List of Submissions to ED 242 *Leases*

1	FinPro
2	Defence Housing Australia
3	HoTARAC
4	Grant Thornton
5	Property Council of Australia
6	Department of Education - WA
7	Representatives of the Australian Accounting Profession (CPA Australia and The Institute of Chartered Accountants in Australia)
8	Macquarie University
9	University of Technology Sydney
10	ANZ
11	NAB
12	Australasian Council of Auditors-General
13	Ernst & Young
14	Group of 100
15	Woolworths
16	PricewaterhouseCoopers

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20 August 2013

The Chairman
Australian Accounting Standards Board
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The Chairman
International Accounting Standards Board
30 Canon Street
London EC4M6XH
United Kingdom

ED/2013/6 Leases

Dear Sirs

In relation to the above exposure draft I would like to comment as follows.

1. Complexity: If there is one word that could be used to describe this proposed standard it is complexity, and this applies along a number of dimensions. First, complexity arises from the concepts underpinning the proposed regulation. This includes the way it distinguishes service contracts from leases of assets, short term leases, Type A leases and finally Type B leases. Furthermore, this is exacerbated by the different accounting treatments prescribed (off balance sheet, on balance sheet, capitalization and whatever label might be applied to treatment for Type B leases). Undoubtedly firms will categorize transactions differently, apply different accounting treatments, and this will undermine comparability across firms and understandability. Second there is complexity in exposition. While experienced standard setters and those used to working with standard setters might possibly feel comfortable in reading and understanding the requirements of the exposure draft, it is extremely doubtful that many practitioners would. It is inevitable that this regulation would not be applied consistently, and this would again undermine comparability. Third, and perhaps most problematically, given the diversity of accounting treatments available it is doubtful that financial statements users would fully understand the information produced, nor the nuances that have shaped these numbers.

2. Scope / Identifying a Lease: The proposed regulation runs the very high risk of repeating history. After the existing regulation was first formulated there was a significant effort by lessees and the leasing industry to structure transactions to ensure that leases were classified as operating leases rather than finance lease. In this way the requirements of lease capitalization could be avoided (Imhoff and Thomas, Economic consequences of accounting standards: The lease disclosure rule change, Journal of Accounting and Economics, 1988, 277-310). As long as there are economic incentives to avoid leases capitalization it is inevitable that lessees and the leasing

industry will endeavor to structure transactions to avoid capitalization. Attention will likely focus on the definition of the lease and ensuring that contracts are classified as service agreements and not contingent on particular assets. I do not believe the current basis for distinction is sufficient strong. I am also pessimistic about whether it can be made sufficiently strong.

3. Categorization of Leases: It is difficult to support the categorization of leases into Types A and B. First, there seems little theoretical support for this distinction. Second, the accounting treatment for Type B is contrived to give a result consistent with the lease expenses method. In particular I am referring to the lack of any real support for the determination of the depreciation charge. Third, the categorization makes little practical difference as for short term leases the income statement effects of lease capitalization are minimal with the interest expense being small relative to lease payments. It just adds to complexity.

4. Contingent rentals: This is one area where the excessive complexity of previous versions of the proposed regulations has been addressed. It is supported on the basis of it being practical and the outputs understandable

Recommendation

It is inevitable that any regulation requiring lease capitalization will be 'gamed'. This will create a diversity of accounting practices and fundamentally undermine the understandability and comparability of financial statement information. Trying to constrain this has also contributed to the complexity of the proposed regulation. To address the diversity of practices users will again endeavor to restate financial statements for off balance sheet leases (Imhoff, Lipe and Wright, Operating leases: Impact of constructive capitalization, Accounting Horizons, 1991, 51-63). However, this requires estimation and it will be done with error.

Accordingly, I would recommend the following

1. A single accounting treatment for all lease type transactions based on current period cash flow (i.e., lease expense method).
2. Full note disclosure of the accounting outcomes of transactions accounted for with and without capitalization by asset category (i.e., a contingency table approach). This would enhance certainty with respect to how transactions are being accounted for, and allow users to accurately restate financial statements if required. It would also address the issue of assets that the firm has no legal title being reported in the balance sheet.

In summary, I have concerns about the complexity of this exposure draft, and I doubt that it will do anything to limit accounting choices for leases and ensure comparability and understandability in financial statements.

Yours faithfully

Peter Wells

12 September 2013

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr Hoogervorst,

Re: ED/2013/6 'Leases'

Australia and New Zealand Banking Group Limited (ANZ) is listed on the Australian Securities Exchange. Our operations are predominately based in Australia, New Zealand and the Asia Pacific region. Our most recent annual results reported profits before tax of US$5.1 billion and total assets of US$601 billion.

We acknowledge the significant progress the International Accounting Standards Board (IASB) has made in relation to the development of a standard that will address the IASB's overriding objective to require lessees to recognise assets and liabilities arising under operating leases. In meeting this objective, we regard the current ED as a significant improvement on the previous ED, in particular the removal of the performance obligation approach.

However, on balance, considering the costs and benefits of the changes proposed, ANZ does not support a change to the current lease accounting requirements. The basis for this view is:

- We believe the introduction of a rules based approach to lease accounting, whereby a lease is classified and measured depending on whether it is property or not, does not reflect the substance of a leasing arrangement. We believe the existing model, which is well understood by preparers and users, more accurately reflects the economics of a leasing transaction as it takes into account the risks and rewards of ownership. Further, users of financial statements understand the existing model and concerns about the current off balance sheet treatment of leases can be mitigated by ensuring lease disclosures allow users of financial statements to identify a company's future cash flow commitments relating to leases and, significant assumptions and judgements made in determining lease commitments are sufficiently disclosed.

- We note that given the number of leases we are involved in, both as lessee and lessor, and the complexity of some of our structured lending leases, the cost of implementing the proposals will be significant and the value derived by the users of financial statements will be minimal.

- While the current leasing requirements do present entities with structuring opportunities, we note that the lack of guidance within the proposals, such as the definition of an identified asset; the distinction between a lease and a service contract; and, the proposals for determining the lease payments to be included in the lease asset, may lead to divergence, either due to inconsistent interpretation or

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deliberate structuring around the complex rules, and thus there will be different applications of the proposals which could undermine the objectives of the ED.

If the IASB continues with its current proposals, we note the following areas of concern:

- The continuous reassessment requirements proposed in the ED will be difficult to achieve in practice for any entity with more than an insignificant number of leases, given the significant time commitment and management overlay required.

- As a regulated entity, we are concerned by the capital implications of the proposals, which could be a significant cost to our business. It is unclear whether the right-of-use asset will be treated as a tangible or intangible asset, which may have consequential implications for regulatory capital purposes, as prudential standards are based off accounting standards.

  We believe that the right-of-use asset should be treated as a tangible asset on the basis that conceptually a tangible asset reflects the economics of a leasing transaction more than an intangible asset. While the IASB is not responsible for regulatory requirements or setting prudential standards, it should be noted that the classification of the right-of-use asset as an intangible asset would affect the calculation of risk-weighted assets, as intangible assets result in a 100% regulatory capital deduction. The impact of this globally would be significant, in particular, in Australia where this regulatory deduction would be on a pre-tax basis. Therefore, we recommend that the IASB clarify the classification of the right-of-use asset.

- The disclosure requirements under the ED are excessive in comparison to the existing leasing disclosures and we would question whether users of financial statements require all of the disclosures proposed.

- The proposals introduce a significant level of complexity that does not exist in the current requirements, due to the calculations required to measure the lease asset and liability. Technology systems will need to be upgraded to accommodate the calculations and disclosure requirements and a significant amount of time will be required to gather all the required information and to review all lease agreements using the new principles and terms referred to in the proposed ED. We would propose the IASB look for opportunities to simplify the measurement of lease assets and liabilities.

Overall, we believe that the proposals are not an improvement to the existing lease accounting requirements. We therefore do not support a change from the existing requirements and we would encourage the IASB to reconsider the costs and benefits of the lease proposals.

Detailed comments on the questions raised in the ED are attached as an Appendix to this letter. Should you have any queries on our comments, please do not hesitate to contact me at shane.buggle@anz.com.

Yours sincerely

Shane Buggle
Deputy Chief Financial Officer

Copy: Chairman, Australian Accounting Standards Board (AASB)

APPENDIX

Question 1
This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether: (a) fulfilment of the contract depends on the use of an identified asset; and (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration. A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset. Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

We believe that the definition of a lease should refer to whether risks and rewards of ownership have been transferred, as opposed to having the ability to direct the use and receive the benefits from use of the identified asset. The current concept of risks and rewards reflects the economics of a leasing transaction, as it considers the lease arrangement in light of the total economic life of the asset. However, the current proposals only consider whether the ability to direct the use and receive the benefits from use of an identified asset occurs over the term of the lease contract. We believe further consideration should be given to considering the lease arrangement against the economic life of the asset and not just the lease term.

We believe the distinction between a lease and a service contract in the ED proposals is unclear. We acknowledge that examples have been provided to determine if an arrangement contains a lease or a service contract, however, we believe additional guidance is required to prevent diverging treatment for similar transactions.

In addition, we believe that the introduction of the concept of 'the use of an identified asset' may lead to divergent treatment, as entities may structure contracts to refer to a type of asset rather than a specific asset.

Question 2
Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We do not agree with the introduction of a rules based approach where income and expenses are measured based on whether the leased asset is property or not. The current proposals will have a financial impact that does not reflect the economics of certain leases currently classified as operating leases. Under the ED, the expense for Type A leases is front-loaded, as a result of the application of the effective interest rate method. However, under the current requirements, the operating lease expense is recognised evenly over the period of the lease, in many cases reflecting the economics of the arrangement and matching the delivery of benefits under the lease. For a lease that is akin to a financing arrangement, that is, where risks and rewards of the underlying asset have been transferred, the proposed treatment is more logical.

We agree that for Type B leases straight line expense recognition is desirable, however we have concerns around the complexity created by this, specifically the calculation of the amortisation of the right-of-use asset. Given the existing model also has straight line expense

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recognition for the majority of property leases (as generally they would be classified as operating leases), we would question whether the benefit of changing models exceeds the cost. As a preparer, significant cost will be incurred to ensure technology systems are upgraded to accommodate these changes. We would support a change in disclosures to allow users of financial statements to make informed decisions regarding a company's lease commitments by reference to note disclosures within a company's annual report (see question 8).

Finally, it is unclear whether the right-of-use asset will be treated as a tangible or intangible asset, which may have consequential implications for regulatory purposes, as prudential standards are based off accounting standards.

We believe that the right-of-use asset should be treated as a tangible asset on the basis that conceptually a tangible asset reflects the economics of a leasing transaction more than an intangible asset. While the IASB is not responsible for regulatory requirements or setting prudential standards, it should be noted that the classification of the right-of-use asset as an intangible asset would affect the calculation of risk-weighted assets, as intangible assets are result in a 100% regulatory capital deduction. The impact of this globally will be significant. Therefore, we recommend that the IASB clarify the classification of the right-of-use asset.

Question 3
Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We do not agree with the different accounting approach for Type A and Type B leases, where a lease receivable is recognised for a Type A lease compared with Type B leases, where the underlying asset continues to be recognised. This is also inconsistent with the proposed lessee accounting, where a right-of-use asset is recognised for both Type A and Type B leases. We believe that the principles should be applied consistently across lease type and between lessee and lessor.

We believe the accounting for a residual asset is complex and do not believe that interest should be recognised on a non-financial asset. We do not support the recognition of a gain at inception of the lease, where this gain is effectively the profit arising from the lease contract; we believe this profit should be earned as the lease service is provided.

In structuring a lease contract, the lessor will consider the expected value of the lease contract and the expected residual value. The lessor is likely to add a profit margin to the expected lease payments and be conservative in the estimation of the residual value – in other words in pricing the lease contract the lease payments will be close to a fair value whereas the residual value is more likely to be conservative and less than the fair value.

We would prefer an approach that determines the residual asset as the difference between the carrying amount of the underlying asset at inception and the present value of lease payments.

Question 4
Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

We do not agree with the principle that lease classification should be based on the nature of the underlying asset. We believe the introduction of a rules based approach to lease

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accounting, whereby a lease is classified and measured based on whether it is property or not, does not reflect the substance of a leasing arrangement. We believe the existing model, which is well understood by preparers and users, more accurately reflects the economics of a leasing transaction as it takes into account the risks and rewards of ownership. Concerns about the current off balance sheet treatment of leases can be mitigated by ensuring lease disclosures allow users of financial statements to identify a company's future cash flow commitment relating to leases and significant assumptions and judgements made in determining the lease commitment are sufficiently disclosed.

We also do not agree that for Type A leases, the total economic life of the underlying asset is used to classifying a lease, compared with the remaining economic life of the underlying asset for Type B leases. We believe a consistent approach should be adopted and that the current principle of the lease term being a major part of the total economic life of the underlying asset should be retained.

The proposals introduce new concepts in classifying a lease, in particular 'insignificant', 'major part' and 'substantially all'. We believe additional guidance should be provided to ensure the concepts are consistently applied.

We support the exemption from applying the ED to short-term leases for both lessees and lessors as this will provide significant relief for entities that are involved in a large number of low-value lease arrangements.

Question 5
Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

We do not agree with the proposals relating to the lease term. We believe that there is insufficient guidance as to what a 'significant economic incentive' to exercise an option is and this may therefore lead to inconsistent application of the standard.

We do not believe that measuring the lease liability by reference to having a significant economic incentive to exercise an option meets the definition of a liability, as the entity does not have a present obligation. Further, the requirement for a lessor to reassess the lease term or lease payments based on whether a lessee has a significant economic incentive to exercise an option seems inappropriate, as in practice, it will be difficult to predict the lessee's actions and, therefore, as lessor we would be unable to measure the asset accurately.

We believe the requirement to reassess the lease term will be onerous for ANZ given the judgement required to determine if there is a significant economic incentive to exercise an option, coupled with the number of leasing arrangements that ANZ has, both as lessee and lessor.

Question 6
Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

We agree that usage and performance-based variable lease payments should be excluded from the measurement of the lease liability. However, we believe there will be divergence or inconsistency in measuring the lease asset or liability for a portfolio that includes market rent reviews, which are common in Australia, and CPI variable lease payments. Applying the reassessment requirements outlined in the ED would lead to significantly different assets and

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liabilities given we would be required to measure the lease liability using CPI at lease commencement date, for term of the lease, compared with measuring the lease liability up to the date of the first market rent review.

Variable lease payments that are in-substance fixed payments are included in the measurement of the lease asset and liability. While the Illustrative Examples give an example of variable lease payments that are in substance fixed payments, there is no definition or guidance as to what an in-substance fixed payment is. We believe a definition and guidance is required for in-substance fixed payments.

Question 7
Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why? Are there any additional transition issues the boards should consider? If yes, what are they and why?

We agree with the proposal of using either a modified retrospective approach or a full retrospective approach on transition. We also agree with the proposal to carry forward amounts recognised as finance leases on transition date.

We recommend sufficient lead time is allowed for application of the standard, as a new system will be required to capture the information required by the proposed ED. In addition, a significant amount of time will be required to gather all the required information and to review all lease agreements using the new principles and terms referred to in the proposed ED.

Question 8
Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

We believe that the disclosures proposed are excessive and we would question whether users of financial statements require all the disclosures proposed, particularly reconciliations of amounts recognised in the statement of financial position. We recommend that disclosures are limited to only what users would want to see. We would therefore support disclosures surrounding the significant assumptions and judgements made in determining the lease commitment, such as determination of the lease term and discount rate used and future cash flow commitment. We would expect these disclosures to be aggregated at a portfolio level, for example by asset type, to ensure users can make informed decisions, without being presented with excessive information.

Users of financial statements are concerned with the future cash flow commitments under lease arrangements and any estimates a company makes in deriving the lease asset and liability balances and therefore disclosures should be limited to these areas.

We believe the IASB should reconsider the level of disclosures, particularly as significant time and cost will be required to adopt the recognition and measurement requirements and including all the disclosures proposed would add to this.

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Questions 9, 10 and 11 (FASB only)
Non-public entities and related party leases.

We have no comment on Questions 9, 10 and 11.

Question 12
Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of an investment property? If not, what alternative would you propose and why?

For sub-leases we do not believe that the right-of-use asset should be within the scope of IAS 40. If fair value measurement were applied to the right-of-use asset, then at the end of the lease term the lessee would have an asset recognised on balance sheet that they would not be able to realise (unless ownership was transferred at the end of the lease term). The right-of-use asset for sub-leases should be measured consistently with other leases to ensure that at the end of the lease term the right-of-use asset is nil. In addition, the lessee’s lease liability of the property lease would be measured in accordance with the proposals and therefore there would be an accounting mismatch if the right-of-use asset is fair valued.

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National Australia Bank

National Australia Bank Limited
ABN 12 004 044 937

800 Bourke Street
Docklands Victoria 3008
AUSTRALIA

13 September 2013

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

cc: Mr Kevin Stevenson, Chairman, Australian Accounting Standards Board (AASB)

Dear Sir

Re: ED/2013/6 Leases

We are pleased to have the opportunity to comment on Exposure Draft 2013/6 *Leases* (the ED). Our comments on the specific questions raised by the IASB are addressed in the Appendix.

National Australia Bank Limited (NAB) is one of the four major Australian banks. Our operations are predominantly based in Australia, New Zealand, the United Kingdom, the United States and Asia. In our September 2012 full year results we reported net profit after tax of A$4.1 billion and total assets of A$763 billion.

In our response to the 2010 ED, NAB did not agree with the right-of-use model and we maintain this view. We do not believe that a lessee has a present obligation to make payments to a lessor at commencement of a lease. The right-of-use approach is inconsistent with other types of contracts, such as supply agreements, under which a right (such as to receive purchased goods) and a liability to make payments for the supply of goods, are not recognised on balance sheet at commencement of the contract.

Notwithstanding our negative views on the right-of-use model, we have provided responses to the specific questions raised by the IASB on the basis that the proposals in the ED will be retained.

We have the following general comments on the ED:

The right-of use model reflects that at commencement date, a lessee obtains the right to use the underlying asset during the lease term and a lessor has provided that right. Under this model, all lease contracts create this right of use, irrespective of the extent of consumption of the economic benefits in the underlying asset, and the right-of-use model should result in a single model. The proposed dual measurement for different leases provides a variation to the right-of-use model, and is the result of a pragmatic approach to achieve a straight-line expense outcome for Type B leases. The proposals are therefore rules-based and result in accounting outcomes for Type B leases that are conceptually impossible to justify.

Consequently, we have the following concerns with the proposals in the revised ED which we address in detail in the Appendix:

a) *Accounting for Type B Leases for lessees and lessors*

- The revised proposals for Type B leases create asymmetrical accounting between lessees and lessors. While a lessee is required to recognise a lease payable reflecting a present obligation to pay lease payments to the lessor, this does not result in a corresponding right to receive the lease payments by the lessor. It is difficult to justify how the present obligation criterion is met by the lessee to pay cashflows, but the right to receive the same cashflows is not recognised by the counterparty.

- The measurement of the right-out-use asset recognised by the lessee is effectively a balancing figure which is determined by the impact of a financing cost combined with an amortisation element to achieve a straight-line expense impact in the P&L. Not only is this measurement inconsistent with the cost model approach for an intangible asset, it will create operational complexities.

- The residual asset recognised in the lessor's books is subsequently measured at its initial carrying value plus the unwinding of the discount, and this accretion in value is recognised as interest income in the P&L. It is unclear to us how to explain the carrying value of this non-financial asset.

In finalising a new leasing standard, we believe the Boards should follow a principles based approach, and provide further clarification on these concepts to enable preparers and users of financial statements to understand these accounting outcomes. We have our doubts that a conceptual justification of the proposed approach is possible and are concerned that the proposal would impose significant cost and effort on preparers to achieve an accounting outcome that is not understandable for users.

b) *Disclosure requirements*

We consider the proposed disclosure requirements extensive and not consistent with the objective of providing useful and relevant information and reducing the burden on preparers of financial statements. We believe these should be revised to remove those disclosures that are onerous, or where useful information is already provided under the IFRS 7 requirements or may be duplicated within IFRS projects that are still under development. Our specific concerns are outlined in Question 8.

c) *Transition and ongoing operations*

We have significant concerns with the cost and effort associated with transitioning to the new requirements and the ongoing operational issues which include:

- Significant system changes and data collation for operating leases at transition will require enormous effort and lead time as much of the information is currently not required.
- Additional effort and changes to system capabilities will be required to obtain ongoing data collation for disclosures.
- The straight-line expense approach by a lessee for Type B leases results in an amortisation expense that will need to be computed outside the amortisation process that our systems currently perform. This would need to be addressed by potentially adding a manual element to the process which would weaken the control

environment, making significant changes to existing systems or developing new system capabilities.

- The interpretation of the lease accounting proposals by regulatory and tax authorities may potentially have significant commercial implications specifically on regulatory capital and tax treatment of leasing transactions.
- Entities in the banking sector will also have to consider and manage the impact of the leasing requirements on their customers, including the potential impact on loans covenants.

In summary, we fail to see how this proposal, which replaces the well understood IAS 17 model with accounting outcomes that cannot be explained from a conceptual perspective to management, users and preparers of financial statements, justifies the significant cost and effort that would be required to implement the ED in its current form.

The Appendix to this letter outlines our responses to the specific questions in the ED which should be read in the context of the general comments raised above.

Should you have any queries regarding our comments, please do not hesitate to contact Marc Smit, Head of Group Accounting Policy at Marc.Smit@nab.com.au.

Yours sincerely

Stephen Gallagher
General Manager Group Finance

Vanessa Fong
Senior Manager Group Accounting Policy

APPENDIX – Response to Specific Questions

Identifying a lease

Question 1
This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether: (a) fulfilment of the contract depends on the use of an identified asset; and (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration. A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset. Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

The ED definition is largely consistent with the definition in IFRIC 4 *Determining whether an Arrangement contains a Lease* and provides additional clarifications and examples.

We agree with the definition and provide the following suggestions for improvement:

- The ED distinguishes leases from service contracts in paragraph 22 of the Basis for Conclusions, which explains that while "...fulfilment of a service contract may require the use of assets, fulfilment typically does not require the delivery of an identified asset." This is demonstrated in the illustrative example IE2. We recommend that the term "service" be specifically defined so that the identification of services is clearly understood without the need to refer to the illustrative example. It could be beneficial to have additional practical illustrative examples such an outsourcing arrangement for IT equipment which includes a service element.

- The term "control" could be tightened by being specifically defined, similar to how control is defined and clarified in other IFRS proposals such *IFRS 10 Consolidated Financial Statements* which discusses substantive and protective rights and *Revenue Recognition* which clarifies the principal and agent relationships in a contract.

Lessee Accounting

Question 2
Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Lessor Accounting

Question 3
Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Lessee accounting cannot be considered in isolation of lessor accounting and we have therefore combined our response to Q2 and Q3.

In our response to the 2010 ED, NAB did not agree with the right-of-use approach and we continue to maintain this view. We do not believe that at commencement of a lease the lessee has a present obligation to pay the lessor for use of the underlying asset. We consider the right-of-use approach inconsistent with other types of contracts, such as supply agreements, under which a right (such as to receive purchased goods) and a liability to make payments are not recognised on balance sheet at commencement of the contract.

We agree that there should be different approaches for different leases, and this is the current approach within IAS 17 which distinguishes between operating and finance leases. However, we believe that this should use the approach currently used in IAS 17 which is based on whether substantially all the risks and rewards incidental to ownership is transferred to the lessee. We believe that in many cases leases are structured based on the risks and benefits the lessee and lessor are willing to have exposure to, rather than to achieve an accounting outcome. A lessee who does not want to invest capital and purchase an asset outright is looking for a "rental" type arrangement where the lessee will not gain exposure to many of the risks and benefits associated with ownership of the underlying asset.

The revised proposal now introduces a dual measurement approach but creates accounting outcomes that are not well explained at a conceptual level. This is the result of a pragmatic compromise, between the objective of bringing more leases on-balance sheet and practical implementation, aimed at achieving a straight-line expense for a small portion of leases.

Lessee Accounting
We have the following concerns on lessee accounting under a Type B lease:

(i) Accounting outcomes are asymmetrical between a lessee and lessor. While the lessee is required to recognise a lease payable reflecting a present obligation to pay lease payments to the lessor, the lessor does not recognize the corresponding right to receive these lease payments as a lease receivable. It is difficult to justify how the present obligation criterion is met by the lessee to pay cashflows due under the lease contract, when the lessor is unable to recognize the right to receive the same cashflows.

(ii) The lessee initially recognizes the right-of-use asset as the present value of lease payments discounted at the rate charged by the lessor (paragraph 38(a)). Following initial recognition, the proposed measurement requirements for this right-of-use asset is effectively a balancing figure determined by a combination of the impact of a financing cost (the discount unwind on the lease liability) and an amortisation expense element, to achieve a straight-line expense impact in the P&L. This measurement is inconsistent with the cost model approach for an intangible asset.

Lessor accounting

We also find the lessor accounting outcomes for Type B leases under this proposal lack conceptual justification. Our concerns over the lessor accounting for Type B leases include the following:

(i) In our response to Q2, we have already outlined our concerns with the asymmetrical accounting outcomes between a lessee and a lessor.

(ii) Partial duplication in the recognition of the economic benefits in the underlying asset for Type B leases, whereby the lessor continues to recognise the underlying asset (no derecognition) and the lessee recognises a portion of the economic benefits in the same underlying asset via a right-of-use asset. An alternative approach would be to require partial derecognition of the underlying asset by the lessor. However, we do not recommend this as we believe this approach will increase the complexity for lessor accounting and will not enhance the usefulness of financial information reported.

(iii) Measurement of the gross residual asset by the lessor accretes in value over time for the effect of the unwinding of the discount and is recognised as interest income (ED paragraph 77(b)). It is unclear how we would explain the carrying value for the residual asset when its outcome conflicts with the measurement criteria for a non-financial asset.

(iv) In addition, we believe the ED does not sufficiently address back-to-back leases (subleases). Where a lessee (head lessee) of a Type B lease subleases the same underlying asset, the sublease will also be classified a Type B and the right-of-use asset will remain on the head lessee's books. In contrast, if the originating lease and sublease were both classified as Type A leases, the head lessee would be able to derecognize the asset and not have to present the right-of-use asset in its books and instead record a receivable (from sub-lessee) and corresponding payable (to lessor). We believe the latter would be a more faithful representation of a back-to-back lease. We recommend an exception be included for back-to-back leases where the original lease is a Type B. This will result in consistent treatment and more faithful presentation of the accounting for back-to-back leases.

In our view, the proposals in this ED have focussed on addressing the concerns over the complexities in the earlier 2010 ED, resulting in accounting outcomes that are not conceptually justifiable, making it difficult to explain or rationalise to management, preparers and users of financial statements. We believe the proposals should be principles based rather than the proposed rules-based approach.

Classification

Question 4
Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

While we in principle support a dual approach to lease accounting, we believe the proposals in this ED are not principle-based and therefore are difficult to justify. The Basis for Conclusions (paragraph 42) explains that the Boards concluded a single lease expense provides better information about a lease where the lessee is expected to consume only an insignificant amount of the economic benefits embedded in the underlying asset - the 'consumption principle'.

Paragraph 11 of the Basis for Conclusions states that, under the 'right-of-use' model, a lessee obtains the right to use the underlying asset for a period of time, and the lessor provides that right. A true right-of-use model, if driven by the creation of this right, would result in a single accounting approach irrespective of the extent of consumption of the economic benefits embedded in the underlying asset. Therefore we believe that using the consumption principle to develop a dual approach for leases, conflicts with the general principle of the right-of-use model.

In addition, when applying the consumption principle under the proposed ED, the classification of a lease is also dependent on the nature of the underlying asset based on whether it is property or not. We understand the Boards decided to include the nature of the underlying asset as a means to simplify the requirements to reduce complexity and the cost of implementing the proposals (paragraph 50 of the Basis for Conclusions).

The proposed classification requirements that would enable a classification change from a Type A to Type B are based on higher thresholds than that used in the existing IAS 17 for distinguishing operating and finance leases. To change the classification from Type A to Type B, the lease term needs to be for a *more than insignificant* portion of the economic life. In contrast, to change the classification from Type B to Type A, the lease term is only required to be for a *major part* of the economic life. Having disparate thresholds can result in two assets, with the same lease term and same economic life, having different lease accounting outcomes depending on whether it is property or not, as illustrated below.

	Non-property	Property
Underlying Asset	Ship	Building
Lease term	5 years	5 years
Economic life	25 years	25 years
Lease type	Type A	Type B

While the Boards have acknowledged (paragraph 51 of the Basis for Conclusion) that applying the principle in the manner proposed would not always result in conclusions that are consistent with the principle, we do not agree that this sufficiently justifies the accounting outcomes for which we have raised concerns in our earlier responses in Q2 and Q3.

We would support classification requirements that are based on the principle of the expected level of consumption but do not agree with this being based on the nature of the underlying asset, specifically the reference to property.

Lease term

Question 5
Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

We support the proposals on lease term and believe this is an improvement to the proposals under the 2010 ED.

In paragraph 140 of the Basis for Conclusions the Boards note that applying the concept of significant economic incentive would provide a threshold similar to well understood existing concepts such as "reasonably certain". Given the term "reasonably certain" is well understood and is already used in existing IFRS, we recommend that it should be captured in the guidance notes in B5–B6 or incorporated in the final standard.

The concept of including lease extension options in measuring the lease liability is contradicted in the requirements for the short term lease exemption. While we support the inclusion of an exemption for short term leases (where the total fixed lease term including any option to extend is less than 12 months), in circumstances where there is an option to extend, even if there is no significant economic incentive in exercising the option, the lease would not qualify for the exemption. We acknowledge that this threshold aims to remove the incentive for abuse; however the concept is counter intuitive and in practice would not provide much relief. We recommend amending the exemption requirement to increase the total term to include the option to extend to three years.

Variable lease payments

Question 6
Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

We agree with the proposals on the measurement of variable lease payments that depend on an index or rate (such as the Consumer Price Index or market interest rate) and the reassessment criteria for subsequent measurement.

We recommend that in-substance fixed payments be defined within the ED to reduce the reliance on illustrative examples which demonstrate the application of this term. We also consider certain minimum payments described in the illustrative example (IE17) to be committed amounts and therefore fixed payments. For example, IE17A refers to variable payments based on a percentage of sales (variable amount) with a minimum amount payable irrespective of sales (the fixed amount). This can be addressed by defining or clarifying in-substance fixed payments within the base IFRS and amending the illustrative examples as appropriate.

Transition

Question 7
Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why? Are there any additional transition issues the boards should consider? If yes, what are they and why?

We agree with the option to apply a full retrospective as well as a modified retrospective approach upon transition. The selection of which transition approach to apply depends on the extent of effort and cost to apply a full retrospective approach compared to the impact on retained earnings under the "short-cut" calculations.

We welcome any practical reliefs that will reduce implementation costs. We recommend that the Boards permit relief from applying the transition requirements to previous operating leases that expire within the financial reporting period of adopting the new standard. We believe the cost and effort in applying transition requirements to these leases will far outweigh any benefits in the information provided to users of financial reports.

When determining the final standard implementation date, consideration should be given to the commercial ramifications and potential flow on effects of changing the accounting for leases for financial institutions such as regulatory capital requirements and tax legislation. Financial institutions may be required to hold additional regulatory capital if right-of use-assets are not viewed by regulators in conjunction with the associated lease liabilities. In Australia, current tax legislation distinguishes between operating and finance leases and further clarification and potential legislation amendments will be required to address the concept of Type A and Type B leases. Furthermore, banks will also need to consider the impact of the leasing requirements on customers, such as updating calculations for banking covenants. Preparers will require sufficient lead time to address these additional areas.

Disclosure

Question 8
Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

We recognize that the new proposals will lead to additional effort and system requirements and would welcome any practical guidance particularly with an extensive list of requirements.

We support the inclusion of paragraph 59 and 99 which require the lessee or lessor to "...consider the level of detail necessary to satisfy the disclosure objective and how much detail to place on each of the various requirements" but believe these should be given equal prominence as the disclosure objectives (in paragraphs 58 and 98). This could be addressed by including a clear statement that each requirement will not necessarily be disclosed in all situations.

We believe there should be more emphasis within the final standard on those requirements that satisfy the disclosure objectives rather than an extensive list of information that may be of interest for all possible users. Information is already currently required to be disclosed under IFRS 7, and therefore additional disclosures under the proposals should cover key information, such as the maturity profile of lease payments which is currently considered useful information under IAS 17.

We question the usefulness of the reconciliation requirement in paragraph 64 (for the lease liability separately for Type A and Type B leases) and paragraph 103 (for the lease receivable). These requirements are extensive and consideration should be given to the overall increasing disclosure requirements within other draft IFRSs. We also recommend further explanation on why there should be separate reconciliations for Type A and Type B leases as this is not adequately addressed within the Basis for Conclusions.

We also recommend clarification within the draft IFRS together with the inclusion of illustrative examples on how the different types of leases will be presented and disclosed in the financial statements. Our preference is to avoid references to *Type A* and *Type B* when presenting information on lease transactions in our financial statements.

The proposed requirements will result in additional effort in monitoring and preparing information and significant changes to existing systems to enable the collation of the required disclosures. Management currently do no use the information required in the proposed disclosures, and therefore we question the relevance or usefulness of providing all information included in the ED. While the ED allows an entity to consider the extent of detail necessarily to satisfy the disclosure objectives, we believe further emphasis should be given to provide clarity that not all requirements in the draft IFRS will be required in all situations. We encourage the IASB to take into account our responses to this ED and consider the increasing disclosure requirements of other ongoing IFRS projects proposals

Question 12 (IASB-only): Consequential amendments to IAS 40

Question 12
The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property. Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

We agree to the proposed amendments to IAS 40 *Investment Property* to include a right-of-use asset within its scope if the leased property meets the definition of investment property as this aims to align IAS 40 with the proposed requirements of the ED.

ACAG AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL

16 September 2013

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
Victoria 8007

Dear Mr Stevenson

IASB Exposure Draft ED/2013/6 – *Leases*

Attached for your information is a copy of the Australasian Council of Auditors-General (ACAG) response to the Exposure Draft referred to above.

The views expressed in this submission represent those of all Australian members of ACAG.

Yours sincerely

Simon O'Neill
Chairman
ACAG Financial Reporting and Auditing Committee

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ACAG AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL

13 September 2013

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr Hoogervorst

IASB Exposure Draft ED/2013/6 - *Leases*

Please find attached the Australasian Council of Auditors-General (ACAG) response to the questions in IASB Exposure Draft ED/2013/6 ('the ED'). The views expressed in this submission represent those of all Australian members of ACAG.

ACAG supports a lease accounting model that recognises all leases in the statement of financial position. However, ACAG does not support the dual model approach proposed in the ED as we believe it is overly complex and costly for preparers to implement and maintain.

ACAG supports a single model that is broadly consistent with that described as a Type A lease in the ED. ACAG believes the Type A model to be more conceptually sound the than the proposed Type B model notwithstanding the proposed Type B model may potentially be simpler to implement. ACAG also recommends:

- The lessor accounting proposed under the Type A model would benefit greatly from reduced complexity in the calculation of both the lease receivable and residual asset, and
- Regardless of the model ultimately chosen by the IASB, we recommend generous concessions are made in respect of the mandatory application date of the final standard as we believe entities will need significant time to prepare for implementation.

The attachment to this letter addresses the specific questions asked by the IASB and articulates our views in more detail. The opportunity to comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

Simon O'Neill
Chairman
ACAG Financial Reporting and Auditing Committee

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Questions for respondents

Scope

Question 1: Identifying a lease

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and
(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

Response:

ACAG is generally supportive of the proposed requirements for how an entity would determine whether a contract contains a lease.

One objective of the Boards in developing the ED, as expressed by BC3(b), was to address the structuring opportunities present in the existing standard. While noting that the approach taken by the Boards in requiring all but short-term leases to be recognised on the balance sheet will reduce these opportunities, ACAG sees some remaining potential for structuring of contracts to avoid being captured by the requirements of the ED.

For example ACAG considers the substitution rights aspects of the ED creates potential structuring opportunities. An arrangement does not constitute a lease for the purposes of the ED if a supplier has the substantive right of substitution of the asset(s), per paragraph 8. Paragraphs 9(a) and 9(b) outline that a substantive right of substitution would only exist where the supplier can substitute the asset without the consent of the customer and there are no barriers (economic or otherwise) which prevent substitution occurring.

Notwithstanding the content of paragraphs 9(a) and 9(b), or the Boards' views as expressed in BC105(b), ACAG can see the potential for contracts for certain assets to be structured in a manner which places them outside of the ED. A contract for the provision of cars, for example, may be deliberately structured to avoid these requirements by avoiding the identification of specific vehicles.

In considering potential areas, ACAG notes the Boards' view as expressed in BC370, that structuring to avoid the requirements of the ED will not be easy. Even so, ACAG considers that the complexity of accounting, the impacts on the statement of financial position, and the 'front-loading' of expenses for Type A leases would still provide sufficient incentive for some entities to structure contracts to avoid the requirements of the ED.

Question 2: Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Response:

ACAG is not supportive of the dual model approach as contained in the Type A and Type B lessee accounting models (see also our response to Question 4 for more discussion on this issue). If, however, the Boards elect to implement this approach, ACAG makes the following observations regarding areas where further clarity would be beneficial.

ACAG notes that there are a number of areas within the ED that provide options regarding the accounting treatment of like transactions. ACAG notes that the inclusion of options of this nature may not provide for the level of comparability between similar entities originally sought. One example of these options concerns the option in paragraph 5 that allows for, but does not require, lessees to apply the requirements in the ED to intangible assets. ACAG recommends that the Boards scope intangibles out of the resulting leases standard in their entirety, until the Boards have completed a separate and comprehensive review of the accounting for intangible assets (as noted in BC81).

ACAG is concerned that the option to combine owned property, plant and equipment (PPE) and right-of-use assets within the one class of PPE as permitted by paragraph 55 will lead to a lack of clear and comparable information for users, due to the interaction with the requirements of IAS 16 *Property, Plant and Equipment*. ACAG believes by virtue of the depreciation pattern for a Type B lease, the lessee should disclose right-of-use assets as a separate class of property, plant and equipment. Without this, it may be difficult for a user to interpret the information about depreciation of PPE.

If the Boards implement the Type B model, ACAG requests further explanation regarding how the balancing figure calculation of amortisation for the right-of-use asset ties to the concept of amortisation within the Conceptual Framework. Specifically, it is unclear how the increasing amortisation figure, throughout the lease term, reflects an expense pattern consistent with how the asset is consumed.

Question 3: Lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Response:

ACAG is not supportive of the lessor accounting model for Type B leases as we believe that a lessor should apply a derecognition approach. Therefore, as noted above, we support the consistent application of an approach based on the Type A model included in the ED. ACAG has identified some specific matters of concern in relation to Type A leases as currently described in the ED, as outlined below.

ACAG understands the Boards see a necessity for including in-substance fixed variable lease payments within the lease receivable of the lessor in order to match the liability recorded by the lessee, as outlined in BC216. ACAG also understands the Boards' view, as outlined in BC229, that entering into a lease, from a lessor's perspective, is not akin to a sale of the underlying asset, resulting in a conclusion that it would be inappropriate to recognise profit associated with the residual asset before the residual asset is sold. While noting this background, ACAG considers that the initial and subsequent measurement and recognition requirements outlined in paragraphs 71-83 and B19-21 of the ED for a Type A lease receivable and residual asset is overly complex and will likely result in the need for specialised skills and/or software for lessor entities. The measurement requirements have the potential to be costly to implement and maintain, particularly given annual re-measurement requirements for leases which reference an index rate (e.g. CPI). In the case of lessor entities whose core business is not leasing, the calculations appear to be particularly onerous.

ACAG believes that the number of assumptions and the degree of estimation uncertainty involved in measuring the lease receivable and residual asset are likely to lead to increased audit costs in auditing lease receivables, residual asset balances and associated profit or loss impacts.

ACAG notes that the ED requires lessors to categorise variable lease payments (e.g. in-substance fixed payments or variable), and depending on this assessment, include them in either the lease receivable or residual asset (paragraph 72). This requirement is likely to lead to divergent practices and therefore contribute to a potential lack of comparability between like entities.

ACAG also notes that both the measurement differences regarding the residual asset, and the judgement regarding which component the variable lease payments are recognised in, will lead to consolidation issues where there are leases between common control entities, such as for whole-of-government financial statements. Accordingly, ACAG recommends the Boards either develop guidance around how the elimination entries work in this situation or consider specific concessions regarding entities under common control. In particular we would like confirmation that any measurement differences between the lessee and lessor are put to equity within the consolidated entity.

Question 4: Classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

Response:

ACAG does not support the Type A and Type B lease classification. ACAG believes that the dual model approach will increase the cost of implementation for many preparers. ACAG's view is that a single model approach reduces cost as it eliminates the costs associated with appropriate determination and audit of initial classification. ACAG also believes that a model consistent with that described by Type A lease model is more conceptually sound as it supports the view that all leases contain a financing element and will avoid a rules-based approach such as that proposed for Type B leases under the ED.

Nonetheless, if the Boards adopt the dual model approach, ACAG considers that there are areas for potential improvement to the ED regarding lease classification, as outlined below.

ACAG believes it would be highly beneficial for the Boards to use more descriptive terminology for the different types of leases under the standard (Type A and Type B) that provide more decision-useful information to general users of financial statements. We note one proposal is to refer to 'accelerated leases' and 'straight-line leases'.

Paragraphs 29 and 30 of the ED use a number of undefined terms that are open for debate as to their meaning. Terms such as "insignificant", "major part" and "substantially all" are likely to be interpreted by different parties in an inconsistent manner. ACAG therefore supports the comments expressed in AV5 that additional guidance is needed in relation to the Boards intended meanings for these terms.

ACAG considers that the current criteria in paragraph 30(b) is likely to result in many more property leases being reported as Type A leases than appears to have been the intention of the Boards. BC56 outlines the intention of the Boards not to capture standard commercial leases of property for periods of up to 15 years. BC56 makes it clear that the Boards consider that both the lease term and the present value of minimum lease payments are unlikely to satisfy the criteria in paragraph 30 requiring recognition as a Type A lease. ACAG believes the current criteria in paragraph 30(b) may still result in a number of property leases being captured as a Type A lease, despite the Boards' stated intention that this not be the case.

Measurement

Question 5: Lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

Response:

ACAG supports the revised proposals regarding the lease term reflected in the ED, requiring only the non-cancellable period plus periods for which the lessee has a significant economic incentive to exercise extension options to be included. ACAG sees that this change has the potential to reduce complexity and estimation uncertainty in measuring the lease liability and receivable.

ACAG is, however, concerned that the term 'significant economic incentive' is unlikely to be interpreted consistently. ACAG therefore believes the Boards should provide additional guidance regarding the term 'significant economic incentive'.

Question 6: Variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

Response:

Majority view

The majority of ACAG members support the approach taken by the Boards in relation to variable lease payments for lessees. ACAG supports the cost-benefit/reliability of measurement argument set out in BC152. Also, ACAG agrees that reassessment of the lease liability and right-of-use asset is warranted when there is a material change in an index or a rate used to determine the lease payments. However, as noted at Question 3, ACAG believes a more simplified and consistent approach should be applied to the measurement of the in-substance fixed variable lease payments for a lessor.

ACAG notes guidance surrounding the term 'in-substance fixed lease payments' is not included in the ED. Rather, the guidance has been included in the Illustrative Examples, of which there are relatively few to provide context for the term. ACAG believes it would be appropriate to include appropriate guidance within the standard (or within an intrinsic appendix to the standard), which illustrates the Boards' intended meaning behind this term.

ACAG believes that asymmetry will be created by the requirements of paragraphs 39 and 71-72 of the ED. Paragraph 39 requires the lessee to only recognise in the lease liability variable lease payments to the extent those payments are dependent on an index or a rate or are in-substance fixed payments. However, a lessor must, by virtue of paragraphs 71-72, estimate the present value of expected variable lease payments and include that amount in the measurement of the residual asset to the extent they are not included in the lease receivable. Accordingly, ACAG requests that the Boards provide guidance on how to account for the measurement difference on consolidation when there is a lease between entities under common control.

Alternate view

Two ACAG members do not support the approach proposed for variable lease payments. These members believe that all variable lease payments should be measured and recognised by both the lessee and lessor. Allowing the lessee not to recognise the variable lease payments provides an opportunity to structure leases so that a greater proportion of leases are subject to variables. This, in turn, provides the opportunity to arbitrarily exclude amounts from the lease liability, and right-of-use asset. These ACAG members believe the recognition model for the lessee is conceptually flawed as it does not provide for faithful representation of the lease liability and right-of-use asset.

Transition

Question 7: Transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

Response:

ACAG supports the modified retrospective approach to transition proposed by the Boards. ACAG agrees with the Boards' views at paragraph BC306 that the costs of a fully retrospective approach would significantly outweigh the benefits. ACAG is, however, supportive of providing the option of a full retrospective approach for preparers who wish to adopt such an option.

ACAG notes that paragraph C9 allows a lessee to apply a single discount rate to a portfolio of leases with reasonably similar characteristics on transition. Example 25 indicates that the lessee's incremental borrowing rate is that as at the effective date of transition (that is, the date to be inserted in paragraph C1). ACAG recommends the Boards make this clear within Appendix C, rather than relying on Example 25 to provide clarification regarding the appropriate date at which the rate should be determined.

ACAG notes the intention of the Boards in providing a modified retrospective approach is to approximate the amounts that would be recognised under a full retrospective approach, as outlined in BC308. ACAG considers there is potential for the amounts recognised under a modified retrospective approach and a full retrospective approach to be materially different. This is particularly the case where a single discount rate, allowed under paragraph C9, is applied to a portfolio of leases and there have been significant changes in the incremental borrowing rate between the commencement dates of the leases and the effective date. Accordingly, ACAG suggests the Boards consider requiring a specific disclosure on transition where the modified retrospective approach is adopted that the amounts recognised would likely materially differ from those which would have been recognised under if a full retrospective approach was adopted.

Irrespective of the lease accounting method adopted by the Boards, ACAG recommends that generous concessions be made in respect of the mandatory application date of the final standard as we believe entities will need significant time to prepare for implementation. We also recommend that the standard not be implemented before the implementation of *Revenue from Contracts with Customers* standard as the ED contains a number of cross references to *Revenue from Contracts with Customers* standard.

Disclosure

Question 8: Disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

Response:

ACAG believes that the disclosure requirements as outlined in the ED are excessive, in particular for entities where leasing is not fundamental to their business. ACAG notes that paragraphs 59 and 99 of the ED indicate that an entity would only include the level of detail to satisfy the disclosure objectives of paragraphs of 58 and 98 respectively. ACAG requests that the wording of paragraphs 59 and 99 be strengthened to more clearly express that an entity only need consider those disclosures that materially benefit the users' understanding of the entity's exposure to leasing activities.

FASB-only

Questions 9, 10 and 11

Response:

ACAG has no comments on Questions 9, 10 and 11.

Investment Property

Question 12: Consequential amendments to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 *Investment Property*. The amendments to IAS 40 propose that a right-of-use asset arising from a lease property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if a leased property meets the definition of investment property? If not, what alternative would you propose and why?

ACAG has no comments regarding Question 12.

OTHER OBSERVATIONS

As identified at Question 3 and Question 6, ACAG believes additional guidance regarding the consolidation process where the lessor and lessee are both part of a consolidated group is warranted. At Question 3 ACAG has highlighted asymmetry as a result of different assessments regarding categorisation and measurement of variable lease payments. At Question 6 ACAG highlighted asymmetry arising from the lack of measurement and recognition of other variable lease payments by the lessee. ACAG further notes that asymmetry would also arise from the inconsistent treatment of residual value guarantees by lessees and lessors, and differences in the lessee's and lessor's expected lease term. Additional asymmetry would occur where a lessee measures (as allowed by paragraphs 52-53 of the ED) a leased property asset as a revalued item of property, plant and equipment or investment property measured at fair value. Accordingly, ACAG believes additional guidance is required on the treatment of such measurement differences on consolidation of lessees and lessors under common control. The current proposals would pose significant challenges on consolidation of large group entities such as whole-of-government financial statements.

When finalising the standard, ACAG requests that Boards specifically consider how peppercorn leases should be accounted for from both a lessee and lessor perspective. Peppercorn leases are those where a lease is entered into and the lessee pays the lessor a minimal amount for the right to use an asset for a fixed period of time. We understand such leases are in widespread use to facilitate access to specific legal rights in relation to leased assets. Notwithstanding the discussion on onerous contracts at BC84-85, which may apply to some peppercorn leases, we request that Board provides specific guidance within the final standard as to how the Boards intend such lease arrangements to be treated.

ACAG notes that under SIC 15 lessees currently recognise a liability for lease incentives received on operating leases. The liability is then released to income on a straight-line basis over the term of the lease. ACAG notes that the ED describes how to remove the incentive received and receivable from the liability and the right-of-use asset. ACAG presumes that lease incentives will be accounted for in accordance with the *Revenue from Contracts with Customers* standard, nonetheless ACAG believes it would be beneficial for the scoping section of the standard resulting from the ED to make clear which standard applies to the accounting for lease incentives.

ACAG suggests that paragraph 33 be worded to more explicitly provide for circumstances where there are multiple buildings with different useful lives which may not be componentised within the lease agreement.

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17 September 2013

Dear Mr Stevenson

Ernst & Young's global submissions to the IASB on the Exposure Draft *Leases*

Please find enclosed Ernst & Young's global submission to the IASB on the above Exposure Draft.

Yours sincerely

Ernst & Young

Ernst & Young

Encl:

Building a better working world

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Invitation to comment — Exposure Draft *Leases*

Dear Board members:

Ernst & Young Global Limited, the central coordinating entity of the global EY organization, is pleased to respond to the Exposure Draft (ED or Proposal) *Leases* issued jointly by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB).

While we continue to support the Boards' efforts to improve the accounting for leases to provide greater transparency in financial reporting and address the needs of users of financial statements, we do not support the Proposal. We are unable to support the Proposal because it is unclear to us whether the ED would significantly improve the decision-useful information available to financial statement users. It also is unclear to us whether any of the perceived benefits to financial statement users would justify the costs and complexity of applying the ED.

We acknowledge that the proposals in the ED address a primary criticism of current lease accounting by requiring lessees to recognize assets and liabilities for rights and obligations created by leases. However, it is unclear whether the Proposal would improve comparability or reduce the number of adjustments that financial statement users make to reported financial information. We are also concerned that significant conceptual and application issues we have identified suggest that the added complexity and costs of applying the Proposal would outweigh any improvements to financial reporting. If the Boards continue to pursue the proposed approach, we believe they must address a number of conceptual and application issues to make the Proposal operational.

We believe the ED should be evaluated primarily based on whether it would provide financial statement users with more decision-useful information than today's guidance on leases. Further, the benefits to users should be sufficient to justify the costs. The Boards have said many aspects of the proposed accounting model respond to financial statement users' requests for improved information.

However, it is not clear which users would benefit, and to what extent they would benefit, from the ED's proposed changes compared to the information they receive today. To address these concerns and provide greater transparency into the outreach with users the Boards have performed, we would suggest that the Boards clarify:

- The specific types of users that have requested the new or enhanced information (e.g., an analysis of the information users have requested broken out by type of information and user category such as buy-side or sell-side analysts, ratings agencies, regulators and accounting or auditing industry observers)

- How the new information improves the usability of financial reporting for the referenced users

Without better insight into users' needs, it is difficult to conclude whether the proposed changes represent a sufficient improvement in financial reporting to justify the additional costs and complexity.

The Boards have noted that today, certain users make adjustments to financial statement information about leases to apply their own approaches for measuring substantive lease obligations (e.g., analysts estimate lease obligations as a multiple of current-year lease expense and include estimates of annual lease expenditures in projections of future cash flows). We understand some financial statement users expect to continue to make significant adjustments (albeit perhaps different adjustments) to the lease-related reported financial information. The continued need to make significant adjustments to the accounting for leases would indicate that the totality of the proposed changes would not meet the intended objectives. Generally, we would have concerns that the accounting for leases under the ED, while intended to meet users' needs, may ultimately be unwound by the very users the Proposal is meant to assist.

Scope/definition of a lease

We agree with the proposed definition of a lease. We also agree that the right to use an asset should focus on the customer's ability to control the use of the asset during the contract term. We believe that using a principle of control that is aligned with concepts of control used elsewhere (e.g., consolidations, revenue recognition) could be an improvement over the current guidance in IFRIC 4, *Determining whether an Arrangement contains a Lease* [ASC 840, *Leases*] as long as that principle is well defined and could be applied in practice.

We understand that regulators and other users of financial statements accept that significant judgment is often required to apply the concept of control when analyzing consolidation. However, we are concerned that regulators and other users of financial statements may not expect a similar level of discretion to be applied when determining whether an arrangement is or contains a lease. We believe the Boards should acknowledge that varying interpretations could lead to diversity in practice in determining whether a contract is a lease and consider whether such diversity would be acceptable to users of financial statements.

While the ED lays out the general principle of control, it is not sufficiently developed to be applied in practice. For example, the ED does not provide adequate guidance for identifying which party controls the use of an identified asset (i.e., has the ability to direct the use of the identified asset and the ability to derive benefits from the use of the identified asset) and requires additional clarification. Given the considerably different accounting proposed for lease contracts and typical service contracts, a well-defined principle of control, as well as appropriate application guidance, is critical. We believe a more thorough description of the control principle, coupled with clear application guidance (including illustrations), is necessary to mitigate the risk that similar transactions would be reported differently due to differing interpretations of the ED's scope.

Ability to direct the use of the identified asset

Under the Proposal, a customer would have the ability to direct the use of the asset when the contract conveys rights that give the customer the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from use of the asset throughout the term of the contract. However, the ED lacks a sufficient framework to help suppliers and customers identify and evaluate which party is making the most significant decisions about the use of the asset. In the absence of a sufficient framework, we believe entities would struggle to make appropriate and consistent judgments, which could lead to a lack of comparability in the accounting for similar transactions. We are particularly concerned that arrangements with significant service components, such as drilling contracts, time charters, power purchase arrangements, tolling agreements and contract manufacturing arrangements, may be difficult to assess.

Paragraph 14 [842-10-15-11] provides examples of such decisions; however, the ED does not provide a framework to apply to those examples. As described in paragraph BC105(d), the Boards decided that the evaluation should be similar to the concept of control applied in other requirements and projects such as the revenue recognition proposals and IFRS 10, *Consolidated Financial Statements* (IFRS 10) [ASC 810-10, *Consolidation – Overall* (ASC 810-10)]. However, the Boards do not explicitly include that intention in the ED (in the standard) or provide guidance on how to apply either of those frameworks in the context of leases.

Examples of necessary additional guidance include how the Boards expect entities to consider the following circumstances:

- When the supplier and customer each have existing rights that give them the unilateral ability to make different significant decisions
- When one or more significant decisions are agreed upon in the contract and other significant decisions are made after the contract's commencement
- When few, if any, significant decisions are made subsequent to the commencement date and therefore the significant decisions are made collectively, by the customer and the supplier (i.e., all significant decisions are jointly agreed upon when entering into the contract)

IFRS 10 [ASC 810-10] and the revenue recognition proposal each contain application guidance and examples that may provide helpful analogies. However, it is not clear whether the Boards intended to use IFRS 10 [ASC 810-10] or the revenue recognition frameworks (or both). It is also not clear how one or both of those frameworks would be applied in the context of lease arrangements. To mitigate the risk of diversity in interpretation, the Boards should incorporate additional application guidance to help entities determine whether the customer or the supplier has the ability to direct the use of the identified asset.

If entities would be required to identify a party with the ability to direct the use of an asset when few, if any, decisions are made after the commencement date, we believe that additional application guidance is needed to make such a requirement operational. When there are few, if any, substantive decisions to be made after the lease commencement date, paragraph 15 [842-10-15-12] provides guidance that we believe indicates entities would attribute the predetermined decisions in the contract to one of the parties even though the decisions were jointly agreed upon (i.e., both parties executed the contract). The requirement to attribute decisions may be inconsistent with how practice might evaluate similar circumstances under IFRS 10 [ASC 810-10] today. IFRS 10 [ASC 810-10] requires consideration of parties' involvement in the design of an entity but does not require a conclusion that a single party has the ability to make significant unilateral decisions in all cases (i.e., in some circumstances, no party consolidates an entity). It is not clear whether the ED, as drafted, would permit entities to reasonably conclude that neither party has the unilateral ability to direct the use of an identified asset.

Many contracts contain terms and conditions that establish the general guidelines, specific decisions about how an asset will be operated or both. For example, the terms of an arrangement for the operation of a manufacturing facility might specify numerous guidelines and decisions about how the facility would be operated. We believe it would be difficult and costly for preparers to determine which party (i.e., the customer or the supplier) was responsible for significant decisions embedded in an agreement that has been executed by, and is binding upon, both parties. We believe the Boards should provide additional guidance to clarify how entities would determine whether a customer's involvement in the determination of a contract's terms gives it the ability to direct the use of the identified asset. For example, the Boards should include guidance about:

- The types of customer involvement in the determination of contract terms and conditions that should be evaluated (e.g., how to consider whether a right within a contract is a participating right or protective right)

- How to determine which party to the contract is responsible for including a contract term or condition that is negotiated to its final form

- How a customer's (or supplier's) ability to change significant operating policies or procedures when circumstances arise, or upon the occurrence of an event, after lease commencement would be considered in the evaluation

Ability to derive benefits from the use of the identified asset

We believe the Boards should enhance the application guidance for determining whether the customer can obtain the benefits from the use of the asset. The ED indicates the customer does not have the ability to derive substantially all of the potential benefits from the identified asset if both of the following conditions exist:

- The customer can use the asset only in conjunction with additional goods or services that are provided by the supplier and not sold separately by the supplier or others

- The asset is incidental to the delivery of services

However, the ED does not adequately describe why the separate availability of an additional good or service from the supplier (i.e., the supplier in the contract) or another supplier is an important factor in determining whether a customer has the ability to derive benefits from the use of the underlying asset. Nor does the ED adequately describe what is meant by "the asset is incidental to the delivery of services." For these reasons, we do not find Illustrative Example 2 (contract for coffee services) and Illustrative Example 3 (contract for medical equipment) to be particularly helpful. Again, without sufficient guidance, we are concerned that diversity in reasonable views and interpretations will develop that will reduce rather than increase comparability in financial reporting.

Additionally, we believe the application guidance as drafted could result in similar transactions being accounted for differently over time. For example, a contract for new medical equipment that can be used only in conjunction with an additional good or service would not be a lease (i.e., assuming the asset is determined to be incidental to the delivery of a service). However, if at a later date, as the product matures in the marketplace and the additional good or service becomes separately available from another supplier, it appears that a second, identical contract that commences at that later date could be accounted for as a lease (i.e., assuming the contract meets the other criteria to be a lease). We struggle to understand how the differences in accounting for transactions such as the examples above would improve financial statement users' understanding of such transactions over time.

We also have operational concerns about how entities would be able to reasonably determine whether an additional good or service in a contract is separately available from another supplier. The ED does not provide guidance on how entities would identify a relevant population of other suppliers and how much effort entities must exert searching for such suppliers. Therefore, it is unclear whether entities would be required to focus on only primary-market suppliers (e.g., the manufacturer, third-party resellers) or whether secondary markets (e.g., online marketplaces, after-market suppliers) would also be considered. We suggest that the Boards clarify the guidance and provide examples to illustrate how entities would identify a relevant population of other suppliers.

In paragraph 19b [842-10-15-16b], the ED indicates that an "asset is incidental to the delivery of services because it is designed to function only with the additional goods or services provided by the supplier. In such cases, the customer receives a bundle of goods or services that combine to deliver an overall service for which the customer has contracted." We believe application guidance is needed to help entities reasonably differentiate between circumstances when a customer is seeking the services and not the asset used to deliver the services. Without such guidance we believe entities would struggle to make appropriate and consistent judgments about this concept.

Lease classification

We do not believe that lease classification under the ED represents an improvement from today's lease accounting standards. A criticism of the current leases guidance is that similar transactions receive different accounting treatment. The ED does not resolve that issue. Instead, the ED would create new and unfamiliar dividing lines between types of leases that would add new complexity in place of an old one.

Additionally, we do not believe the proposed application guidance for lease classification[1] based on the nature of the underlying asset (i.e., whether the underlying asset is property or an asset other than property) follows the ED's principle of classifying leases based on the lessee's consumption of the economic benefits embedded in the underlying asset. Therefore, we believe the Boards should more clearly articulate the basis for differentiating lease accounting based on the nature of the underlying asset and how this approach represents an improvement for financial statements users.

Notwithstanding our concern regarding whether the nature of the underlying asset is an appropriate distinguishing factor for the two types of proposed leases, we believe that further clarification of the term property is also needed to make the lease classification application guidance operational. Under today's US GAAP standards, certain structures that are attached to real estate (e.g., pipelines, cellular towers, refineries, power plants) are often considered to be integral equipment and therefore treated as real estate for accounting purposes. We note that the IFRS Interpretations Committee is currently debating whether the scope of investment property in IAS 40, *Investment Property* (IAS 40), could be broadened to include structures such as those described above.[2] A concept similar to integral equipment is not present in the ED, and the ED defines property as "land or a building, or part of a building, or both." As such, it appears that the proposed definition of property does not include many of today's US GAAP integral equipment assets that are economically similar to assets included in the proposed definition of property. If the Boards continue to use property as the dividing line between lease types, we believe the Boards should revise the definition of property to include assets with economic characteristics similar to those considered integral equipment in US GAAP today. Given the lack of an underlying conceptual basis, we are also concerned the proposed definition of property could lead to diversity in interpretations and result in similar transactions for the same type of asset (e.g., contracts for the lease of space on cellular towers) being accounted for differently by different entities, adversely affecting the comparability of financial information across different entities.

Lessee accounting

We support recognizing leases on balance sheet if done in a practical and principled manner that provides financial statement users with relevant information with which to make decisions. However, we struggle to understand the conceptual basis for the proposed approach to accounting for Type B leases under the ED. The Boards note that financial statement users have indicated a preference for an approach that results in straight-line expense recognition for certain leases. We therefore believe the Boards should acknowledge that the Type B approach is a compromise to provide relevant users with information requested rather than attempt to create a conceptual justification that cannot be supported. The Boards also should fully support that conclusion with a more transparent and robust discussion of the types of users that find straight-line expense recognition more meaningful, how they will use it and why they also requested that those leases be recognized on balance sheet.

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1 Refer to paragraphs 29 and 30 [842-10-25-6 and 7].

2 In the July 2013 meeting, the IFRS Interpretations Committee discussed broadening the scope of investment property in IAS 40 to also include structures such as telecommunications towers, based on the way such assets are used (rather than based on the physical structure of the assets). Although the Interpretations Committee expressed general support for such a change, it determined it was difficult to recommend an approach for amending the definition of investment property in IAS 40 because the same definition of property is used in the *Leases* exposure draft. The Interpretations Committee decided to report its views and concerns back to the IASB so the IASB could consider the issue in finalizing the proposed *Leases* guidance.

It is not clear why the Boards believe users require different expense and cash flow presentation for Type A and Type B leases but do not require different presentation on the balance sheet (e.g., a lessee would be allowed to present right-of-use assets within the same line items as the corresponding underlying assets, regardless of whether they are Type A or Type B leases).

It is unclear why the amortization of a Type B right-of-use asset (i.e., a non-financial asset) is influenced by the subsequent accounting for the lease liability (i.e., a separately accounted for financial liability). That approach appears to lack a conceptual basis and is inconsistent with the subsequent measurement of other non-financial assets. Further, the proposed amortization approach is not consistent with the consumption of the economic benefits embedded in the underlying asset. Given these conceptual flaws, it is not clear how the right-of-use asset measured under the ED for Type B leases would be meaningful to financial statement users.

We also note that today's recordkeeping and information systems are not designed to track the proposed amortization methodology. This fact adds to our concern that the overall costs and complexity of the proposed Type B lessee approach would outweigh the benefits of the information that would be provided to financial statement users.

If the Boards have determined that financial statement users would benefit from a straight-line accounting approach for certain leases, we believe that they could use a less complex approach that would have equal conceptual merit to the proposed approach.

Additionally, we note that the proposed accounting for Type A leases is also significantly more complex than the accounting for those arrangements under today's guidance. The proposed lessee model (for both Type A and Type B leases) would introduce new complexities. In particular, the requirement for lessees to reassess and remeasure lease liabilities on an ongoing basis would give rise to significant costs (e.g., information systems costs, costs of implementing and maintaining internal controls over financial reporting) that are not present today.

Lessor accounting

It is not clear to us how the proposed lessor accounting and its related complexities represent an improvement to today's accounting. Primarily, we have concerns about the complexity of the proposed Type A lease approach. In particular, we believe the proposed guidance for reassessments of the lease receivable and residual asset require additional clarification (e.g., discount rate to be used, considerations about unearned profit in a residual asset). Without additional application guidance the proposed approach would lead to significant operational difficulties.

In addition, we do not find the accretion of the residual asset over the lease term to be conceptually consistent with the initial measurement of the residual asset on a historical cost basis. We note that the accretion of the lessor's residual asset (i.e., a non-financial asset) is conceptually inconsistent with the measurement of long-lived non-financial assets (e.g., property, plant and equipment) at historical cost. We also believe the accretion of the residual asset is conceptually inconsistent with the proposed application of the IAS 36 and ASC 360 impairment models for long-lived assets. However, the proposed accounting for the residual asset is in some respects (e.g., accretion) similar to the accounting for a financial instrument that would be subject to IAS 39, *Financial Instruments: Recognition and*

Measurement. We believe the Boards should better articulate the conceptual basis for how the accretion of the residual asset aligns with the measurement basis (including impairment) used for other long-term non-financial assets and how such measurement improves financial reporting for financial statement users.

We do not believe the proposed Type A model for lessors is operational. Focusing on reassessment of Type A leases, it is not clear how lessors would determine the rate the lessor *would* charge the lessee and the fair value of the residual asset when performing a remeasurement of the lease receivable. Would the lessor be expected to determine the fair value of the existing residual asset or the underlying asset at the reassessment date to calculate what the revised discount rate would be? The Boards should provide guidance to clearly define how a lessor should determine the rate the lessor *would* charge the lessee when remeasuring a lease receivable.

It is also unclear whether lessors would adjust or remeasure the unearned profit (i.e., an element of the lessor's recognized residual asset) when performing a reassessment. As drafted, it appears that lessors would be required to adjust the carrying amount of the residual asset to the amount that the lessor expects to derive from the underlying asset following the end of the revised lease term (paragraph 78 [842-30-35-3]). Such an adjustment could fully eliminate the unearned profit embedded in the recognized residual asset upon remeasurement, even if the lease term that does not extend the lease for the underlying asset's entire economic life. The Boards should clarify whether — and if so, how — the embedded unearned profit would be adjusted upon reassessment.

We understand that the approach to lessor accounting for Type B leases was developed in response to feedback from financial statement users and requests from those users for specific information about certain types of leases. In addition, we note there are inconsistencies between the proposed approach for lessor and lessee accounting for Type B leases that result in dissimilar accounting by a lessee and a lessor for the same transaction. Said another way, it appears to be inconsistent for a lessee in a Type B lease to recognize the contractual obligation (i.e., lease payable) and an offsetting right-of-use asset and for the lessor not to recognize a lease receivable (and continue to recognize the underlying asset). It is also not clear why the users of the lessee's financial statements would find the balance sheet information decision-useful given that some users of the lessor's financial statements have indicated that such information may be less useful than the information provided under current operating lease accounting. This raises questions as to the conceptual basis for recognizing leases on the balance sheet. We believe the Boards should clearly articulate how the needs of users of lessors' financial statements differ from those of users of lessees' financial statements in respect to Type B leases.

Our responses to the specific questions posed in the ED are set forth in Appendix A to this letter, and our comments on the other aspects of the ED are included in Appendix B. We would be pleased to discuss our comments further with the Boards or their staffs at your convenience. Please contact Rich Jones at +1 212 773 8716 or Leo van der Tas at +31 88 407 5035.

Very truly yours,

Ernst + Young Global Limited

Appendix A — Responses to the questions in the Exposure Draft *Leases*

Question 1: identifying a lease This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether: (a) fulfilment of the contract depends on the use of an identified asset; and (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration. A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset. Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

We agree with the proposed definition of a lease. We also agree that the right to use an asset should focus on the customer's ability to control the use of the asset during the contract term. We believe that using a principle of control that is aligned with concepts of control used elsewhere (e.g., consolidations, revenue recognition) could be an improvement over the current guidance in IFRIC 4, *Determining whether an Arrangement contains a Lease* [ASC 840, *Leases*] as long as that principle is well defined and could be applied in practice.

We understand that regulators and other users of financial statements accept that significant judgment is often required to apply the concept of control when analyzing consolidation. However, we are concerned that regulators and other users of financial statements may not expect a similar level of discretion to be applied when determining whether an arrangement is or contains a lease. We believe the Boards should acknowledge that varying interpretations could lead to diversity in practice in determining whether a contract is a lease and consider whether such diversity would be acceptable to users of financial statements.

While the ED lays out the general principle of control, it is not sufficiently developed to be applied in practice. For example, the ED does not provide adequate guidance for identifying which party controls the use of an identified asset (i.e., the "ability to direct the use of the identified asset" and the "ability to derive benefits from the use of the identified asset") and requires additional clarification. Given the considerably different accounting proposed for lease contracts and typical service contracts, a well-defined principle of control as well as appropriate application guidance is critical. We believe a more thorough description of the control principle, coupled with clear application guidance (including illustrations), is necessary to mitigate the risk that similar transactions would be reported differently due to differing interpretations of the ED's scope.

Ability to direct the use of the identified asset

Under the Proposal, a customer would have the ability to direct the use of the asset "when the contract conveys rights that give the customer the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from use of the asset throughout the term of the contract." However, the ED lacks a sufficient framework to help suppliers and customers identify and evaluate which party is making the most significant decisions about the use of the asset. In the absence of a sufficient framework, we believe entities would struggle to make appropriate and consistent judgments, which could lead to a lack of comparability in the accounting for similar transactions. We are particularly concerned that arrangements with significant service components, such as drilling contracts, time charters, power purchase arrangements, tolling agreements and contract manufacturing arrangements, may be difficult to assess.

Paragraph 14 [842-10-15-11] provides examples of such decisions; however, the ED does not provide a framework to apply to those examples. As described in paragraph BC105(d), the Boards decided that the evaluation should be similar to the concept of control applied in other requirements and projects such as the revenue recognition proposals and IFRS 10, *Consolidated Financial Statements* (IFRS 10) [ASC 810-10, *Consolidation — Overall* (ASC 810-10)]. However, the Boards do not explicitly include that intention in the ED (in the standard) or provide guidance on how to apply either of those frameworks in the context of leases.

Examples of necessary additional guidance would include how the Boards expect entities to consider the following circumstances:

- When the supplier and customer each have existing rights that give them the unilateral ability to make different significant decisions
- When one or more significant decisions are agreed upon in the contract and other significant decisions are made after the contract's commencement
- When few, if any, significant decisions are made subsequent to the commencement date and therefore the significant decisions are made, collectively, by the customer and the supplier (i.e., all significant decisions are jointly agreed upon when entering into the contract)

IFRS 10 [ASC 810-10] and the revenue recognition proposal each contain application guidance and examples that may provide helpful analogies. However, it is not clear whether the Boards intended to use IFRS 10 [ASC 810-10] or the revenue recognition frameworks (or both). It is also not clear how one or both of those frameworks would be applied in the context of lease arrangements. To mitigate the risk of diversity in interpretation, the Boards should incorporate additional application guidance to help entities determine whether the customer or the supplier has the ability to direct the use of the identified asset.

If entities would be required to identify a party with the ability to direct the use of an asset when few, if any, decisions are made after the commencement date, we believe that additional application guidance is needed to make such a requirement operational. When there are few, if any, substantive decisions to be made after the lease commencement date, paragraph 15 [842-10-15-12] provides guidance that we believe indicates entities would attribute the predetermined decisions in the contract to one of the parties even though the decisions were jointly agreed upon (i.e., both parties executed the contract). The requirement to attribute decisions may be inconsistent with how practice might evaluate similar circumstances under IFRS 10 [ASC 810-10] today. IFRS 10 [ASC 810-10] requires consideration of parties' involvement in the design of an entity but does not require a conclusion that a single party has the ability to make significant unilateral decisions in all cases (i.e., in some circumstances, no party consolidates an entity). It is not clear whether the ED, as drafted, would permit entities to reasonably conclude that neither party has the unilateral ability to direct the use of an identified asset.

Many contracts contain terms and conditions that establish the general guidelines, specific decisions about how an asset will be operated or both. For example, the terms of an arrangement for the operation of a manufacturing facility might specify numerous guidelines and decisions about how the facility would be operated. We believe it would be difficult and costly for preparers to determine which party (i.e., the customer or the supplier) was responsible for significant decisions embedded in an agreement that has been executed by, and is binding upon, both parties. We believe the Boards should provide additional guidance to clarify how entities would determine whether a customer's involvement in the determination of a contract's terms gives it the ability to direct the use of the identified asset. For example, the Boards should include guidance about:

- The types of customer involvement in the determination of contract terms and conditions that should be evaluated (e.g., how to consider whether a right within a contract is a participating right or protective right)

- How to determine which party to the contract is responsible for including a contract term or condition that is negotiated to its final form

- How a customer's (or supplier's) ability to change significant operating policies or procedures when circumstances arise, or upon the occurrence of an event, after lease commencement would be considered in the evaluation

Ability to derive benefits from the use of the identified asset

We believe the Boards should enhance the application guidance for determining whether the customer can obtain the benefits from the use of the asset. The ED indicates the customer does not have the ability to derive substantially all of the potential benefits from the identified asset if both of the following conditions exist:

- The customer can use the asset only in conjunction with additional goods or services that are provided by the supplier and not sold separately by the supplier or others

- The asset is incidental to the delivery of services

However, the ED does not adequately describe why the separate availability of an additional good or service from the supplier (i.e., the supplier in the contract) or another supplier is an important factor in determining whether a customer has the ability to derive benefits from the use of the underlying asset. Nor does the ED adequately describe what is meant by the "asset is incidental to the delivery of services." For these reasons, we do not find Illustrative Example 2 (contract for coffee services) and

Illustrative Example 3 (contract for medical equipment) to be particularly helpful. Again, without sufficient guidance, we are concerned that diversity in reasonable views and interpretations will develop that will reduce rather than increase comparability in financial reporting.

Additionally, we believe the application guidance as drafted could result in similar transactions being accounted for differently over time. For example, a contract for new medical equipment that can be used only in conjunction with an additional good or service would not be a lease (i.e., assuming the asset is determined to be incidental to the delivery of a service). However, if at a later date, as the product matures in the marketplace and the additional good or service becomes separately available from another supplier, it appears that a second, identical contract that commences at that later date could be accounted for as a lease (i.e., assuming the contract meets the other criteria to be a lease). We struggle to understand how the differences in accounting for transactions such as the examples above would improve financial statement users' understanding of such transactions over time.

We also have operational concerns about how entities would be able to reasonably determine whether an additional good or service in a contract is separately available from another supplier. The ED does not provide guidance on how entities would identify a relevant population of other suppliers and how much effort entities must exert searching for such suppliers. Therefore, it is unclear whether entities would be required to focus on only primary-market suppliers (e.g., the manufacturer, third-party resellers) or whether secondary markets (e.g., online marketplaces, after-market suppliers) would also be considered. We suggest that the Boards clarify the guidance and provide examples to illustrate how entities would identify a relevant population of other suppliers.

In paragraph 19b [842-10-15-16b], the ED indicates that an "asset is incidental to the delivery of services because it is designed to function only with the additional goods or services provided by the supplier. In such cases, the customer receives a bundle of goods or services that combine to deliver an overall service for which the customer has contracted." We believe application guidance is needed to help entities reasonably differentiate between circumstances when a customer is seeking the services and not the asset used to deliver the services. Without such guidance we believe entities would struggle to make appropriate and consistent judgments about this concept.

Transfer of title

It is unclear whether transactions that automatically transfer title to an identified asset at the end of the contract term would be within the ED's scope. We do not see a conceptual difference between a lease transaction that automatically transfers title and a lease with a purchase option when the lessee has a significant economic incentive to exercise that option (e.g., a $1 purchase option may create a significant economic incentive for the lessee to exercise the option). In paragraph BC118, the Boards indicate that the ED does not apply to transactions for which control of the underlying asset is transferred to the lessee. However, the ED does not articulate whether arrangements with an automatic transfer of title convey the right to use an identified asset for a period of time (i.e., a lease) or whether control of the identified asset is transferred to the lessee immediately (i.e., a sale). While the accounting for a sale and lease would be similar in many ways, differences in financial reporting (e.g., presentation, disclosure) would exist.

To improve consistency in financial reporting, we believe leases with an automatic transfer of title should be within the scope of this Proposal.

Additional illustrations in application guidance

We believe identifying a lease is one of the most critical issues in the Proposal. During redeliberations and the Boards' outreach, a number of arrangements were identified for which determining whether the arrangement is, or contains, a lease is not clear. We note that examples of these types of arrangements (e.g., tolling agreements, time charters, drilling contracts) are not included in the illustrative examples in the ED. We believe financial statement users would be better served if the Boards provided guidance for common complex arrangements. Without adequate application guidance, we believe that preparers would struggle to consistently apply the Proposal's definition of a lease.

Question 2: lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We support recognizing leases on balance sheet if done in a practical and principled manner that provides financial statement users with relevant information with which to make decisions. However, we struggle to understand the conceptual basis for the proposed approach to accounting for Type B leases under the ED. The Boards note that financial statement users have indicated a preference for an approach that results in straight-line expense recognition for certain leases. We therefore believe the Boards should acknowledge that the Type B approach is a compromise to provide relevant users with information requested rather than attempt to create a conceptual justification that cannot be supported. The Boards also should fully support that conclusion with a more transparent and robust discussion of the types of users that find straight-line expense recognition more meaningful, how they will use it and why they also requested that those leases be recognized on balance sheet.

It is not clear why the Boards believe users require different expense and cash flow presentation for Type A and Type B leases but do not require different presentation on the balance sheet (e.g., a lessee would be allowed to present right-of-use assets within the same line items as the corresponding underlying assets, regardless of whether they are Type A or Type B leases).

It is unclear why the amortization of a Type B right-of-use asset (i.e., a non-financial asset) is influenced by the subsequent accounting for the lease liability (i.e., a separately accounted for financial liability). That approach appears to lack a conceptual basis and is inconsistent with the subsequent measurement of other non-financial assets. Further, the proposed amortization approach is not consistent with the consumption of the economic benefits embedded in the underlying asset. Given these conceptual flaws, it is not clear how the right-of-use asset measured under the ED for Type B leases would be meaningful to financial statement users.

We also note that today's recordkeeping and information systems are not designed to track the proposed amortization methodology. This fact adds to our concern that the overall costs and complexity of the proposed Type B lessee approach would outweigh the benefits of the information that would be provided to financial statement users.

If the Boards have determined that financial statement users would benefit from a straight-line accounting approach for certain leases, we believe that they could use a less complex approach that would have equal conceptual merit to the proposed approach.

Additionally, we note that the proposed accounting for Type A leases is also significantly more complex than the accounting for those arrangements under today's guidance. The proposed lessee model (for both Type A and Type B leases) would introduce new complexities. In particular, the requirement for lessees to reassess and remeasure lease liabilities on an ongoing basis would give rise to significant costs (e.g., information systems costs, costs of implementing and maintaining internal controls over financial reporting) that are not present today.

Question 3: lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

It is not clear to us how the proposed lessor accounting and its related complexities represent an improvement to today's accounting. Primarily, we have concerns about the complexity of the proposed Type A lease approach. In particular, we believe the proposed guidance for reassessments of the lease receivable and residual asset require additional clarification (e.g., discount rate to be used, considerations about unearned profit in residual asset). Without additional application guidance the proposed approach would lead to significant operational difficulties.

In addition, we do not find the accretion of the residual asset over the lease term to be conceptually consistent with the initial measurement of the residual asset on a historical cost basis. We note that the accretion of the lessor's residual asset (i.e., a non-financial asset) is conceptually inconsistent with the measurement of long-lived non-financial assets (e.g., property, plant and equipment) at historical cost. We also believe the accretion of the residual asset is conceptually inconsistent with the proposed application of the IAS 36 and ASC 360 impairment models for long-lived assets. However, the proposed accounting for the residual asset is in some respects (e.g., accretion) similar to the accounting for a financial instrument that would be subject to IAS 39, *Financial Instruments: Recognition and Measurement*. We believe the Boards should better articulate the conceptual basis for how the accretion of the residual asset aligns with the measurement basis (including impairment) used for other long-lived non-financial assets and how such measurement improves financial reporting for financial statement users.

We do not believe the proposed Type A model for lessors is operational. Focusing on reassessment of Type A leases, it is not clear how lessors would determine the rate the lessor *would* charge the lessee and the fair value of the residual asset when performing a remeasurement of the lease receivable. Would the lessor be expected to determine the fair value of the existing residual asset or the underlying asset at the reassessment date to calculate what the revised discount rate would be? The Boards should provide guidance to clearly define how a lessor should determine the rate the lessor *would* charge the lessee when remeasuring a lease receivable.

It is also unclear whether lessors would adjust or remeasure the unearned profit (i.e., an element of the lessor's recognized residual asset) when performing a reassessment. As drafted, it appears that lessors would be required to adjust the carrying amount of the residual asset to the amount that the lessor expects to derive from the underlying asset following the end of the revised lease term (paragraph 78 [842-30-35-3]). Such an interpretation would fully eliminate the unearned profit embedded in the recognized residual asset upon remeasurement, even if the lease term does not extend the lease for the underlying asset's entire economic life. The Boards should clarify whether and if so how the embedded unearned profit would be adjusted upon reassessment.

We understand that the approach to lessor accounting for Type B leases was developed in response to feedback from financial statement users and requests from those users for specific information about certain types of leases. In addition, we note there are inconsistencies between the proposed approach for lessor and lessee accounting for Type B leases that result in dissimilar accounting by a lessee and a lessor for the same transaction. Said another way, it appears to be inconsistent for a lessee in a Type B lease to recognize the contractual obligation (i.e., lease payable) and an offsetting right-of-use asset and for the lessor not to recognize a lease receivable (and continue to recognize the underlying asset). It is also not clear why the users of the lessee's financial statements would find the balance sheet information decision-useful given that some users of the lessor's financial statements have indicated that such information is less useful than the information provided under current operating lease accounting. This raises questions as to the conceptual basis for recognizing leases on the balance sheet. We believe the Boards should clearly articulate how the needs of users of lessors' financial statements differ from those of users of lessees' financial statements in respect to Type B leases.

Question 4: classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

We do not believe that lease classification under the ED represents an improvement from today's lease accounting standards. A criticism of the current leases guidance is that similar transactions receive different accounting treatment. The ED does not resolve that issue. Instead, the ED would create new and unfamiliar dividing lines between types of leases that would add new complexity in place of an old one.

Additionally, we do not believe the proposed application guidance for lease classification based on the nature of the underlying asset (i.e., whether the underlying asset is property or an asset other than property) follows the ED's principle of classifying leases based on the lessee's consumption of the economic benefits embedded in the underlying asset. Therefore, we believe the Boards should more clearly articulate the basis for differentiating lease accounting based on the nature of the underlying asset and how this approach represents an improvement for financial statements users.

We encourage the Boards to consider whether converging aspects of lease classification guidance in IAS 17 (e.g., principles-based classification that excludes bright-lines) and ASC 840 (e.g., guidance for leases with government entities, guidance for leases late in economic lives of underlying assets) might represent a more practical and pragmatic approach.

Inclusion of the lease classification principle in the standard

We believe that the principle(s) of a "principles-based" standard should be included in the standard itself. However, the Boards' lease classification principle is articulated only in the basis for conclusions. Instead, the ED provides conflicting application guidance that appears to be based primarily on the nature of the underlying asset (i.e., property or other than property). The Boards acknowledge the application guidance would not always result in conclusions that are consistent with the principle (paragraph BC51). If the ED's approach were to continue, we believe the standard itself should contain a principle with well-developed application guidance that would faithfully represent that principle.

Lease classification based on the nature of the underlying asset

Notwithstanding our concern regarding whether the nature of the underlying asset is an appropriate distinguishing factor for the two types of proposed leases, we believe that further clarification of the term property is also needed to make the lease classification application guidance operational. Under today's US GAAP standards, certain structures that are attached to real estate (e.g., pipelines, cellular towers, refineries, power plants) are often considered to be integral equipment and therefore treated as real estate for accounting purposes. We note that the IFRS Interpretations Committee is currently debating whether the scope of investment property in IAS 40 could be broadened to include structures such as those described above. A concept similar to integral equipment is not present in the ED, and the ED defines property as "land or a building, or part of a building, or both." As such, it appears that the proposed definition of property does not include many of today's US GAAP integral equipment assets that are economically similar to assets included in the proposed definition of property. If the Boards continue to use property as the dividing line between lease types, we believe the Boards should revise the definition of property to include assets with economic characteristics similar to those considered integral equipment in US GAAP today (e.g., pipelines, cellular towers, refineries, power plants). Given the lack of an underlying conceptual basis, we are also concerned that the proposed definition of property could lead to diversity in interpretations and result in similar transactions for the same type of asset (e.g., contracts for the lease of space on cellular towers) being accounted for differently by different entities, adversely affecting the comparability of financial information across different entities.

We also believe there is an inconsistency in the application guidance for the classification of leases of assets other than property. Specifically, one exception criterion refers to total economic life of the underlying asset, whereas the other exception criterion refers to the fair value of the underlying asset at the commencement date, which could be influenced by prior leases of the same asset. We believe the Boards should more clearly articulate the explanation for this inconsistency.

Question 5: lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

We generally agree with the proposals on lease term, including the requirement to reassess the lease term. However, we have the following suggestions that we believe would make application more understandable and practical.

Reassessment

We support the concept of reassessing the lease term. However, we have concerns that the following aspects of the reassessment requirements, as proposed, would create costs without the corresponding benefit.

Lessees and lessors would need to implement process and controls to continuously monitor factors that could trigger reassessment of the lease term. We observe that the factors referred to in paragraph B5 [842-10-55-4] (i.e., market-, contract-, asset- and entity-based factors) potentially could change multiple times within a given reporting period. The continuous reassessment could result in remeasurement of a lease liability or receivable within a single reporting period. To reduce costs and improve practical application of the Proposal, the Boards should consider requiring reassessments of the lease term (and lease payments) based on periodic intervals, such as at an annual reassessment date or at annual reporting dates (also refer to our discussion below on reassessment of variable lease payments based on an index or rate).

The Boards should consider what reassessment interval is appropriate for financial statement users. We note that precedence for other periodic reassessments currently exists. For example, IAS 16 and IAS 38 require an annual reassessment of depreciable/amortizable lives of long-lived tangible and intangible assets with finite lives, respectively. Likewise under ASC 350, goodwill of each reporting unit must be tested for impairment at least annually (and in between in certain circumstances). To provide greater clarity about significant changes between periodic reassessment, additional reassessments could be required when renewal options or termination options are exercised. We believe including a more practical reassessment requirement would help reduce the costs of compliance associated with reassessment, including the costs of establishing related processes and controls, yet may still provide relevant and decision-useful information to financial statement users.

Additionally, we are concerned that the guidance indicating that a change in market-based factors, in isolation, would not trigger reassessment of the lease term may not afford preparers the relief that the Boards' may have intended. We have observed that changes in market-based factors generally occur in conjunction with, or as a result of, changes in other factors (e.g., asset-based factors, entity-based factors). For example, a decline in market rents for a retail space in a shopping center may result from a change in other factors such as reduced foot traffic in that shopping center (i.e., an asset-based factor).

We believe that additional clarity is needed regarding lessee and lessor considerations of market-based factors in a reassessment of the lease term (or lease payments). Because market-based factors are generally influenced by changes in other factors (e.g., asset-based factors) it is unclear to what extent the Boards intended this provision to provide relief. If the Boards agree with our observations we would suggest that they consider clarifying in the standard that market-based factors are often influenced by other factors. We believe such a clarification would help mitigate the risk that preparers might not interpret or apply the intended relief consistently when evaluating whether a reassessment of the lease term (or lease payments) is required.

Finally, while the ED provides detailed requirements for the reassessment of the lease receivable (and lease term) for lessors in Type A leases, it does not provide guidance as to whether lessors in Type B leases would be required to make a similar reassessment. Although lessors with Type B leases would not recognize a lease receivable, the recognition of periodic lease income amounts would be determined based on the lease payments and the lease term. Therefore, a change in either the lease term or lease payments could affect the periodic amounts the lessor would recognize for a Type B lease. We believe the Boards should clarify whether reassessment would be required. If the Boards determine that reassessment is appropriate, they should provide implementation guidance to illustrate reassessment of the lease term and lease payments for lessors of Type B leases and how any adjustment would be recorded (e.g., prospectively, cumulative catch-up).

Question 6: variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

We generally agree with the proposals on the measurement of variable lease payments. We believe that lease payments should include only those payments during the lease term that represent a present obligation of the lessee. In our view, performance-based and usage-based variable lease payments do not represent obligations of the lessee prior to the occurrence of the applicable triggering event. For example, we do not believe that a lease payment that a lessee can avoid by not using the underlying asset represents a present obligation of the lessee. Also we believe that variable lease payments based on a rate or an index or future changes in a rate or index would represent a present obligation of the lessee. In such cases, only the measurement of the obligation is uncertain.

We believe clarity is needed in determining when a lessor would include variable lease payments not based on an index or rate (e.g., usage- or performance-based variable lease payments) in the determination of the rate the lessor charges the lessee. Expected variable payments that are not included in the receivable but influence the discount rate would be included in the value of the residual asset (paragraph 71 [842-30-30-4]). However, it is not clear whether lessors would be required to consider expected variable payments in determining the rate the lessor charges the lessee. If lessors would be permitted to consider such expected variable payments for some leases, but not others, we believe the Boards should clarify whether such an approach would be made as a policy election. It is also unclear how such an option (if permitted) would serve to improve comparability in financial reporting. The Boards should also provide implementation guidance and illustrative examples of a lessor, including expected variable lease payments in the determination of the rate the lessor charges the lessee.

Reassessment

We are concerned that the requirement to reassess variable lease payments at the end of each reporting period may be overly burdensome and may not provide users with sufficient incremental information to justify the costs. For example, a contract with lease payments based on a reference interest rate that is a published weekly could result in remeasurement of a lease liability or receivable multiple times within a single reporting period. We suggest that the Boards clarify that reassessments of the lease payments could be performed at periodic intervals, such as at a specific annual reassessment date or at an entity's annual financial reporting dates (also refer to our discussion above on re-assessment of the lease term in response to Question 5). We believe a periodic (e.g., annual) reassessment of lease payments would be more practical and mitigate costs to preparers, and it may still be responsive to the Boards' concerns about the decision-usefulness of information available to financial statement users.

Question 7: transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

We recognize that the proposed full retrospective and modified retrospective approaches are intended to provide financial statement users with trend information about lease activity for the comparative periods presented in the financial statements in the period of adoption. However, we believe the Boards should consider whether a transition approach similar to the modified retrospective approach for the revenue recognition project could be provided without reducing the usefulness of reporting financial information.

Modified retrospective transition application issues

Notwithstanding our comments above about additional relief in transition, we believe the Boards should provide transition guidance for arrangements that are leases under current leases standards but would not be within the scope of the Proposal (e.g., a take-or-pay arrangement that is a lease today but would not meet the proposed definition of a lease). We believe such guidance is needed to ensure consistency in the accounting and financial reporting for such arrangements.

It is unclear whether entities would apply the proposed classification guidance to current operating leases in transition using information available as of the lease commencement date or another date (e.g., the effective date or the beginning of the earliest comparative period presented in the financial statements). It is important to clearly identify the time at which transition classification should be assessed because lease classification exception criteria could be met when assessed as of one date but not met when assessed as of another date. We recommend that the Boards clearly identify whether lease classification at transition would be determined as of the lease commencement date or as of another date.

For current finance and capital leases, the Proposal does not address lessors' accounting for the lease receivable balance (effectively the residual asset) that remains at the end of the lease term. The transition requirement in paragraph C17(c) [842-10-65-1(t)] states that the lessor would classify the entire net investment in the lease as a receivable and that the residual value of the underlying asset would be included in that measurement. Therefore, at the end of the lease, there would be a remaining balance for the lease receivable that represents the residual asset. It appears reasonable that a lessor would reclassify the lease receivable to the appropriate category of asset in accordance with applicable Standards [Topics]. However, the ED does not provide applicable guidance. We believe the Boards should specify the accounting for the remaining lease receivable at the end of leases that are transitioned in accordance with paragraph C17(c) [842-10-65-1(t)].

The Boards should also address the consequences of retrospective application of the ED to the capitalized costs of assets subject to other standards. In today's accounting, the cost of a lease (e.g., the lease costs in an operating lease or the amortization and interest in a finance/capital lease) is capitalized if the costs are directly attributable to another asset, such as PPE, inventory or intangibles. If a company capitalizes certain lease expenses, a change in the accounting for leases would lead to a change in the capitalized cost of the related asset (e.g., inventory, PPE). It is unclear how these previously capitalized costs would be recognized when transition to the ED is applied retrospectively. That is, it is not clear whether such costs would be removed from the cost of the asset and recalculated using the proposed guidance or whether they would be ignored. The practical consequences of transition may be more complex than anticipated, and we suggest that the Boards address these types of costs in the transition requirements. One possible solution would be to include a relief similar to that provided in paragraph 173(a) of IAS 19, *Employee Benefits*.

In addition, the FASB should include transition guidance for arrangements described in ASC 840-40-15-5 for which a lessee is considered the owner of an asset during the construction period.

Question 8: disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

We share the Boards' commitment to ensuring that financial statement users have access to appropriate decision-useful financial information. We are concerned, however, that the volume of new required disclosures may indicate the proposed changes to the financial statements may not meet the objectives of providing greater transparency for financial statement users.

Further, we have concerns that the proposed disclosures would contribute to, and perhaps exacerbate, the disclosure overload that we believe already exists today. In June 2012 we updated a study of 40 years of US GAAP financial statements that demonstrated a compound annual growth rate of 7.6% in disclosure, with disclosures roughly doubling every 10 years.[3] Although the financial statements analyzed were prepared on a US GAAP basis, we believe our observations have relevance for financial statements prepared on both US GAAP and IFRS bases. We do not believe this growth rate of disclosures will abate given the significant additional disclosures that have been proposed in recent additions to IFRS and US GAAP as well as current exposure drafts, including the *Leases* ED. We find the growing volume of required disclosures to be concerning because we believe it often makes the most important information difficult to find in the financial statement notes. We believe this could discourage some financial statement users from attempting to use the financial statement notes.

Notwithstanding our comments below regarding uncertainty about which users would benefit from certain disclosures, we recognize that the Boards proposed the individual disclosures in the ED for particular reasons. When each of those proposed disclosures is viewed in isolation we acknowledge that they may provide some information that certain users of the financial statements would want. However, consistent with our views about disclosure overload in general, we believe that such one-off analysis and consideration of disclosures gives equal weight to all required disclosures. Such an approach may not capture the concern that users are forced to wade through a large volume of information in an effort to find the information that is most important and decision-useful.

In our cover letter, we noted that we believe it is not clear which financial statement users would benefit, and to what extent they would benefit, from the ED's proposed changes compared to the information they receive today. We believe this lack of clarity also applies to the proposed changes to disclosures. It is not clear to us how the proposed disclosures are responsive to financial statement users' requests for additional information or which users would benefit from those changes. To provide greater transparency into the outreach with users the Boards have performed, we would suggest that the Boards clarify:

- The specific types of users that have requested the new or enhanced information (e.g., an analysis of the information users have requested broken out by type of information and user category such as buy-side or sell-side analysts, ratings agencies, regulators and accounting or auditing industry observers)

- How the new information improves the usability of financial reporting for the referenced users

Without better insight into users' needs, it is difficult to conclude whether the proposed changes (including changes to disclosure) represent a sufficient improvement in financial reporting to justify the additional costs and complexity.

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[3] EY, To the Point, *Now is the time to address disclosure overload*, dated 21 June 2012. We studied the annual reports of 25 large, well-known companies to determine the average number of pages in the notes to the financial statements and to predict the future volume if growth continued at historic rates.

Question 9: (FASB-only): nonpublic entities

To strive for a reasonable balance between the costs and benefits of information, the FASB decided to provide the following specified reliefs for nonpublic entities:

(a) To permit a nonpublic entity to make an accounting policy election to use a risk-free discount rate to measure the lease liability. If an entity elects to use a risk-free discount rate, that fact should be disclosed.

(b) To exempt a nonpublic entity from the requirement to provide a reconciliation of the opening and closing balance of the lease liability.

Will these specified reliefs for nonpublic entities help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements? If not, what changes do you propose and why?

We are supportive of exploring ways to provide relief to nonpublic companies. We believe the two proposed reliefs specified in Question 9 would reduce the financial reporting burden for nonpublic entities.

However, we also believe that any alternatives (including reliefs) provided to nonpublic companies should not result in fundamentally different bases for preparing the financial statements as compared to public companies. We believe that the achievement of this goal generally depends on providing recognition and measurement alternatives that:

- Have objectives that are similar to the recognition and measurement objectives for public companies
- Provide practical expedients for initial recognition and measurement
- Are disclosed in accounting policies
- Do not create significant obstacles if an entity decides to go public

We believe the risk-free discount rate relief would provide an effective practical expedient for the initial measurement of the lease liability and should appropriately be disclosed as an accounting policy election in the financial statement notes. However, because the risk-free interest rate would also be used to measure the lease liability subsequent to lease commencement, we have concerns that this relief could create a significant obstacle to going public for nonpublic entities with significant leasing activities (as a lessee). That is, we believe it could be costly for such a nonpublic entity, which elects the risk-free interest rate relief, to retrospectively adjust its financial statements to reflect the use of a different discount rate (i.e., the lessee's incremental borrowing rate), consistent with the rate that a public company would have used, prior to going public. Therefore, we believe that the Board should provide specific guidance (including application guidance) for nonpublic entity lessees (which make the risk-free discount rate election) to remeasure lease liabilities in transition to becoming a public company.

Question 10: (FASB-only): related party leases

Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases (for example, to require the lease to be accounted for based on the economic substance of the lease rather than the legally enforceable terms and conditions)? If not, what different recognition and measurement requirements do you propose and why?

Question 11: (FASB-only): related party leases

Do you agree that it is not necessary to provide additional disclosures (beyond those required by Topic 850) for related party leases? If not, what additional disclosure requirements would you propose and why?

We agree that it is not necessary to provide different recognition and measurement requirements for related party leases. We believe that lessees and lessors accounting for related party leases on the basis of the legally enforceable terms and conditions of the arrangements, along with adequate disclosure about those related party lease arrangements, should adequately meet the needs of financial statement users. We also agree that it is not necessary to provide additional disclosures beyond those required by ASC 850 for related party leases.

Question 12: (IASB-only): Consequential amendments to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 *Investment Property*. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

We agree with the proposed amendments to IAS 40. We believe that removing the existing accounting policy choice will enhance comparability among investment property companies.

Appendix B

General comments about the Proposal

In addition to our responses to the questions specified in the ED (Appendix A), we have other comments that we explain below.

Executory costs

Under US GAAP,[4] lease-related executory costs (e.g., insurance, maintenance, taxes) are considered lease elements for the purpose of separating the lease and non-lease elements of a contract. Similarly, costs for services and taxes to be paid by and reimbursed to the lessor are excluded from minimum lease payments under IAS 17.[5] However, the Proposal does not clarify how to evaluate executory costs to determine whether they would be considered lease or non-lease components.

It appears that certain costs under existing accounting standards considered lease executory costs (e.g., costs for maintenance services) would be non-lease components of contracts. However, it is less clear whether other costs (e.g., insurance, taxes) would be part of a lease component or a separate non-lease component. In addition, executory costs may be paid to a third party by the lessee or the lessor (gross vs. net), and the party that is primarily obligated to the third party may vary (e.g., the lessor is primarily obligated for real estate taxes, but under the lease the lessee is obligated to make real estate tax payments directly to the taxing authority). As executory costs are common in many types of lease contracts, we encourage the Boards to provide clarifying guidance on the accounting for such costs. The Boards should provide adequate guidance to clarify how entities should evaluate all costs that are considered executory costs today for the purposes of identifying lease and non-lease components in a contract and to ensure that the lease accounting for gross and net leases will be the same.

Reassessment of lease classification

The Proposal would require entities to assess the classification of leases only at lease commencement (paragraph 28 [842-10-25-5]). As described in paragraph BC127, the Boards concluded that the costs and added complexity of reassessing lease classification would outweigh the benefits. We note that not reassessing lease classification could result in accounting that does not reflect the underlying economics of some leases. For example, consider a land lease with a two-year noncancelable period and a renewal option for 97 years. Also assume that the lease payments during the noncancelable period and the renewal period are at market rates and that there are no other factors present that would create a significant economic incentive for the lessee to exercise the renewal option. At lease commencement, the lease term is determined to be two years. The lease is classified as Type B because it is a lease of property and neither of the exception criteria specific to leases of property is met. Further, assume that in the second year of the lease the lessee decides to construct a building on the leased land and exercises its option to renew the lease. Although the lessor and lessee would reassess and remeasure the lease receivable and lease liability, respectively, the lease would continue

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[4] Refer to ASC 840-10-15-19.

[5] Refer to IAS 17.4.

to be classified as Type B, even if the present value of the revised lease payments over the remaining lease term of 97 years accounts for substantially all of the fair value of the land. While we recognize that this is an extreme example, we would expect to see similar transactions, albeit with shorter terms and assets with shorter economic lives.

We believe the Boards should acknowledge that the requirement to assess lease classification only at lease commencement has the potential to give rise to accounting that does not reflect the underlying economics of some leases.

Sale and leaseback transactions

Transferee accounting for amounts paid in a sale and leaseback accounted for as a financing arrangement

We believe the proposed transferee accounting for amounts paid in a sale and leaseback transaction, when the transfer of the asset is not a sale, should be clarified. Paragraph 115b [842-40-25-4b] states that the transferee would not recognize the transferred asset; rather, it would account for amounts paid to the transferor as a receivable in accordance with applicable Standards [Topics]. It is not clear which other Standards [Topics] would apply to the recognized receivable. We are concerned that other potentially relevant Standards [Topics] (e.g., IAS 39, *Financial Instruments: Recognition and Measurement*, and ASC 310, *Receivables*) may not provide adequate guidance with respect to the subsequent measurement of this receivable because this guidance applies to financial assets. In the case of a sale and leaseback transaction accounted for as a financing arrangement, the transferee's receivable would ultimately be settled through a combination of financial assets (i.e., cash payments) and non-financial assets (i.e., the underlying asset). It is unclear how the proposed accounting by the transferee would consider the nature of the underlying asset for subsequent measurement purposes. For example, it is unclear how the transferee's accounting for the lease receivable would consider a decline in the fair value of the underlying asset subsequent to the commencement date. We suggest that the Boards provide additional guidance to address the transferee's subsequent measurement of the receivable recognized in sale and leaseback transactions accounted for as financing arrangements.

Lessor put options in sale and leaseback transactions

We understand that in conjunction with the revenue recognition project, the Boards recently deliberated the role of repurchase options when determining whether (or when) control passes to a buyer. We note that the Proposal's guidance for sale and leaseback transactions in paragraph 113 [842-40-25-3] would require entities to look to the revenue recognition proposal to determine whether a sale has occurred based on whether a transferee obtains control of the asset in accordance with the requirements for determining when a performance obligation is satisfied. The role of repurchase option provisions is important to the Proposal's guidance for sale and leaseback transactions because the evaluation of whether or not control passes to the transferee determines whether the transaction would be accounted for as a sale and a lease or as a financing arrangement. The Boards should clarify how repurchase provisions (including those at, above and below the market value of the asset at commencement) would be considered in the evaluation of whether control passes to the transferee in a sale and leaseback transaction.

Guidance about scope — extractive industries

The ED would not apply to leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraph 4b [842-10-15-1b]). In certain extractive industries (e.g., mining industry, oil and gas industry), leases of the rights to explore for or extract non-regenerative resources also frequently include the rights to use the land above which those subsurface resources are located. It is unclear whether the rights to use the land (surface rights), which are associated with a lease to explore for non-regenerative resources, would be within the scope of the ED. We recommend that the Boards clarify whether the rights to use land associated with leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources would be excluded from the ED.

Also, extractive industry activities are often conducted through a variety of joint arrangements. In some joint arrangements, an operator (one of the parties to the joint arrangement) is appointed to conduct activities, such as entering into lease arrangements, on behalf of the joint arrangement. In other joint arrangements, all of the parties to the joint arrangement may jointly enter into a lease arrangement. We recommend that the Boards clarify, with illustrative examples, the application of the guidance for identifying a lease to leases entered into by joint arrangements commonly found in the extractive industries. It would be helpful if examples illustrated both a joint arrangement in which an operator (with the authority to enter into leases to fulfill its role as operator) enters into a lease contract on behalf of the joint arrangement as well as a joint arrangement in which all of the parties to the joint arrangement jointly enter into a lease contract.

Other comments about the proposed lessee accounting approach

In addition to our response to Question 2 in Appendix A, we have the following observations and comments about the proposed lessee accounting approach.

Lessee allocation of contract consideration

The Proposal does not address whether, or how, lessees would allocate subsequent changes to the contract consideration related to non-lease components. A change in the contract consideration for non-lease components could be viewed as affecting the consideration allocable to lease components in the following scenarios:

- The lessee allocated contract consideration to the components of the contract on a relative standalone price basis.
- The lessee allocated the contract consideration to the components of the contract using a residual method, and one of the components without a standalone observable price was a lease component.

It is unclear if the lease liability would be remeasured upon a subsequent change to the contract consideration related to a non-lease component. The Boards should clarify whether, and if so, how, lessees should adjust the consideration allocated to a lease component for subsequent changes in contract consideration.

Reassessment of the lease liability

When reassessing the lease liability for a change in the lease payments, the Proposal indicates that lessees would reassess the discount rate used to measure the lease liability in certain circumstances. Paragraph 81 [842-30-35-6] states, "A lessee shall determine the revised discount rate at the date of reassessment as the rate the lessor ***would*** (emphasis added) charge the lessee at that date (or, if that rate is not readily determinable, the lessee's incremental borrowing rate on that date, or the risk-free rate at that date for a nonpublic entity that elected to use the risk-free rate) on the basis of the remaining lease term."

The Boards should clarify how a lessee would determine the rate the lessor *would* charge the lessee for the purpose of remeasuring a lease liability. It is not clear if the rate implicit in the lease as of the reassessment date constitutes the rate the lessor *would* charge. Clarifying guidance should address whether the lessee, in determining the rate the lessor *would* charge, would be required to assess the amount the lessor expects to derive from the underlying asset following the lease term and the fair value of the underlying asset as of the remeasurement date.

Contingent lease incentives

The Proposal would require lessees to account for lease incentives receivable from the lessor at the commencement date as a reduction to the lease payments (paragraph 39a [842-20-30-3a]) and for lease incentives that are received from the lessor at, or prior to, the commencement date as a reduction of the initial measurement of the right-of-use asset (paragraph 40 [842-20-30-4]). However, the ED does not address lease incentives that are contingently receivable at the lease commencement date and will be paid subsequently.

Contingently receivable lease incentives are common in many lease arrangements. For example, lessors often provide tenant improvement allowances that become payable to the lessee (often up to a specified amount) only as the lessee incurs costs for eligible leasehold improvements. These costs are typically incurred after lease commencement. Therefore, the lease incentive is neither received nor receivable by the lessee at the commencement date. We believe the Boards should clarify how, and when, lessees should recognize and measure contingently receivable lease incentives. Absent clarifying guidance, we believe varying accounting for contingently receivable lease incentives could develop, which would lead to reduced comparability of accounting for similar transactions across entities.

Onerous contracts (FASB only)

The FASB's Proposal would require lessees to disclose information about leases that have not yet commenced but create significant rights and obligations for the lessee (paragraph 842-20-50-3b). In paragraph BC85 the Board explains that entities should apply ASC 450, *Contingencies* (ASC 450), to account for a lease that is onerous between the date of inception and the commencement date. However, it is not clear how ASC 450 would apply as the concept of an onerous contract is not present in ASC 450.

Lease deposits

The ED does not address how entities would account for lease deposits. It is not clear whether deposits made by a lessee upon entering into a lease would be considered in determining the lease payments for the purpose of measuring the lessee's lease liability or the lessor's lease receivable (for Type A leases). We suggest that the Boards clarify whether lease deposits would be considered in the recognition and measurement of lease-related assets and liabilities and provide application guidance for the related accounting. We are concerned that without such clarifying guidance, diversity could develop in the accounting for lease deposits and lead to reduced comparability of accounting for similar transactions across entities.

Currently, ASC 840 contains guidance for lessee accounting for maintenance deposits under arrangements that are leases.[6] Preparers in the airline industry utilize this guidance to determine when amounts paid under lease arrangements should be accounted for as a deposit and when they should be accounted for as a lease payment. Because the amendments in the Proposal would supersede ASC 840 in its entirety, it appears that the existing guidance for lessee accounting for maintenance deposits would be eliminated. As there is no similar guidance included in the ED, we believe the Boards should acknowledge that varying interpretations could lead to diversity in practice in determining whether amounts paid to lessors should be included in the accounting for the lease or treated as deposits and consider whether such diversity would be acceptable to users of financial statements, including regulators.

Subsequent measurement of right-of-use assets acquired in business combinations (Type B leases)

It is unclear how the right-of-use asset for Type B leases acquired in a business combination would be measured subsequent to the business combination. The remaining costs of a lease described in paragraph B16 [842-20-55-8] for determining the straight-line periodic lease cost do not give consideration to the adjustments made to the initial measurement of a Type B right-of-use asset acquired in a business combination. We suggest the Boards clarify that the remaining costs of a lease would include the adjustments made to the measurement of a Type B right-of-use asset in a business combination to reflect favorable or unfavorable terms of the lease and any other intangible assets associated with the lease.

Other comments about the proposed lessor accounting approach

In addition to our response to Question 3 in Appendix A, we have the following observations and comments about the proposed lessor accounting approach.

Lessor recognition of Type B lease income on a basis other than straight-line

The proposed guidance for lessor recognition of Type B lease income in paragraph 93 [842-30-25-2] states that "A lessor shall recognize lease payments as lease income in profit or loss over the lease term on either a straight-line basis or another systematic basis if that basis is more representative of

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[6] EITF 08-3, *Accounting by Lessees for Maintenance Deposits*, was codified in ASC 840-10, *Leases — Overall*.

the pattern in which income is *earned* (emphasis added) from the underlying asset." Today, IAS 17 requires lessors to recognize lease income on a straight-line basis over the lease term unless another systematic and rational basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished. ASC 840 requires lessors to recognize lease income on a straight-line basis over the lease term unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property. In practice, lessors typically recognize operating lease income on a straight-line basis.

In paragraph BC277, the Boards indicate that in the case of stepped rent increases when those stepped rents are expected to compensate the lessor for increases in market rentals, recognizing lease income as lease payments are received would better reflect the pattern in which income is earned from the underlying asset. However, it is unclear if the same logic could permit a lessor that receives straight-line rent payments to recognize periodic lease income on an increasing basis over the lease term to the extent the lessor expects market rentals to increase over the lease term. In that case, the lessor might conclude recognizing income on a back-loaded basis (i.e., less income recognized in the early periods and more in the later periods) better reflects the pattern in which income is earned. Similarly, a lessor might recognize lease income on a front-loaded basis (i.e., more income recognized in the early periods and less in the later periods) in circumstances in which the lessor expects market rentals to decrease over the lease term. Also, there might not be a clear distinction between increases in scheduled lease payments designed to reflect the pattern in which lease income is earned and other scheduled increases (e.g., increases that may be more reflective of lease incentives).

We believe the Boards should more clearly articulate the intended meaning of earned as used in paragraph 93 [842-30-25-2] and provide illustrations of acceptable systematic bases for recognizing lease income. Additionally, we believe the Boards should clarify whether the periodic lease income recognized on a systematic basis, other than straight-line, could exceed the periodic lease payments. Additional guidance may mitigate the risk that reasonable but differing judgments may reduce comparability of the accounting for similar arrangements.

Lease payments structured as residual value guarantees

For purposes of measuring lease receivables, lessors' lease payments would include fixed lease payments structured as residual value guarantees (paragraph 70d [842-30-30-2d]). We acknowledge that the Boards provide implementation guidance in paragraphs B17 and B18 [842-30-55-1 and 2] with an example of a lease payment structured as a residual value guarantee. The implementation guidance in paragraph B17 [842-30-55-1] explains that in such circumstances "… the lessor will pay to the counterparty, or the counterparty can retain, any difference between the selling price of an underlying asset and an amount specified in the contract." Accordingly, the lessor receives a fixed amount for the residual asset, which is similar to a fixed lease payment receivable at the end of the lease term. In BC220 the Boards note that the specified amount is economically the same as a fixed balloon lease payment that is a feature in some leases.

We agree with the Boards' conclusion that lease payments structured as residual value guarantees are economically the same as fixed lease payments. However, we believe that confusion could arise when lessors attempt to apply the proposed guidance to certain lease arrangements commonly referred to as synthetic leases. For example, consider a lease contract that includes a lessee's partial residual value guarantee. In this example, the lessee assumes the first $85 of the loss if the future selling price of the underlying asset is less than the specified price of $100. The lessee would receive any appreciation above $100 (i.e., the lessee would keep any amounts above $100 if the underlying asset is sold for more than the specified price). In this circumstance, we believe the amount the lessor would receive at the end of the lease is not fixed because the lessor would absorb any losses in excess of $85. We believe the Boards should clearly articulate that the concept of including lease payments structured as residual value guarantees would apply only when the amount the lessor will receive is fully fixed. That is, residual value guarantees that introduce an element of variability would not be included in the lessor's lease payments. Absent such guidance, we believe entities might struggle to determine whether certain residual value guarantees should be included in lease payments. In addition, we believe the Boards should clarify why they believe this accounting is appropriate for lessors but not lessees (e.g., a lessee in an arrangement with a lease payment structured as a residual value guarantee may expect to pay zero under the residual value guarantee).

Type A lease approach complexity

As noted in our cover letter, we have concerns about the complexity of the proposed Type A lease approach for lessors. In particular, we believe clarification of the proposed guidance for reassessments of the lease receivable is needed. We believe it is not clear how lessors would determine the rate the lessor *would* charge the lessee and the fair value of the residual asset when performing a reassessment of the lease receivable. Without such clarification, we believe lessors will experience operational difficulties with the proposed reassessment provisions.

Discount rate — incorporating the possibility of change in variable lease payments

The ED requires lessors to remeasure lease receivables to reflect changes to the lease payments (paragraph 78 and 79 [842-30-35-3 and 4]). In the circumstances set forth in paragraph 80 [842-30-35-5], the lessor would be required to determine a revised discount rate (used to discount the lease payments to present value), unless the possibility of the change was reflected in determining the discount rate at the commencement date. The Boards should clarify how a lessor would demonstrate whether the possibility of future changes in lease payments is reflected in the rate the lessor charges the lessee. Additionally, the Boards should provide application guidance to illustrate the calculation of a discount rate that reflects the possibility of a future change in the lease payments.

Rate the lessor would charge the lessee upon reassessment

When determining the revised discount rate to be used to remeasure a lease receivable, paragraph 81 [842-30-35-6] specifies that the "lessor shall determine the revised discount rate at the date of reassessment as the rate the lessor ***would*** (emphasis added) charge the lessee at that date on the basis of the remaining lease term."

The ED does not define the rate the lessor *would* charge the lessee, nor does it provide application guidance or illustrative examples of how this rate would be determined. We do not understand the meaning of the rate the lessor *would* charge the lessee or how a lessor would determine that rate. It is not clear if the rate implicit in the lease as of the reassessment date constitutes the rate the lessor *would* charge. It is also unclear whether the lessor, upon reassessment, would be required to determine the then-current fair value of the underlying asset and the residual asset at the reassessment date in order to determine the rate the lessor *would* charge the lessee.

The Boards should clarify how a lessor would determine the rate the lessor *would* charge the lessee for the purpose of remeasuring a lease receivable. We believe clarifying guidance (including illustrative examples) should address how a lessor would determine the rate the lessor *would* charge the lessee upon a reassessment of the lease receivable. That guidance should also address whether the lessor would be required to assess the amount the lessor expects to derive from the underlying asset following the lease term and the fair value of the underlying asset as of the remeasurement date. Without a clear definition and application guidance, we have concerns that lessors may develop diverse views as to how to determine the rate the lessor would charge the lessee, which could adversely affect the comparability of accounting for similar transactions.

Considerations about unearned profit in the adjustment to the residual asset upon a reassessment

As part of a reassessment (and remeasurement) of the lease receivable to reflect a change in the lease payments, paragraph 78 [842-30-35-3] states that a lessor would also adjust the carrying amount of the residual asset to reflect the amount the lessor expects to derive from the underlying asset following the end of the lease term. We note that the description of the revised carrying amount of the residual asset does not include any discussion of unearned profit. As such, it is unclear whether lessors would consider unearned profit when adjusting the carrying amount of the residual asset upon a reassessment. Not considering unearned profit in the remeasurement of the residual asset could result in recognition of profit embedded in the recognized residual asset upon remeasurement.

The Boards should provide clarifying guidance about how lessors would calculate the adjustment to the residual asset upon a reassessment. For example, we believe the Boards should clarify:

- Whether (and if so, how) lessors should consider unearned profit when remeasuring the residual asset
- Whether (and if so, how) lessors would consider the fair value of the underlying asset at the reassessment date when determining the revised amount that the lessor expects to derive from the underlying asset following the lease term
- Whether (and if so, how) lessors would consider the rate the lessor *would* charge the lessee when determining the adjustment that should be made to the carrying amount of the residual asset (see prior comments above regarding the discount rate to use upon reassessment)

We also believe illustrative examples are needed to help lessors apply the lessor reassessment concepts. In the absence of such clarifications and implementation guidance (i.e., illustrative examples), we have concerns that differences in judgments about reassessments could lead to different accounting treatments for similar transactions.

Residual asset impairment

We believe application guidance is needed regarding the impairment of residual assets. For example, it is not clear how lessors would determine the appropriate rate at which to accrete the residual asset following an impairment. In the circumstance that a residual asset is impaired, the fair value of that asset would be determined using market participant considerations (including a market participant discount rate) as required by IAS 36 [ASC 360]. Because the adjusted carrying amount of the residual asset would reflect market participant considerations, it is unclear whether the lessor would subsequently accrete the residual asset using the rate the lessor charges the lessee or a different rate. The Boards should clarify what rate the lessor would use to accrete the residual asset following an impairment and provide application guidance to assist lessors in applying that guidance.

Lessor reassessment of the lease term and lease payments in Type B leases

The ED provides detailed guidance for the reassessment of the lease term and the lease payments (i.e., upon the occurrence of certain changes) for lessees in both types of leases and for lessors in Type A leases. However, it does not provide guidance as to whether lessors in Type B leases would also reassess the lease term or the lease payments. Lease payments and the lease term both could be important inputs to the determination of how Type B lease income is recognized. Therefore, we believe the Boards should provide additional guidance to clarify whether lessors would be required to reassess the lease term and lease payments for Type B leases consistent with the reassessment provisions included for lessors in Type A leases.

Other comments about the proposed consequential amendments

Amendments to IFRS 1

Based on the proposed consequential amendment to IFRS 1, IAS 10 IG4, it appears the IASB intends for classification at transition to be performed as of the lease commencement date. If this is the Board's intention, we recommend that the IASB permit preparers to use the earliest comparative period if the information necessary to classify a lease is not available. We acknowledge that this could result in different lease classifications, particularly for leases of assets other than property for which one of the lease classification exception criteria is based on the *total* economic life of the underlying asset. However, in some lease arrangements the commencement date could be many years prior to the transition date of the Proposal, and it could be difficult, if not impossible, for preparers to make the judgments required to appropriately classify the lease in accordance with the requirements of the ED.

Amendments to IFRS 3 and ASC 805

The proposed consequential amendment in IFRS 3, paragraph B45B [ASC 805-20-25-20] states, "the acquirer would not recognise assets or liabilities at the acquisition date for leases which, at that date, have a remaining maximum possible term under the contract of 12 months or less." It appears that this proposed consequential amendment would preclude the recognition of assets or liabilities related to any off-market terms of leases with remaining maximum possible terms of 12 months or less at the acquisition date. This appears inconsistent with the general recognition principle of IFRS 3, paragraphs 11 and 12 [ASC 805-20-25-1], which requires separate recognition of identifiable assets acquired and liabilities assumed that meet both of the following conditions:

- The identifiable assets acquired and liabilities assumed meet the definitions of assets and liabilities in the Conceptual Framework [Concepts Statement 6] at the acquisition date.
- The identifiable assets acquired and liabilities assumed are part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions.

The Boards should clarify the rationale for not recognizing assets and liabilities related to acquired leases with maximum possible terms of 12 months or less. It is unclear whether the Boards believe that lease contracts are different from non-lease executory contracts for which assets and liabilities would be recognized for any off-market terms, regardless of the length of such contracts. In the absence of a conceptual basis for affording a unique exception to lease contracts, we recommend that the Boards consider revising the consequential amendments to indicate that an acquirer would recognize assets or liabilities for the off-market terms of leases with a maximum possible term of 12 months or less.

Amendments to IFRS 5

The proposed amendment to IFRS 5 revises example 4 in that standard so that a sale and leaseback transaction in which the transfer of the asset is not a sale would not meet the criterion to be classified as held for sale under IFRS 5. The proposed amendment makes reference to paragraph 115 of the ED in the context of "sale and leaseback accounting." However, paragraph 115 of the ED does not address sale and leaseback accounting. Instead, it describes the accounting for a transfer that does not qualify as a sale, i.e., a financing. We recommend the proposed amendment to IFRS 5 read as follows: "An entity is committed to a plan to 'sell' a property that is in use as part of a sale and leaseback transaction, and the transaction does not qualify as a sale in accordance with paragraphs 111 and 112 of [draft] IFRS X, *Leases*."

Amendments to IAS 7

The consequential amendment to paragraph 33 of IAS 7 proposes to add a sentence clarifying that the unwinding of the discount on the lease receivable would be presented in operating cash flows. The reason for this is not clear, as the unwinding of the discount is not a cash transaction. Presumably, the IASB's intention was to require preparers to present the portion of the cash receipt related to the interest on the receivable as operating cash flows. We recommend that the IASB revise the wording of this sentence to clarify this point.

Amendments to IAS 40

Today, there are valuation questions regarding the fair value measurement of an interest held under a lease that meets the definition of investment property as the interaction between current lease accounting and the fair value model in IAS 40 is not entirely clear. For example, when an entity values a leased investment property (i.e., leased and subleased to a third party), it may include extension periods that are not included in the lease term. This is because there is a relatively high threshold for a lessee to include extension periods in the lease term ("reasonably certain"). However, for valuation purposes, these extension periods are included since the threshold for valuations is lower than accounting requirements. The valuer generally assumes that the investment property will generate more income and that the rental payments will increase in the extension periods. It is unclear if this would be permitted under the ED. Also, valuers often apply the same discount rate to cash inflows and cash outflows when valuing investment property. However, cash inflows often include an element of uncertainty, whereas the cash outflows are often contractually set. Added clarity in IAS 40 and/or IFRS 13 regarding the proper valuation methods would help ensure consistent application.

Another area where the Board could provide clarification in IAS 40 is the interaction between leased land and a building. A common scenario in the real estate industry is when an entity leases land to build a multi-story building. Once the building is completed, the floors are rented to different lessees under Type B leases. Assuming the entity applied the fair value model in IAS 40, how would the leased land be treated? Would the land qualify as: (i) a separate investment property to be fair-valued under IAS 40, (ii) a separate owner-occupied right-of-use asset measured under the *Leases* ED or (iii) included in the fair value of the building (i.e., one investment property asset)? It is not clear in the ED how this would be treated, and we believe the Board should clarify the interaction between the *Leases* ED and IAS 40.

Amendments to IAS 41

The scope of the ED excludes biological assets entirely. This creates a void when the ED interacts with IAS 41 because it is not clear *who* recognizes a leased biological asset. For example, assume Entity A leases a dairy cow from Entity B in order to obtain its agricultural produce: milk. It is unclear if Entity A, Entity B or both would record the "leased" dairy cow on its balance sheet. IAS 17 is structured so that it does not apply to the measurement of the biological asset (i.e., fair value), but it does apply to the recognition (i.e., who recognizes the biological asset). We believe the consequential amendments should address the accounting for a transaction involving a "lease" of biological assets.

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19 September 2013

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Dear Mr Hoogervorst

ED/2013/6 'Leases'

The Group of 100 (G100) is an organization of chief financial officers from Australia's largest business enterprises with the purpose of advancing Australia's financial competitiveness. We are pleased to provide comments on this Exposure Draft.

The G100 considers that the current approach to accounting for leases is well understood by preparers and users and provides sufficient information to enable an assessment of the impact of leasing transactions on the financial position and operations of the entity.

We acknowledge the Board's work in addressing the deficiencies and complexity in earlier iterations of the proposed new lease accounting framework, however, in our view:

- **i. the proposals in the ED are complex, will involve undue costs for preparers to implement and those costs outweigh the benefits of the changes;**
- **ii. there is no conceptual basis for key aspects of the proposals, which sets an undesirable precedent in the standard-setting process and will make the on-going maintenance of the standard difficult;**
- **iii. the proposals will not reduce the propensity for users of the financial statements to make adjustments and therefore the changes cannot be considered more useful to users;**
- **iv. the extensive proposed disclosures, including separate disclosures for Type A and Type B leases are an additional burden and contrary to the G100's previously stated position on the need to rationalise and reduce unnecessary disclosures in financial reporting; and**
- **v. the current approach to accounting for leases is well understood by preparers and users and provides sufficient information to enable an assessment of the impact of leasing transactions on the financial position and operations of an entity.**

For these reasons the G100 does not support the issuance of a final standard based on the proposals in the ED.

Our comments below are provided on the basis that the IASB proceeds with the proposals and should not be interpreted as support for the changes to the lease accounting model.

The current project revisiting the conceptual framework offers the opportunity for the IASB to address issues relating to the rights of use approach to accounting for a range of services and arrangements including supply contracts. In respect of accounting for leases it appears that the approach is moving from the recognition of in-substance purchases of assets to the recognition as what some describe as notional assets.

In principle, the rights of use model if applied consistently would not require a distinction to be made between different types of leases. However, in view of the practical and implementation difficulties associated with such an approach we consider the proposals to identify Type A and Type B leases is a reasonable pragmatic approach to achieve the perceived benefits of changes to accounting for leases. We believe that if the proposals proceed in their current form the IASB should be transparent in its approach and state that the different classifications are made on the basis of practicality in the current environment.

Q1 Identifying a lease*: This revised ED defines a lease as a 'contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. An entity would determine whether a contract contains a lease by assessing whether:*

a. fulfilment of the contract depends on the use of an identified asset; and
b. the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paras 6-19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

The G100 has the following concerns about the definition of a lease:

a. the practical difficulties associated with distinguishing between leases and service contracts and, in many instances, where an agreement includes both a lease and a service arrangement. For example, it is likely to be difficult, and in some cases impractical, to seek to separate a service contract and a lease and between different service components embedded in a lease, in the following types of arrangements:

- capacity arrangements such as occurs with transmission by pipelines where participants have a right to specified capacity as occurs in the oil and gas industry;

- outsourcing arrangements where the entity has not specified the particular assets to be used as occurs in the waste removal industry and information processing. For example, in respect of waste removal an entity may contract for the removal of waste but does not specify the trucks to be used although all the capacity of the trucks is used;

- the construction of accommodation at mining sites and detention facilities by a third party who provides a complete portfolio of services subject to meeting specified performance criteria;

- medical suppliers often provide a machine to a medical facility for an insignificant or no charge provided the medical facility purchases a minimum number of consumables which can only be used on that machine. Similar arrangements also occur in the beverage and printing industries;

- take or pay arrangements in the mining industry where a railroad is built and independently managed by a third party, to a remote location, say, to provide access to a port or loading facility;

- property leasing arrangements where the lessee's use of the property such as retail space in a shopping centre is significantly dependent on the provision of a wide range of services by the lessor and, without these services, would not expect to be liable for the lease payments; and

- head leases that set out overall parameters covering large numbers of small value assets (eg personal computers) that are also subject to individual agreements (mainly for security and asset tracking purposes). These agreements may not allow the lessor to reclaim the asset at any time but for the lessee the costs of breaking the lease are not large enough to deter the lessee from returning one or more of the assets before the end of the lease.

b. as all Type A leases except short-term leases, will be recognised on the balance sheet there will be more focus on identifying the components particularly where an agreement includes an embedded operating lease. Under current requirements there is little to be gained in the separation because operating leases and service contracts are accounted for on a similar basis. The allocation of consideration between the various components will become more significant. While lessors are likely to have such information, lessees may not have reliable information to do so.

c. the application of the notion of control (where the lessee has the right to control the use of an asset) may involve the exercise of judgment compared to current practice in several industries where take-or-pay contracts and certain power purchase arrangements are common. For example, an entity may enter a contract to provide water to a customer via a network of pipelines and supply points. The network of pipes is not easily interchangeable and no other assets may feasibly be used to deliver the service.

Under the contract, the customer may be given the ability to use 50% of the pipeline whenever it requires it. Under IFRIC 4, this would likely be considered a lease because it is likely that this contract would give the customer 'the right to direct others to operate the asset in a manner it determines while obtaining more than an insignificant portion of its outputs'. There would be some judgment involved in determining whether the contract falls within the scope of the proposed draft standard.

Q2 Lessee accounting*: Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?*

In principle, as mentioned above, application of the right of use approach should not distinguish between leases of different types of assets. However, the G100 accepts that accounting for different classes/types of leases depending on whether the lessee is expected to consume the majority of the economic benefits of an asset is a practical compromise. We believe that the current accounting and distinction between finance leases and operating leases is appropriate and that if the proposals proceed in their current form different opportunities for structuring transactions are created.

If the proposals proceed the G100 considers that the relief in relation to short-term leases is of little benefit to preparers and users and is unlikely to provide significant relief in practice.

We believe the maximum possible terms of twelve months is too short to include anything but incidental leases in respect of office equipment, telecommunications, cars, hotel rooms etc. It would appear that the major concerns about existing lessee accounting relate to the lack of recognition of significant operating assets. As such, we believe that short-term leases be defined as having a maximum possible term of 3 years with related extension options only being included in that threshold if there is an economic incentive to exercise those options.

Q3 Lessor accounting*: Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?*

Yes. The G100 considers that the current approach to lessor accounting in IAS 17 *'Leases'* is appropriate. We believe that the concerns and issues raised about accounting for leases have been raised in respect of lessee accounting and not the approach adopted by lessors.

The existing lessor accounting model is well understood by users, preparers, auditors and regulators and provides appropriate information to users of financial statements as it reflects the underlying economic substance of the different types of lessor transactions.

***Q4 Classification of leases**: Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paras 28-34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?*

The G100 supports the principle that the lessee's expected consumption of the economic benefits embedded in an asset should determine its classification and suggests that such an approach underlies the present finance lease/operating lease basis of classification. While there is no basis in principle for treating property differently we consider that the distinction is made on pragmatic grounds.

***Q5 Lease term**: Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?*

The G100 acknowledges that the current proposals are more operational and less complex that those in ED 2010/9 and closer to the current treatment of renewal options (periods).

However, the practical distinction between 'reasonably certain' of being exercised and 'significant economic incentive' and the reasons for the change in terminology is not clear when it appears they are seeking to achieve the same outcome.

Currently when entities assess the 'reasonably certain' criteria under IAS 17 they include in the assessment a range of economic incentives such as comparisons with current market rates, the relative costs of continuing with the lease and its replacement and the ongoing significance of the lease item to the entity's operations.

If the proposals proceed the G100 considers that the relief in relation to short-term leases is of little benefit to preparers and users and is unlikely to provide significant relief in practice. We believe the maximum possible terms of twelve months is too short to include anything but incidental leases in respect of office equipment, telecommunications, cars, hotel rooms etc.

It would appear that the major concerns about existing lessee accounting relate to the lack of recognition of significant operating assets. As such, we believe that short-term leases be defined as having a maximum possible term of 3 years with related extension options only being included in that threshold if there is an economic incentive to exercise those options.

Q6 Variable lease payments*: Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?*

The G100 believes that the current proposals are a reasonable and practicable approach when compared with those in ED 2010/9. However, we believe that the full requirements should be located in the base IFRS and not left to illustration by way of examples such as occurs with the interpretation of 'in substance fixed payments'.

The meaning of 'in substance' is not clear as it would appear that an assessment should be made against a fixed market rental for the same asset and accordingly we consider that, if retained, further guidance is necessary.

Q7 Transition*: Paras C2-C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?*

Are there are additional transition issues the boards should consider? If yes, what are they and why?

While full retrospective application would provide more reliable comparative information, the practicalities and costs of doing so are unlikely to justify the perceived benefits for most types of entities. In the absence of grandfathering existing leases, the modified retrospective approach is a reasonable practical compromise. However, we support an approach where entities can choose to apply either the modified and/or full retrospective approach depending on the circumstances of the entity.

The G100 recommends that the Board considers permitting relief from applying the transition requirements to operating leases that expire within the financial reporting period of adopting the new lease standard. The cost and effort in applying transition requirements to these leases would far outweigh any benefits in information provided to users of financial reports.

When determining the implementation date for the standard, consideration should be given to potential flow-on impact for financial institutions due to, for example, regulatory capital and tax requirements. Financial institutions may be required to hold additional regulatory capital if the right of use assets are not viewed by regulators in conjunction with the associated lease liability. In Australia, current tax legislation distinguishes between operating and finance leases and further clarification and potential amendments will be required to address the concept of Type A and Type B leases. Furthermore, financial institutions will also have to consider the impact of the leasing requirements on customers, such as updating calculations banking covenants to capture changes in the accounting leases and will require sufficient lead time to address these additional areas.

Q8 Disclosure*: Paras 58-67 and 98-109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments: reconciliation of amounts recognised in the statement of financial position: and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?*

The G100 supports the disclosure objective specified in paras 58 and 98 and recommends that paras 59 and 99 should be given equal prominence otherwise users, auditors and regulators are likely to expect disclosure of all items mentioned irrespective of their materiality and relevance.

The G100 believes that the proposed disclosures represent a virtual shopping list of information that possibly some users may find to be of interest. For example, we believe that given the disclosure objective the standard should specify key disclosures relating to the impact of leasing on the entity, such as, maturity profile of payments, and rely on the judgment of directors as to additional disclosures that are material and relevant to an understanding of the entity's financial performance and position for shareholders and other users.

We believe that the accumulation of disclosures on a topic-by-topic basis and their application to all types of entities fails to address well publicised views on the sources of discontent about the disclosure overload and the relevance and usefulness of many disclosures.

We draw to your attention the recently published AASB Essay 2013-1 "*Rethinking the path from an objective of economic decision making to a disclosure and presentation framework*" which advocates a purpose-driven disclosure and presentation framework which focuses on the economic characteristics of the entity. Such an approach applied to lease disclosures would focus on the economic significance of leasing to the financing and operations of the entity.

Q9 – Q11 Not applicable.

Q12 (IASB-only): Consequential amendments to IAS 40*: The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised ED, including amendments to IAS 40 'Investment Property'. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property.*

This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

The G100 has concerns about the practicality of the proposed requirements for those lessees who sub-lease property but may not have fair value information in respect of the sub-let property.

OTHER ITEMS

The term 'significant' is used extensively in the proposals without explanation as to the meaning and purpose of the description. It would be helpful to preparers if the term were explained as, for example, the meaning of "significant" in relation to "material" and whether "significant" overrides "material".

Yours sincerely
GROUP OF 100 INC

Terry Bowen
President

c.c. K Stevenson – Chairman AASB

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11 September 2013

Dear Sirs/Mesdames

Request for Comment on IASB Exposure Draft ED/2013/6 *Leases*

Thank you for the opportunity to comment on the IASB Exposure Draft ED/2013/6 Leases ("revised ED").

Woolworths Limited ("Woolworths") is one of the largest retailers in Australia and New Zealand, with 3,113 retail locations and a further 765 wholesale supplied stores in Australia and New Zealand as at 30 June 2013. The Woolworths business includes:

- Australian Food and Liquor – Woolworths' Australian supermarkets, retail liquor outlets and Australian food and liquor wholesale and online business
- New Zealand Supermarkets – New Zealand Supermarkets (trading as Countdown), supermarkets wholesale and online business
- Petrol – Australian petroleum products retail outlets (including outlets which are co-branded Woolworths/Caltex)
- BIG W – discount department stores and online business
- Hotels – pub operations including bars, restaurants, gaming functions and accommodation
- Home Improvement – Home Improvement retail stores, wholesale and online business
- Property – comprising property leasing, management and development.

Woolworths has approximately 6,000 leases, of which approximately 3,000 are store leases. Each of our businesses has different lease arrangements in addition to the lease arrangements that are applicable to our corporate and warehouse operations. Accordingly we consider that we are well placed to provide comment on the impact of the changes across the Australian and New Zealand retail economies.

We commend the International Accounting Standards Board ("the Board") for the extensive outreach that it has conducted in response to concerns expressed by respondents in respect of the previous Exposure Draft and specifically its willingness to find a solution to the profit or loss distortion that the previous proposals created as well as reconsider the treatment of turnover rents and extension options.

In summary, we continue to support the retention of the existing guidance in IAS 17 (refer to our previous submissions dated 10 July 2009, 14 December 2010 and 1 May 2012) until such time as the IASB has adequately differentiated the boundary between an executory and a financing contract. We are concerned that the cost of implementing these proposals exceeds the benefit to users of the financial statements. We estimate the cost of implementing the proposals will be in excess of A$1.5 million.

We see no benefit from moving away from the existing IAS 17 model. The market is already fully informed of leasehold obligations. The new standard leads to significant additional complexity, huge costs and administrative burden on companies and for no benefit. There has been no significant user issues that we are aware of on the current accounting for leases which has been well established for a significant period of time.

We strongly recommended that proper cost benefit analysis be undertaken to justify the significant burden that will be placed on companies globally.

To the extent that the Board continues to believe that all leases should be recognised on balance sheet:

- We agree that a single model is not appropriate for all leases. In particular, real estate leases are significantly different to leases of other assets
- We agree that the straight-line income statement profile under the dual model more appropriately reflects the substance of our real estate leases.

Further commentary is set out below.

The existing IAS 17 model should be retained. To the extent the Board continue to pursue Balance Sheet lease recognition, until there is adequate differentiation between an executory and a financing contract as part of the Conceptual Framework Project, IAS 17 should be retained.

We recommend that the Board do not make any recognition or measurement changes to IAS 17 until such time as it has adequately differentiated the boundary between an executory and a financing contract as part of the Conceptual Framework Project. This is because:

- We believe that the adoption of the dual model in the revised ED calls into question whether all leases are in fact financing and whether it is appropriate to recognise a right-of-use asset and lease liability for all leases
- We do not believe that real estate leases have been satisfactorily distinguished from executory contracts. Real estate leases are more executory in nature because both the lessor and lessee have ongoing obligations under the lease contract. If either party fails to meet their obligations at any point during the contract, this would lead to restitution in the form of reduced rental payments or rights to end the lease agreement. The lessor of real estate assets provides the mix of tenants, ambiance of the centre to attract customers, overall quality of the property and amenity protection, including quiet enjoyment, centre cleaning, maintenance, building insurance and parking facilities. The lessee agrees to remain open for certain hours to assist with the centre ambiance, adds brands and merchandising. Without the operating business generating customer traffic the lease has no value
- The lessee receives the benefits of using the property at the same time as it pays for this benefit and as a result there is no financing element within the lease
- Recognition of real estate leases on balance sheet is inconsistent with the accounting treatment proposed for the lessor
- Users are expected to continue to make adjustments to suit their needs, therefore no significant benefit is provided as a result of recognising the leases on balance sheet
- The cost to implement the revised changes is expected to be in excess of A$1.5 million as a result of the volume of leases, the inception dates and IT system changes. In addition to this, we will have higher recurring costs as a result of the ongoing reassessment of CPI linked rents and renewal options, increased stakeholder education and audit fees.

We acknowledge that until such time as the Conceptual Framework Project is completed, it may be necessary to consider whether additional disclosures (including those in the revised ED) are necessary to satisfy the needs of users. We recommend that the Board hold specific public roundtables with:

- Users – to understand their requirements and the benefits of such disclosures
- Preparers – to understand the complexity and cost of the disclosures proposed by the users.

The results of these roundtables should be exposed for comment prior to finalisation of any amendments to IAS 17.

A single model is not appropriate for all leases

To the extent that IAS 17 is not retained, we agree with the Board that a dual model is necessary because not all leases have the same economic substance. In our opinion, real estate leases are significantly different to motor vehicle, office equipment or plant & equipment leases because:

- Real estate is generally an appreciating asset, that may include both land and buildings
- Real estate is required to be maintained, as set out in the lease agreement, and may also be upgraded during the life of the lease
- Real estate typically has a relatively long life and a large proportion of the lease payments may relate to the land element inherent in the lease
- In many cases the lessee is unable to purchase the real estate (e.g. part of shopping centre)
- In many cases the lessee is unwilling to take on the risk associated with real estate ownership (e.g. fluctuations in the value of the real estate, maintenance or full management of the property)
- Substantial management is required by the lessor during the lease term (e.g. providing mix of tenants, ambiance of centre to attract customers, overall quality of the property, amenity protection including quiet enjoyment, centre cleaning, maintenance, building insurance, parking facilities).

This view of real estate is also consistent with the way in which we manage our business internally. Property owned by Woolworths is primarily recorded in a separate division and leased out to the retail divisions under an operating lease to ensure that the results of the retail divisions are not distorted by the impact and risks of owning property.

The straight-line profile of the dual model reflects the economic substance of real estate leases

We agree that the straight-line expense for real estate leases most closely reflects the economics of a Type B real estate lease because there is limited transfer of risk and the lessee is generally expected to consume only an insignificant portion of the economic benefits of the real estate. In addition, the straight-line expense:

- Is consistent with how leases are priced. Real estate rentals are driven by the market and are based on market yields. They do not include a return for that part of the property that is consumed and 'lending' return arising from lessor not being able to use the residual asset during the lease term
- Is consistent with how equity analysts and institutional investors analyse our business. In the retail industry, equity analysts and institutional investors commonly use an earnings based measure such as earnings before interest, tax, depreciation and amortisation ("EBITDA"), earnings before interest and tax ("EBIT") or net profit after tax ("NPAT") to assess performance and drive the valuation of the business because actual cash flow can be distorted by the timing differences in working capital. The analysts typically do not make any adjustment to earnings to recognise the real estate leases as "financing transactions"
- Is easily understood by users of the financial statements
- Is consistent with the lessor that recognises rental income on a straight-line basis over the life of the lease.

****

Our response to matters on which specific comment is requested is included in the attached Appendix.

If you have any questions regarding this submission, please do not hesitate to contact either Martyn Roberts (General Manager – Corporate Strategy and Business Development and Acting Group Financial Controller and Investor Relations Manager) at MRoberts@woolworths.com.au or myself at TPockett@woolworths.com.au.

Yours faithfully

Tom Pockett
Finance Director

APPENDIX: RESPONSES TO QUESTIONS

The responses to the questions below are provided on the assumption that the final Standard adopts the right-of-use approach as set out in the revised ED.

Question 1: Identifying a lease

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and

(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

We believe the revised definition is an improvement on the guidance that is currently included in IFRIC 4 *Determining whether an Arrangement contains a Lease*. We anticipate that there may be some practical difficulties from the perspective of the purchaser in understanding whether there are economic or other barriers that would prevent the supplier from substituting alternative assets, especially where the arrangement does not prohibit substitution. We recommend the final Standard clarify that the purchaser would only need to consider information that it would reasonably be aware of, for example through supplier negotiations or publicly available information.

Question 2: Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Subject to our concerns expressed in the covering letter, and specifically that we continue to believe that IAS 17 should be retained until such time as the Conceptual Framework Project distinguish between executory and financing arrangements, we agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ based on the underlying economics of the leases. The consumption principle is a reasonable methodology for distinguishing between different leases.

Question 3: Lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We support retention of the current IAS 17 principles. IAS 17 is well understood by users and preparers and we are not aware of any concerns being raised in respect of the current accounting applied by lessors.

Question 4: Classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

Yes, for the reasons set out in our covering letter, we agree that real estate leases are significantly different from leases of other assets and that the classification should differ based on whether the underlying asset is property or another asset.

We also agree that, for the purposes of classification, land and buildings should be assessed together. However, we do not believe that it is appropriate to make the assumption that the economic life of the building is always the economic life of the property being leased. Where the building element is clearly immaterial in relation to the land, recognition as a Type A lease would be misleading.

In addition, for the purposes of classification, the lease term should be compared to the *total* economic life, rather than the *remaining* economic life of the building. We are concerned that this creates inconsistent treatment between, for example, the first ten years of a real estate lease and the last ten years of the same real estate lease. We recommend that the Board amend paragraph 30 to refer to the *total* economic life.

Question 5: Lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

We continue to believe that the existing definition of 'reasonably certain of exercise' should be retained as we believe it is well understood. In addition, the Board views the concept of 'significant economic incentive' as being a similar threshold; therefore we are unclear as to the benefit of the change.

To the extent the final Standard includes the concept of 'significant economic incentive' we agree with the basis for conclusions that an expectation of exercise alone without any economic incentive to do so would not meet the threshold. We also agree with considering contract, asset and market-based factors as these are not subject to significant judgment. However the interpretation of 'significant' and 'economic incentive' in the context of entity-based factors is unclear. For example, in retail it is not uncommon to renew a lease, however this decision is made based on the facts and circumstances *in existence at the time of renewal* and may include factors such as profitability of the store, location, rental cost and strategic advantage. In our opinion, these factors do not indicate significant economic incentive at either the beginning of the lease or until such time as the economic decision to renew has been made. In addition, the rental and any incentives are negotiated at the time of renewal, therefore we believe that it would be inconsistent with the economic reality of how leases are negotiated to straight-line the lease incentive across a period beyond the non-cancellable period of the lease.

To the extent that the Board is concerned about structuring of shorter term leases, Woolworths would not restructure leases to shorten the lease term with more renewal options as this may result in an increased cost to our business to compensate the lessor.

We are also concerned about the requirement to continually reassess the inclusion of renewal options. In our view, this is too onerous, as it will require extensive manpower to consider each of the factors over our large portfolio. Practically this is no different to requiring a reassessment at each reporting date, including half-year reporting periods, which the Board has acknowledged is too onerous.

Question 6: Variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

We commend the Board for listening to our concerns that the inclusion of contingent rentals, such as turnover rents, would result in significant measurement uncertainty and complexity. We agree with the proposals.

Question 7: Transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

We agree with the transition proposals. Given the complexity and significant time impost of these proposals, we recommend the Board propose an extended implementation period. This will allow IT software providers sufficient time to develop robust systems and ourselves time to:

- Implement the proposals, gather data and develop appropriate internal controls systems to manage judgments
- Educate and gain acceptance of the changes by users of the financial information
- Renegotiate debt covenants
- Review key financial ratios impacting management compensation.

We recommend that the effective date of the proposals is consistent with the final Revenue Standard and that this is not before years beginning on or after 1 January 2018.

Question 8: Disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

We request the Board develop a disclosure framework that will simplify and ensure the relevance of financial statement lease disclosures.

We agree that Woolworths, as preparer of the financial statements, should be able to exercise judgment to determine the level of disclosures necessary to provide useful information to users. The revised ED proposes extensive qualitative disclosures. Woolworths has approximately 6,000 leases, of which approximately 3,000 are store leases and it will be important that we are able to provide information at a level that is useful, but not in such detail that it obscures the material information. In line with this principle, we recommend that entities should be able to determine the appropriate number of time bands for the purpose of the maturity analysis of lease payments.

Consistent with our concerns about real estate leases, and their nature, we question the usefulness, which in our view is negligible, of providing reconciliations for the right-of-use asset and lease liability for Type B leases.

Other comments

Short-term leases

To the extent that the Board decide that all leases should be recognised on balance sheet, in our view the short-term exemption should be extended to leases with a maximum possible term of 3 years. Related extension options should only be included in that threshold if it is reasonably certain that those options will be exercised.

Impairment

We request that the Board provide guidance in respect of the application of IAS 36 *Impairment of Assets* for Type B leases. Under the principles in the revised ED a right-of-use asset is included within the carrying amount of the cash generating unit. However, the cash flows remain unchanged and therefore it would be misleading to recognise an impairment, merely because of the change in accounting model.

Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

via email: standard@aasb.gov.au

1 October 2013

Dear Kevin

Re: Exposure draft 242 *Leases*

I am enclosing a copy of PricewaterhouseCooopers' response to the International Accounting Standards Board's exposure draft ED/2013/6 *Leases*.

The letter reflects the views of the PricewaterhouseCoopers (PwC) network of firms and as such includes our own comments on the matters raised in the exposure draft. PwC refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

AASB specific matters for comment
We are not aware of any regulatory or other issues that could affect the implementation of the proposals for not-for-profit and public sector entities.

Subject to our concerns about specific matters as expressed in our submissions to the IASB, the proposals would result in financial statements that would be useful to users. Should the proposed amendments be approved by the IASB, we are not aware of anything that would indicate that the proposals are not in the best interests of the Australian economy.

I would welcome the opportunity to discuss our firm's views at your convenience. Please contact me on (02) 8266 4664 if you would like to discuss our comments further.

Yours sincerely,

Paul Brunner
Partner, PricewaterhouseCoopers

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12 September 2013

Dear Sir/Madam

Exposure draft: Leases

We are responding to the invitation from the IASB and the FASB ('the boards') to comment on the revised exposure draft 'Leases' (the 'exposure draft' or 'proposed standard'). Following consultation with members of the PwC network of firms, this response summarises the views of those member firms that commented on the exposure draft. 'PwC' refers to the network of firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We recognise the significant efforts that the boards have made to address the concerns raised by constituents on the previous exposure draft issued in 2010. Accounting for leases is an important topic given their pervasiveness and their significance to businesses across multiple industries. Therefore, we support the boards' efforts to develop an accounting standard that will meet the boards' objectives to increase transparency and provide a more faithful representation of the rights and obligations arising from leasing transactions.

We continue to support the boards' core principle that an entity should recognise assets and liabilities arising from a lease. We acknowledge that the current model for lessees has long been criticised for failing to meet the needs of users of financial statements. We agree that a lessee should recognise an asset representing the right to use an underlying asset during the lease term (the right-of-use asset) and a liability to make lease payments. For lessees, we believe that the proposed standard is consistent with the boards' respective conceptual frameworks and, thus, provides a better foundation for a new accounting model than the current model, which requires recognition of an asset and liability in more limited circumstances.

Notwithstanding the above, we agree with the boards that the economic characteristics of leases take a variety of forms. We also agree that a single 'right-of-use' model for all leases might be complex to apply in some circumstances and will, in practice, reduce the income statement's usefulness to many users. For this reason, we agree with the boards that different types of leases should be treated differently. However, we find the boards' decision to classify leases based on the principle of consumption to be lessor-focused and typically not relevant or intuitive for many lessees. We also do

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not find the presumptions applicable to 'property' and 'other than property' to be sufficiently neutral or decision-useful for many users.

In considering the theoretical merits and costs of the proposed change, we believe the proposed classification model would not substantively improve upon the current distinctions in IAS 17. Accordingly, we recommend incorporating IAS 17's classification criteria into the proposed standard, instead of the consumption principle. We believe operational concerns would be significantly lessened if the current 'dividing line' in IAS 17 (as articulated in paragraphs 10 to 15A) for distinguishing between finance and operating leases was retained for the purpose of income statement classification. This would not be very different from the proposed model for property leases (as the criteria for rebutting the Type B presumption resemble those for identifying finance leases under IAS 17). It would also address many of the difficulties relating to non-property leases with economics similar to property leases, without sacrificing the boards' principal objective of balance sheet recognition. For example, it would require Type A lease treatment for the majority of arrangements in which the lessee clearly consumes the underlying asset. We believe this recommendation would be supported by many constituents, given the familiarity of IAS 17's classification criteria, ease implementation for preparers, and reduce complexity, all while enhancing the usefulness of information to users.

There are a number of other matters that we would like to raise for the boards' consideration, including where the concepts in the exposure draft could be more clearly articulated, where its current proposals might be challenging to apply, and where the guidance may not appear to produce benefits that compensate for their expected costs. In the appendix to this letter we highlight these matters in our responses to the boards' questions in the exposure draft.

If you have any questions about our letter, please do not hesitate to contact John Hitchins, PwC Global Chief Accountant (+44 20 7804 2497), Paul Kepple, PwC US Chief Accountant (+1 973 236 5293), Peter Hogarth (+44 20 7213 1654), Chad Soares (+1 973 236 4569), or Marc Jerusalem (+1 973 236 4714).

Yours faithfully

PricewaterhouseCoopers International Ltd

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Appendix

Responses to detailed questions in the exposure draft

Question 1

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

We support the boards' proposed definition for a lease. When an arrangement involves nothing more than conveyance of the right to use a specific asset for a period of time, determining whether the arrangement contains a lease is usually straightforward. In our view, the difficulty arises when the right to use an asset is conveyed in some other manner, involving the delivery of other goods and services in a multiple element arrangement. We believe the new guidance for distinguishing a lease from a service contract addresses many of the known application issues of IFRIC 4/EITF 01-8 that were raised in our comment letter on the 2010 exposure draft. We also believe that the greater alignment of the concept of the right to control the use of the identified asset with IFRS 10 and the revenue recognition proposals improves the guidance. However, we have identified a few remaining areas of concern regarding some of the proposed guidance and examples.

The guidance on substitution rights (including, as set out in example 1, cases where the vendor may acquire a substitute asset in the future) does not sufficiently consider all of the commercial conditions motivating the parties to an arrangement. We expect that arrangements in which the vendor has substantive substitution rights would be atypical in practice (particularly when the asset is located at the customer's premises and is operated by the customer, in which case we would expect the arrangement to contain a lease or series of leases). This is due to the prohibitive costs and operational barriers that may arise from substitution; yet, the examples give little insight into how to weigh costs and benefits and appear to downplay the economic costs of substitution in assessing whether an asset is identifiable. For example, the proposed guidance is supplier-focused and overlooks the potential disruption to the customer's business that could be caused by substitution. It also fails to consider how substitution rights might benefit the supplier so that the supplier would be economically motivated to substitute the asset; if there were sound business objectives for including substitution rights in an arrangement, it should be expected that substitution would have occurred in similar arrangements in the past. We believe that these factors are important and should be included in the final standard.

Also, there appears to be a presumption in example 1(c) that the purchaser/lessee will have visibility of the supplier/lessor's access to additional assets and finance, which in reality is unlikely to be the case. We recommend that the assessment focuses on the substance of the contractual terms and information readily available to the purchaser rather than on the supplier's financial position or its access to assets.

In relation to example 2, we believe that if a lessee has the ability to control an asset, the contract is a lease. The determination should not depend on whether the consumables can only be supplied by the supplier. In examples 2 and 3, there seems to be little economic difference in the purchaser's ability to exercise control; in the former case it is restricted by practicality and in the latter by contract. In both cases the equipment is physically operated by the purchaser. We understand how, from a seller/lessor's perspective, the distinction is important given the need to be consistent with guidance in

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the revenue exposure draft (that is, a performance obligation is distinct if the entity regularly sells the good or service separately or the customer can benefit from it on its own or together with other resources that are readily available). However, we are not convinced that the distinction as illustrated in these examples is meaningful from the perspective of the purchaser.

In our view, a more clear-cut example of equipment that is incidental to the delivery of a service could be drafted in respect of an arrangement involving a set-top box for provision of cable or satellite television services. It is important for the boards to illustrate clearly when a purchaser does and does not control the right to use an asset and articulate the key factors that drive the conclusion. We believe that entities in some industries (for example, shipping) may find it challenging to apply the proposed guidance by reference to the examples in the exposure draft in their particular circumstances.

We recommend that the fact pattern in example 5 is improved to clarify the key factors that influenced the conclusion in order to make the example useful for other scenarios. We understand that there are various activities involved in power purchase agreements (for example, design, dispatch, fuel supply, operations, and maintenance), which are not always carried out solely by the purchaser or the supplier. The example does not clearly illustrate how to assess control when key activities are shared between the purchaser and the supplier. To illustrate our point, consider the case of a purchaser of electricity that was involved in the design of a wind facility, but not involved in its operation and maintenance. Does this demonstrate sufficient 'control' by the purchaser to consider the contract a lease? Furthermore, it is not clear to us what 'involvement' in design means, as there could be differing levels of involvement ranging from passive interest to outright control, particularly in the case of renewable energy facilities. We believe it would be useful if the boards explained how the current consolidation rules in IFRS 10 are aligned with the points above, in order to help preparers to apply the example to other scenarios. In our view, the proposed guidance may be interpreted differently from paragraph B51 of IFRS 10, which states that being involved in the design alone is not sufficient to give an investor control.

Although the exposure draft contains guidance on linked transactions in respect of sale and leaseback transactions, we recommend that it also includes general guidance for the purpose of identifying whether a series of arrangements together represent a lease (or leases). Such guidance is proposed in the revenue exposure draft (paragraphs 16-17) and, for IFRS reporters, paragraph IG B6 of IFRS 9. We believe that similar guidance in the proposed standard would assist in the analysis of sale and leaseback transactions, but would more widely be of use to preparers when analysing other contracts such as 'lease-in lease-out' transactions and others currently contemplated in SIC-27.

Question 2

Do you agree that the recognition, measurement, and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We agree that the economic characteristics of leases take a variety of forms (notwithstanding that they all contain an element of financing) and that distinguishing between different leases is appropriate. However, we have concerns with respect to the proposed basis for classifying leases. We discuss these concerns and our proposed alternative in greater detail in our response to question 4.

The proposed presentation in the cash flow statement for Type A and Type B leases seems appropriate.

Question 3

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

In our response to the 2010 exposure draft, we disagreed with the boards' proposals for lessor accounting. We did not believe that the 'hybrid approach' was a demonstrative improvement of current lessor accounting in accordance with IAS 17/ASC 840. We therefore proposed that lessor accounting should not be amended at that time but that it should be revisited in the future.

Now that the boards propose that both lessors and lessees would apply a consistent dual model, one of our significant concerns from 2010 no longer applies. The proposals for lessors are now little different from current accounting, except that the dividing line is in a different place. We therefore support the notion that lessees and lessors use symmetrical approaches, subject to our comments on lease classification, which are set out in our response to question 4.

Question 4

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

As noted in our cover letter, we find the boards' decision to classify leases based on the principle of consumption to be lessor-focused and typically not relevant or intuitive for many lessees. We also do not find the presumptions applicable to 'property' and 'other than property' to be sufficiently neutral or decision-useful for many users.

In considering the theoretical merits and costs of the proposed change, we believe the proposed classification model would not substantively improve upon the current distinctions in IAS 17. Accordingly, we recommend incorporating IAS 17's classification criteria into the proposed standard, instead of the consumption principle. We believe operational concerns would be significantly lessened if the current 'dividing line' in IAS 17 (as articulated in paragraphs 10 to 15A) for distinguishing between finance and operating leases was retained for the purpose of income statement classification. This would not be very different from the proposed model for property leases (as the criteria for rebutting the Type B presumption resemble those for identifying finance leases under IAS 17). It would also address many of the difficulties relating to non-property leases with economics similar to property leases without sacrificing the boards' principal objective of balance sheet recognition. For example, it would require Type A lease treatment for the majority of arrangements in which the lessee clearly consumes the underlying asset. We believe this recommendation would be supported by many constituents, given the familiarity with IAS 17's classification criteria, ease implementation for preparers, and reduce complexity, all while enhancing the usefulness of information to users.

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We also are concerned that a model based solely on the type of asset (that is, property/other than property) would not adequately address the significant number of leases that are priced similarly to property leases, even when considering the proposed practical expedients. For example, certain assets, such as some aircraft, rail cars, and ships, have comparable economic lives to property and are often priced in a manner similar to property leases. However, most of these assets would be treated as Type A leases by both lessors and lessees solely because they are not 'property'. We believe that accounting for some of these types of leases as Type A leases could prove as complex as the boards acknowledge it would be for property leases. Similarly, the fact that land could be a Type A lease under the proposed standard appears to be inconsistent with the notion of consumption. If the boards decide to continue to use a consumption principle, we recommend providing guidance similar to paragraph 15A of IAS 17 such that, in determining whether land is a Type A or Type B lease, an important consideration is that land normally has an indefinite economic life.

In light of recent discussions by the IFRS Interpretations Committee about the definition of 'property' (land or a building, or part of a building, or both), we believe there will likely be mixed views on what 'property' represents. We think that the accounting should be neutral and determined by the substance of the transaction rather than the nature of the underlying asset.

The narrow definition of property raises further practical difficulties, particularly when determining the primary asset in a multiple element arrangement. For example, while the primary asset in a power station may be the power generating equipment, we believe that the building and the land on which it is built should not be disregarded. The location of the asset (inherent in the land) may significantly affect the pricing of the lease or the decision to execute an arrangement in the first place; to ignore that aspect would be inconsistent with the underlying economics of the arrangement. If the boards decide to retain the proposed guidance with respect to the classification of leases, we recommend that the boards provide additional guidance on how integral equipment (as currently contemplated under US GAAP) should be accounted for.

Question 5

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

We agree that a lease term should include options to extend a lease or not to terminate a lease only when the definition of a liability (for a lessee) and asset (for a lessor) is met. We believe that by raising the hurdle of which extension periods are included in the lease term (as compared to the guidance in the 2010 exposure draft), the proposed guidance will better conform with these definitions and reduce operational complexity when considering the reassessment requirements applicable to lessors and lessees.

We note in paragraph 140 of the Basis for Conclusions that "applying the concept of 'significant economic incentive' would provide a threshold that is similar to the concepts of 'reasonably assured' and 'reasonably certain' in existing US GAAP and IFRS". To avoid ambiguity, we suggest that the proposed standard uses the words 'reasonably certain' instead of 'significant economic incentive' in assessing whether extension options should be included in the lease term, both in terms of the classification of the lease as well as in the measurement of the lease liability.

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If the boards retain the term 'significant economic incentive' in a new leasing standard, it should be noted that the concept is also relevant in the boards' proposed guidance for put options in a revenue transaction (paragraphs B43-B44/IG43-IG44 in the revenue exposure draft). It is implicit in that proposed guidance that the assessment of whether a customer has a significant economic incentive to exercise a put option is performed only at contract inception. If such an incentive exists, the arrangement is treated as a lease. It is not clear what an entity should do if, under the proposed guidance for reassessing lease transactions, it is subsequently concluded that the incentive no longer exists. In our view, once a transaction has been determined to be a lease, it should be treated as such unless there is a contract modification as described in paragraph 36 of the leases exposure draft. We recommend the boards make this clear.

Both the leases and revenue exposure drafts acknowledge that various factors need to be considered when determining whether a significant economic incentive to exercise an option exists. However, we note that the exposure drafts contain different approaches to option prices. The revenue exposure draft states that "if the repurchase price is expected to significantly exceed the market value of the asset, the customer has an economic incentive to exercise the put option". There is no such explicit statement in the leases exposure draft. We do not believe it is helpful for the proposed revenue standard to include a statement that singles out one possible factor, as this could cause readers to perceive that this factor is more important than any other. We believe that determination of whether a customer/lessee has a significant economic incentive to exercise an option requires consideration of various factors, one of which will be the option price relative to market prices. Given that the proposals provide guidance to determine when a revenue arrangement contains a lease, we believe that consistent principles and terminology should be applied. For the reasons set out above, we believe that the phrase 'significant economic incentive' should be replaced by 'reasonably certain' in both future standards. Moreover, the criteria should be described similarly in both standards.

We agree with the requirement to reassess the lease term by considering changes in relevant factors, as it provides users with more relevant information about the lease payments and greater certainty over the amount and timing of cash flows.

Question 6

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

We agree with the proposal to exclude performance and usage driven variable lease payments from the lease liability. We also agree with including in the measurement variable lease payments that are in-substance fixed payments, as the lessee has no ability to avoid making payment. We believe, however, that the examples contained in the exposure draft could be improved. In both examples, the lessee cannot avoid a minimum payment regardless of the outcome of the contingency; hence the payments are contractually fixed, not fixed 'in-substance'. Accordingly, we recommend that the boards provide clear guidance on whether, and under what circumstances, 'in-substance fixed payments' include payments that are contractually variable.

We agree that it is appropriate for entities to re-measure lease assets (lessor) and liabilities (lessee) for variable lease payments based on an index or a rate. However, we do not agree that such remeasurement should be required at every reporting date, absent a contractual change in the cash flows. It seems an unnecessary burden for preparers to have to adjust lease balances repeatedly when the quantum of such adjustments, for example, on a quarterly basis, is likely to be minimal. We recommend that lease assets and liabilities be adjusted only when the contractual cash flows change (for example, on an annual basis if the contract stipulates that the lease payments are adjusted based on the index at the anniversary date).

We note that the boards appear to propose that lessors and lessees account for 'lease payments structured as a residual value guarantee' differently. When entities enter into a contract in which any difference between a specified amount and the market value of an underlying asset at the end of the lease term is paid to, or received from, the lessee, the lessor would include that stipulated amount in the measurement of its lease receivable. However, it does not appear that a lessee would include the stipulated amount in the measurement of its lease liability because the lessee only includes amounts expected to be payable. We recommend that lessees apply a symmetrical approach for such residual value guarantees that are economically similar to a fixed lease payment, and include the guaranteed amount in the measurement of their lease liability and right-of-use asset.

In an arrangement where a lessee guarantees that the value of an underlying asset will be at least a specified amount (that is, an indemnification against a loss) but does not guarantee that the lessor receive a fixed payment as described above, we agree with the boards' proposal that lessees and lessors should apply a symmetrical approach and include only the amounts that they expect to pay/receive in the measurement of lease assets and lease liabilities. For lease classification purposes, however, we recommend that lessors and lessees consider the maximum amount payable under residual value guarantees in determining the 'significance' of the present value of the lease payments relative to the fair value of the underlying asset. We believe that when the lessee takes on virtually all of the risks of ownership, it is indicative of a financed purchase and, thus, the lease should be accounted for as a Type A lease.

Question 7

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

We support the proposal to permit companies to apply all of the requirements of the proposed standard retrospectively. However, it is not clear in the transition guidance whether this would be applied by class of lease (that is, Type A or Type B) or on an 'all-or-nothing' basis. We encourage the boards to seek views from users and preparers regarding which approach would be preferable.

We agree that there needs to be a modified retrospective approach, as the cost of a full retrospective approach would be likely to outweigh the benefits in many cases. However, the modified retrospective approach could be made simpler.

Under the proposed modified retrospective approach, we agree with the method used to measure a lease liability. However, we believe that the method for measuring a right-of-use asset is unduly complex. In our view, given the changes the boards have made to their proposals for lease term and variable payments, which reduce the impact of the front-loading effect for lessees, the modified retrospective approach should be as proposed for Type B leases in all cases where leases were not previously recognised on-balance sheet (that is, the lease liability and right-of-use asset should be measured at equal amounts at transition), subject to adjustments for prepaid, accrued and impaired amounts.

The proposed modified retrospective approach also does not envisage a situation where an operating lease was previously considered onerous. For such existing lease contracts, a provision would already be recorded on the balance sheet by the lessee. However, the proposed standard suggests that a lessee would record a right-of-use asset at an amount equal to the lease liability. Applying the proposed impairment guidance subsequently would result in a loss being recognised for a second time. We recommend that the modified retrospective approach allows for the fact that the right-of-use asset's value might be impaired at the date of transition. A simple way to address this could be to adjust the right-of-use asset by the amount of any provision previously recorded for the onerous lease.

It appears that lessees will be required to use discount rates that will exist as at the effective date of the proposed standard (for example, 1 January 2017) rather than as of the beginning of the earliest comparative period presented (for example, 1 January 2015). Since lessees with large lease portfolios may, from a practical perspective, need to maintain two sets of books during the period before the effective date, it would be preferable to allow them to use the discount rate in effect at the earliest date they would apply the proposed guidance.

For lessors, the guidance on transition of existing finance lease residual assets needs to be clarified. Under the proposed guidance, upon transition a lessor would record a lease receivable equal to the existing carrying amount of the 'net investment in the lease' (including the residual asset). Subsequently, the lessor would account for the lease receivable in accordance with the guidance pertaining to lease receivables, while ignoring guidance pertaining to residual assets. However, when determining whether the lease receivable, including the residual asset, is impaired, the guidance does not allow the lessor to consider the cash flows it expects to derive from the underlying asset at the end of the lease term. This would appear to lead to a lessor recognising an impairment charge when the combined receivable and residual assets are not actually impaired. Furthermore, the proposed standard provides no guidance on accounting for the residual asset at the end of the lease term. We encourage the boards to consider whether lessors should separately recognise the receivable and residual balances of existing finance leases upon transition and subsequently apply the proposed standard.

We note that paragraph C15 of the exposure draft could be interpreted as having only one outcome for previously securitised lease receivables; that is, on transition a lessor must account for them as secured borrowings. We believe that it may not always be appropriate to account for such receivables as secured borrowings, in particular if they could have been derecognised under IAS 39 or FAS 166 had they been recognised on the balance sheet initially. We recommend that the transition guidance is made clearer, so that a lessor applies the relevant derecognition guidance under the applicable accounting standard to determine whether the receivables should be derecognised or accounted for as secured borrowings.

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We are concerned that the proposed transition guidance for entities involved in sale and leaseback transactions, where the transaction fails to meet the criteria for a sale under the revenue exposure draft, is not adequate. Specifically, the boards should consider providing transition guidance for buyer-lessors in sale and leaseback transactions (that is, purchase/lease out) that may not meet the proposed sale criteria under the revenue exposure draft due to the seller having an option to repurchase the asset. Under current guidance, notwithstanding whether a seller accounts for the transaction as a 'sale', a buyer typically accounts for the transaction as an asset purchase and subsequent lease. We believe that the proposed guidance, however, would require buyer-lessors to account for these transactions as financing receivables. Lease transactions with financial lessors are commonly structured as sale and leaseback transactions. Given the magnitude of such transactions, we recommend that the boards consider providing buyer-lessors more explicit transition guidance, particularly clarifying whether the asset would be carried forward at its previous carrying amount and subsequently measured under the applicable standards for financial instruments.

If the boards adopt our recommendation to retain IAS 17's lease classification criteria, we would further suggest that the boards permit a simplified transition approach similar to that proposed in the revenue exposure draft. Under that approach, entities would apply the requirements of the proposed standard as of the effective date and recognise the cumulative effect of transition in the opening balance of retained earnings on the effective date. Whilst we acknowledge that there may be a significant impact on the balance sheet, income statement differences between the periods presented would be less pronounced if IAS 17's lease classification criteria were applied, thus reducing the need to restate comparative periods. Furthermore, this approach would reduce the need to consider leases that will end during comparative periods prior to the effective date, and reduce the need to consider changes in discount rates between the earliest period presented and the effective date.

Question 8

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

We do not agree that there should be a difference in disclosure requirements between US GAAP and IFRS other than in respect of valuation options that are available under IFRS but not US GAAP. We believe that the reconciliation requirement for the right-of-use assets for Type B leases, as it stands, does not provide users with the most useful information as the Type B leases apply a balancing figure for the amortisation charge to achieve an overall straight-line expense. However, we can see value in the reconciliation for Type A right-of-use assets and, on balance, we would support the inclusion of consistent disclosure requirements in this respect under both IFRS and US GAAP.

We agree with the other disclosure requirements as suggested by the boards.

Question 9

To strive for a reasonable balance between the costs and benefits of information, the FASB decided to provide the following specified reliefs for nonpublic entities:

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(a) To permit a nonpublic entity to make an accounting policy election to use a risk-free discount rate to measure the lease liability. If an entity elects to use a risk-free discount rate, that fact should be disclosed.

(b) To exempt a nonpublic entity from the requirement to provide a reconciliation of the opening and closing balance of the lease liability.

Will these specified reliefs for nonpublic entities help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements? If not, what changes do you propose and why?

We do not agree with the proposed relief to allow nonpublic entities to make a policy election to measure lease liabilities using a risk-free rate. Such a policy election would overstate the lease liability reported in balance sheets as the risk-free rate is substantially below most entities' potential borrowing rates. We note that private companies today use their credit-adjusted risk-free rate in other transactions, such as, to measure asset retirement obligations or exit costs, and would be required to continue to do so. We do not see significant benefit provided by the relief.

If nonpublic companies would find it difficult to identify an incremental borrowing rate, we would be supportive of allowing lessees to determine their credit-adjusted risk-free rate using a 'best estimate' approach.

Question 10

Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases (for example, to require the lease to be accounted for based on the economic substance of the lease rather than the legally enforceable terms and conditions)? If not, what different recognition and measurement requirements do you propose and why?

We note that Topic 850 requires disclosure of transactions between related parties, including those to which no amounts or nominal amounts are ascribed, as related party transactions cannot be presumed to be carried out on an arm's length basis. Accordingly, we agree that it is not necessary to provide different recognition and measurement requirements for related party leases. Arguably, the requirement to account for the lease based on economic substance is necessary under current US GAAP, as lease classification determines whether assets and liabilities are recorded on balance sheet or not. Furthermore, if related parties were required to account for leases based on their economic substance when contractual terms are lacking, the entities would necessarily make highly subjective judgements to impute important provisions such as: the appropriate lease term, the commensurate discount rate, and the balance of fixed vs. variable payments. The resulting balance sheet and income statement amounts may not be more useful to users than the amounts and disclosures required by the proposed standard.

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Question 11

Do you agree that it is not necessary to provide additional disclosures (beyond those required by Topic 850) for related party leases? If not, what additional disclosure requirements would you propose and why?

We agree that additional disclosures are not required for related party leases. Given that related party transactions cannot be presumed to be carried out on an arm's length basis, we agree that disclosure of transactions between related parties, including those to which no amounts or nominal amounts are ascribed, is sufficient.

Question 12

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

We agree with the boards' proposals to expand the scope of IAS 40 for right-of-use assets.

Whilst the boards have not sought comment on the other consequential amendments, we make the following observations in respect of the proposed amendments to IFRS 3.

We note the proposed amendment to paragraph 17(a) repeats the message of the last sentence of the paragraph after the bullets (which has not been amended and is not shown in the exposure draft). We recommend that the final sentence is removed. Furthermore, we understand that it is the boards' intention that lease classification not be reassessed upon a business combination. However, we believe the phrase "if the contractual terms and conditions of a lease are modified..." in the proposed wording may be ambiguous, as it is possible to interpret this as forward-looking rather than what has happened in the past. We recommend replacing the words 'are modified' with the words 'have been modified'.

Paragraph B45C provides guidance on measuring residual assets on acquisition of a lessor. It appears that it is presumed the fair value of the underlying asset at acquisition will be greater than the carrying amount of the lease receivable at that date. It is unclear what accounting should be applied if this is not the case (that is, if the carrying amount of the lease receivable is greater than the fair value of the underlying asset). We believe in this scenario a liability or 'negative residual asset' would not be recognised, but it would be useful if the boards expand on the guidance for such a situation.