the case of tax-variable leases, tax is very much a transactional matter. The cash flow assumptions set out, or referred to, in the agreement usually assume that the asset is the only asset of the lessor, and the lessee indemnifies the lessor against the consequence of changes in the assumed tax cash flows. Tax for the purpose of income recognition is therefore an indemnified cash flow and not an allocation of the actual tax of the entity.

(c) A further criticism that is sometimes levelled at the actuarial after tax method is that the method of income recognition from an asset should not reflect how that asset is financed. In fact, the actuarial after-tax method does not assume any particular form of funding or gearing, and gearing has little or no impact on the allocation of interest income arising. However, because of the operation of tax indemnities, the cash flow model normally assumes an interest cost in the assumed cash flows from the lease on the assumption that the lessor borrows 100% of the funds he needs to support his net cash investment in the lease. Furthermore, many of these leases are interest rate variable, and the same model is used to re-calculate rent in the event of changes in the interest reference rate (e.g. 3 month LIBOR). The cash flow model is therefore crucial to the contractual terms between the parties. It is therefore important not to confuse the actuarial after-tax method with US leverage lease accounting, where the pattern of debt repayments may affect the pattern of income recognition.

We appreciate that the IASB does not wish to provide a choice of options in the way lessors account for leases. However, we believe we have a strong case for distinguishing tax-variable leases from non-tax variable leases. **We therefore would urge the IASB to either permit or require an after-tax method of accounting for tax-variable leases, while retaining the net investment method for non tax-variable leases. A tax variable lease can be defined as a lease where the tax consequences of the lease form a material and integral part of the overall return from the lease, and the lease terms reasonably protect the lessor's after-tax return from the consequences of future changes in rate or basis of taxation, or early termination.**

Para 9 of IAS 17 Indicators

Paragraph *9* was added to IAS 17 when it was revised in 1997. The intention was to provide 'indicators' which individually or in combination could lead to a lease being classified as a finance lease. These were intended to be helpful, but as currently drafted they are a source of confusion.

In particular, the circumstance in paragraph 9(a) is potentially misleading. If a lease can be cancelled with all losses associated with cancellation borne by the lessor then clearly the lease is an operating lease (e.g. a daily rental contract). However, the drafting suggests that the converse is true. Consider a three-year operating lease, with no provisions to cancel and with the lessor taking substantial residual risk at the end of the contract. If a lessee's right to terminate is included into the lease, but with the lessee bearing the risk on termination, then the termination right as no effect on the lease at all— it simply remains a 3 year 'noncancellable lease'. Clearly the nature of a termination clause will be important in determining the true lease term and is therefore critical to the interpretation of paragraphs 8 (c) and 8 (d) of IAS 17, but it is not itself a finance lease 'indicator'.

Similarly, in the circumstances described in paragraph 9(c), the lease term (as defined in paragraph 3) would almost certainly include the secondary period. Accordingly the principal effect of 9 (c) is to assist in the interpretation of the lease term for the purposes of paragraphs 8(c) and 8(d). It is not itself an indicator or whether a lease is a finance lease or not.

We would therefore suggest that paragraph 9(a) and (c) of lAS 17 be re-written into a short paragraph on termination and renewal terms that emphasises the need to apply a substantive interpretation of the lease term.

lAS 16 Property, Plant and Equipment

Residual value measurement

Under the draft proposals the residual value of an asset is the estimated a mount that the entity would currently obtain from the disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of the useful life.

The treatment of residual values in the accounts of operating lessors has a crucial impact of the reported profitability of their businesses, particularly where a market decline in residual values may indicate the impairment of leased assets. The IASB's proposal to annually reassess residual values on the basis of current prices differs from the current UK practice, which requires prices at the date of acquisition or valuation.

From an industry perspective we can see practical advantages from re-estimating residual values on large fleets of assets, such as ears, in terms of current prices, because there are many sources of data available in that form, both internally and externally, and assets such as ears are usually held for short periods of time. However, from a conceptual viewpoint, residual values are estimates of uncertain future amounts and there are good reasons why lessors should set residual values cautiously, particularly in relation to assets that are subject to technological risk (e.g. computers) or those assets that are not actively traded in established second hand markets. In making rental pricing decisions, lessors generally make assumptions about residual values that discount future estimates to reflect risk. **The FLA's Statement of Recommended Practice (SORP) emphasises this point by stating that for accounting purposes, the estimates of residual values should be the amounts that can be "safely expected to be realised under anticipated business conditions, net of disposal costs and should reflect uncertainty". We would urge the IASB adopt a similar note of caution**

We would also question whether it is appropriate to recognise ‘holding gains’ on residual value estimates made since the acquisition of an asset. For example, the estimated residual value of building after 25 years may well exceed its original cost. The approach suggested in the exposure draft would result in depreciation in the early years being reversed in later years simply because of the impact of inflation. **For this reason we would suggest that residual value estimates should not exceed original estimates made at acquisition or current prices.**

Residual value adjustments

We note an inconsistency in the treatment of residual values between paragraph 32 of IAS 17 dealing with finance leases and paragraph 46 of IAS 16 dealing with operating lease assets. Paragraph 32 of IAS 17, requires only downward adjustments in unguaranteed residual values to be recognised, and the adjustment is spread over the whole lease term, with any catch up adjustment occurring in the current period. Paragraph 46 of IAS 16 requires upward and downward adjustments of residual values to be spread forward unless an impairment loss arises under IAS 36.

In our view, there is little or no conceptual basis for supporting these different treatments, and the mix of rules provides an unnecessary level of complexity for lessors with large fleets of leased assets. Conceptually, from the lessor’s perspective, it would be much simpler and more practical to treat residual values as though they were separate assets and apply normal impairment tests to them, rather than as currently to the carrying value of leased assets as a whole. In our view if residual values have declined in the current period, the economic cost should be borne in the current period: it is not a cost that is properly allocable to future periods.

However, as explained above, if residual value estimates increase, we would suggest that such changes are not reflected in income until the residual value is realised.

Operating lease assets - depreciation methods

Paragraph 47 of IAS 16 refers to the selection of a depreciation method based on the expected pattern of consumption of the future economic benefits embodied in an asset. The same paragraph gives examples of such methods. Paragraph 45 of IAS 17 states that depreciation of leased assets should be on a basis consistent with the lessor’s normal depreciation policy for similar assets (presumably not leased out). In our view, this is inconsistent with the principle that depreciation should reflect the consumption of future economic benefits since the benefits of the leased asset (the cash flows from rental and future rights to the residual value) are different from the benefits derived from the own use of an asset. The effect of these two paragraphs would seem to prohibit forms of depreciation that treat operating leased assets as though they were hybrid financial assets. The UK SORP on leasing permits these financial deprecation methods, under certain conditions. **We would suggest paragraph 45 of IAS 17 be amended and a much simpler reference is made to**

IAS 16 and lAS 38 that does not force leased assets to be depreciated in the same way as assets held for own use.

Fair values

We note that under the lAS 16 ‘Allowed Alternative Treatment’ an item of property, plant and equipment shall be carried at revalued amount, being its *fair value* at the date of revaluation less accumulated depreciation and subsequent impairment losses. This contrasts with the UK standard FRS 15, which uses existing use value with attributable acquisition costs, for non-specialised properties. That is, the UK approach looks at the value of the assets to the business rather than their exit values. In our view, the use of exit values will give rise to significant anomalies where properties are significantly customised to needs of the owner’s business. We note from the Appendix to the ED lAS 16 that the TASB is participating in research concerning the issues in revaluations. We would suggest that the completion of such research should be a priority.

lAS 40

Question 1

Do you agree that the definition of investment property should be changed to permit the inclusion of property interest held under and an operating lease provided that:

(a) the rest of the definition of investment property is met; and

(b) the lessee uses the fair value model set out in lAS 40, paragraphs 2 7-49?

Yes. However, the intent of the changes is to allow the recognition of substantial investments in investment property. That is, the substance of the arrangement between the owner and lessee is of a disposal of a property interest, the owner retaining merely a future residual interest and right to a small ground rent. As defined the conditions could apply to any back-to-back property leasing arrangement where no cash investment is made by the lessee.

Question 2

Do you agree that a lessee that classifies a property interest as investment property should account for the lease as if it were a finance lease?

Generally speaking, professional valuations of investment leasehold property are made on the basis of committed rents to the next rent review, market rents thereafter, less underlying ground rents: that is, the investor’s net interest in the property. In our view, revaluing the net interest makes more sense than grossing up the asset and liability by the present value of ground rents and applying fair values only to the rents receivable. However, these proposals are still preferable to current prohibition of leaseholds from investment property status.

Question 3

Do you agree that the Board should not eliminate the choice between the cost model and the fair value model in the improvements project, but should keep the matter under review with a view to reconsidering the option to use the cost model in due course?

In our view the fair value basis is the right approach for investment properties. However, while the US continues to use a strict historical cost approach, it would be sensible to retain the option to use the cost model.

lAS 1

Question 1

Do you agree with the proposed approach regarding departure from a requirement of an International Financial Reporting Standard or an Interpretation of an International Financial Reporting Standard to achieve a fair presentation?

We agree with the sentiment behind this question that departures from IFRS or Interpretations of IFRS should be rare events where the application of the IFRS or Interpretation did not present fairly the financial position, the performance of the entity or changes in financial position.

However as drafted, paragraph 13 of lAS 1 does not say this, it merely refers to conflicts with the objective of financial statements as set out in the Framework. Paragraph 12 of the Framework, however, does not set out an over arching requirement to present fairly the financial position of an entity; it merely talks of the objective of financial statements as being to "provide information about financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions". There is therefore no direct link between paragraph 13 of IAS 1 and the need to present fairly the financial position (or in UK parlance a 'true and fair view'). In our view lAS 1 should be amended to state explicitly the objective of financial statements in terms of the need to 'present fairly' or to present a 'true and fair view' of the financial position.

Question 5

Do you agree that an entity should disclose the judgements made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements?

In our view, the requirements of paragraphs 108 and 109 are too broad and could result in needless boilerplate disclosure. The guiding principle should be to disclose sufficient information to provide a true and fair view. We accept that in some cases it may be necessary to explain the nature of the judgements being made, where alternative judgements could give widely different results. In these circumstances there should be an onus on the entity to explain why it has taken a particular view. The need to explain is because of the range of possible variations rather than the importance of the policy.

Question 6

Do you agree that an entity should disclose key assumptions about the future, and other sources of measurement uncertainty, that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year?

If such uncertainty is concerned about the appropriate measurement of assets and liabilities at the balance sheet date, the evidence of which may be slow to emerge, then we would agree. However, the question seems to include all manner of possible 'non-adjusting' events that would affect the following years results. In our view, this would simply lead to further boilerplate disclosures, would not be meaningful and it would be difficult for the reader to distinguish those matters they should be concerned about from the boilerplate disclosures.

Other

The introductory paragraph to each of the proposed standards notes that IAS are not intended to apply to immaterial items, and cross-refers to the Board's draft of the 'Preface to International Accounting Standards'. However, this paragraph does not appear in the revised Preface published by the Board in May 2002. We strongly object to this change, which was not anticipated in the exposure draft.

IAS 8

Question 1

Do you agree that the allowed alternative treatment should be eliminated for voluntary changes in accounting policies and correction of errors, meaning that those changes and corrections should be accounted for retrospectively as if the new accounting policy had always been in use, or the error had never occurred?

In our view, voluntary changes in accounting policies a*nd fundamental* accounting errors should always be dealt with retrospectively.

Question 2

Do you agree with eliminating the distinction between fundamental errors and other material errors?

No. Prior year adjustments should be rare events. Extending the treatment to other material errors simply opens up the opportunity for entities to manipulate current earnings and could result in published earnings taking on the same characteristics as GNP statistics - revised every quarter!