



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

10 December 2010

Dear Kevin

Exposure Draft ED 202

I am enclosing a copy of the PwC response to the International Accounting Standards Board's Exposure Draft ED/2010/9 *Leases* [AASB ED 202].

The letter reflects the views of the PwC network of firms and as such includes our own comments on the matters raised in the Exposure Draft.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (03) 8603 3868 if you would like to discuss this further.

Yours sincerely

A handwritten signature in cursive script that reads 'Jan McCahey'.

Jan McCahey

Partner

Assurance

PricewaterhouseCoopers, ABN 52 780 433 757
Freshwater Place, 2 Southbank Boulevard
GPO BOX 1331L, Melbourne Victoria 3001 Australia
T +61 3 8603 1000, F +61 3 8613 2308, www.pwc.com.au

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

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

30 November 2010

Dear Sir/Madam

Exposure draft: Leases

We are responding to the invitation of the IASB and the FASB ('the boards') to comment on the 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 who 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 acknowledge that the current model for lessees has long been criticised for failing to meet the needs of financial statements users. We believe the proposed right-of-use model in the exposure draft addresses a number of these criticisms. We agree with the boards' objective to report relevant and representationally faithful information to users of financial statements about the amounts, timing and uncertainty of cash flows arising from leases. While we acknowledge that the proposals address the primary concern - that is, the recognition of assets and liabilities arising out of lease contracts - we understand that the application of the proposals might reduce the income statement's usefulness to many users. As a consequence we understand that some users might continue to make adjustments to reported amounts. We also believe that the proposals will result in significant cost and complexity for some preparers.

We support the boards' objective, but we do not believe that the proposals fully meet this objective in a number of key areas, which should be reconsidered by the boards. These key areas include the measurement of more complex leases, specifically term extension options and contingent payments, lessor accounting and transition provisions. We propose in this letter a number of solutions in each of these areas, which we believe will enhance the benefits for users and, in many cases, also reduce the cost and complexity for preparers.

In addition, there are a number of matters that are not addressed in the exposure draft but that we believe should be addressed or further clarified in the final standard; these issues include lease modifications, the impact of the passage of time between lease inception and lease commencement and the treatment of non-monetary lease incentives. These issues are described in greater detail in our response to question 18 in the appendix to this letter.

*PricewaterhouseCoopers LLP, 10-18 Union Street, London SE1 1SZ
T: +44 (0) 20 7583 5000, F: +44 (0) 20 7822 4652, www.pwc.co.uk*



Lessee accounting

We believe that the proposed right-of-use approach accomplishes the boards' aim to develop a model where assets and liabilities arising under a simple lease are recognised in a principled manner. 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. However, we disagree with the boards on the measurement of the right-of-use asset and liability to make lease payments for more complex leases that contain options and contingent payments.

More complex leases that contain term extension options

We agree with the boards on pragmatic grounds that options should not be separated from the underlying lease contract. However, we believe that payments that would become due if an option were to be exercised should only be recognised where the definition of a liability is met in the case of lessees and the definition of an asset is met in the case of lessors. As with other options in financial accounting, we believe lease term extension options should not be accounted for as if they were exercised.

We disagree with the boards' proposal that the lease term should be measured as 'the longest period more likely than not to occur'. We believe that optional extension periods should be included in the determination of lease term (and therefore in the measurement of the right-of-use asset and obligation to pay rentals) only where it is 'virtually certain' that the option will be exercised - that is, structuring of the contractual terms as an option was non-substantive.

While remaining consistent with the boards' broad principles and goals, we believe this change would address many of the concerns being voiced by preparers, including increasing the objectivity of the standard and reducing its complexity and the frequency of reassessment changes.

More complex leases that contain contingent payments

We disagree with the boards' proposal that all contingent payments should be included in the measurement of the right-of-use asset and obligation to pay rentals. We believe that only contingencies that are not within the control of the lessee should be included in the measurement as they meet the definition of a liability. Where the lessee is able to avoid the contingent lease payments (that is, they are within its control), these should not be included. This approach would be consistent with the treatment of contingent interest payments on debt instruments accounted for in accordance with IAS 32, 'Financial instruments: Presentation'. Under this approach 'usage' based contingencies (such as mileage under a car rental contract) would be excluded but index-based and many performance-based contingencies, such as those based on sales, would be included. We view usage-based contingencies as similar to options, and as with other options in financial accounting, we believe they should not be accounted for as if they were exercised.

A consequence of the right-of-use approach to lessee accounting is that total expenses will be higher in the earlier years of a lease. Inclusion of contingent payments in measuring the right-of-use asset exacerbates this issue. Considering the example of a typical lease of a retail store, applying a straight-line or time-based amortisation approach will produce higher expense in the earlier periods of lower revenue.



We believe that the contingent component of a right-of-use asset should be amortised on a basis that reflects the future economic benefit flowing from that component. The nature of many contingent payments is such that the benefit will only flow if the contingency is met so there is a direct linkage between the contingency and benefit. We therefore believe that amortisation based on benefit is the only methodology that will reflect the economics of the arrangement. Whether or not intangible assets should be amortised on a basis that reflects the benefits that flow from them seems to be an important point of principle. We suggest that the boards clarify this principle.

Lessor accounting

Although we agree with the boards' aim to develop a consistent model for both lessees and lessors, we do not believe that the 'hybrid approach' to lessor accounting achieves this aim.

We believe that the performance obligation approach is not consistent conceptually with the proposals for lessee accounting. The derecognition approach is a better fit with the right-of-use approach, but applying it to all leases would be inconsistent with the boards' proposed accounting for leases/licenses of intangible assets as set out in their recent revenue exposure draft. We are also aware of a number of practical issues in applying the derecognition approach for certain types of leases such as real estate leases (when measured at something other than fair value) and time charter shipping.

We agree with the boards' acknowledgement that lessee accounting is of greater concern to users than lessor accounting. Although we would prefer the boards look at lessor and lessee accounting at the same time, we do not believe the proposed 'hybrid approach' is a sufficiently significant improvement to current guidance to justify the substantial cost of change. Accordingly we recommend that lessors continue to apply the existing lease guidance until the boards are able to develop a lessor approach that is consistent with both lessee accounting and accounting for leases/licences of intangible assets. In the meantime in the case of the latter, we are aware that there is currently diversity in practice; we therefore accept that these be dealt with through the model proposed in the revenue exposure draft as a pragmatic interim solution to accounting for leases/licences of intangible assets.

We believe that the numerous projects the boards aim to complete over the next year will result in limited time to develop and improve the lessor model. We therefore believe the boards' primary focus should be on lessee accounting and that lessor accounting should be revisited in the future. We realise that this will create some complications (for example with sub-leasing and sale/leaseback type transactions); however, we believe these issues can be adequately addressed in the interim.

Scope

In principle, all rights to use an asset should be within the scope of the leasing standard, regardless of whether the asset is tangible or intangible. We therefore believe that, conceptually, the scope of the proposed leasing standard should include any arrangements whereby the lessee obtains the right to use the service potential of an asset, including intangible assets.

We acknowledge that including arrangements involving certain intangible assets would significantly change practice in some industries such as computer software and pharmaceuticals. Considering all aspects of the various types of transaction involved will take time and significantly increase the



timeframe of the project. We therefore accept the proposed scope exclusion for intangible assets as a pragmatic solution at the current time.

We are aware of a number of inconsistencies between the accounting for leases of tangible assets under the proposed leasing standard and the accounting for licences of intangible assets under the proposed revenue standard, such as the accounting for initial direct costs. We would urge the boards to either explain why these differences are justified, or eliminate these inconsistencies before these two standards are finalised.

We support the boards' proposed scope exclusion for investment properties measured at fair value in accordance with IAS 40, 'Investment property'. We encourage the FASB to provide a similar scope exclusion to entities already accounting for investment real estate on a fair value basis today (that is, pension funds and certain real estate investment funds). We understand that the FASB is also considering a convergence project for fair valuing real estate investment property for certain types of reporting entities; this would presumably also result in a scope exemption from the lease standard for those real estate investment properties measured at fair value. We urge the FASB to consider both the timing of such a project and its potential implications for the planned implementation dates of the lease standard for lessors in order to allow for simultaneous adoption of both standards.

We are aware that preparers have found it challenging to apply the current criteria for determining whether an arrangement contains a lease outlined in IFRIC 4 and ASC 840-10-15-6 through 15-21 (formerly EITF 01-8); we acknowledge that these challenges will become more pronounced on adoption of the proposed guidance on lease accounting. We urge the boards to take this opportunity to address many of the known issues with the current guidance as part of the proposed standard. In order to facilitate these efforts we would welcome the opportunity to meet with the boards to share our knowledge of the issues in applying the current guidance in practice.

Transition

We believe the 'simplified retrospective approach' may be effective for many companies; however, we believe that in some cases a 'full retrospective approach' may yield a more faithful representation of the economics. An option to apply such a method should therefore be available to those willing to undertake the additional effort and cost.

Because we believe that for lessees the new guidance would be an improvement in financial reporting, we believe that preparers should be allowed to adopt early if they wish.

There are a number of transition matters that we believe should be addressed in the final standard, including sale and leaseback transactions and, regarding US GAAP only, leveraged lease accounting.

Effective date and next steps

We welcome the boards' request for views on the effective date for converged standards. We will respond to this wider effective date question in due course. In respect of the proposed leasing standard, we believe that the implementation will be complex and costly and for this reason the effective date for this proposed standard should be relatively long to reflect this complexity.



The boards currently have a significant workload and a number of projects to be completed over the next year. We believe that most of the matters we raise in this comment letter need to be addressed before the leasing standard is finalised. However, there are certain matters that we believe can be addressed over the longer term, such as development of a comprehensive model for lessor accounting that is consistent with both lessee accounting and intangible licence accounting. We believe the boards should work towards including licences of intangible assets entirely within the scope of the leasing standard as part of a longer term phase of the project.

Our answers to the specific questions in the exposure draft are attached in the appendix to this letter.

If you have any questions in relation to the 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) or Tom Wilkin (+1 973 236 4251).

Yours faithfully

A handwritten signature in cursive script that reads "PricewaterhouseCoopers LLP".

PricewaterhouseCoopers LLP



Responses to detailed questions in the exposure draft

Question 1

(a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We support the proposed right-of-use model for lessees. We acknowledge the criticism that the existing leasing model in IAS 17 and ASC 840 fails to meet the needs of users as it does not provide a faithful representation of leasing transactions in the statement of financial position. We are therefore supportive of the boards' aim to develop a new approach to lease accounting that would ensure all assets and liabilities arising under leases are recognised in the statement of financial position.

We agree with the boards' analysis that rights and obligations arising in a simple lease meet the definition of assets and liabilities, respectively. As a result, for lessees we believe the 'right-of-use' model provides a better underpinning for a new standard than the current IAS 17 and ASC 840 accounting model. However, we have some concerns around the measurement of more complex leases under the right-of-use approach - in particular regarding extension options and contingent rent. These concerns are discussed in more detail in our responses to questions 8 and 9.

While we agree with the boards that recognising all leases on the statement of financial position will provide better information to users, we are aware that it will exacerbate the issues already experienced by preparers distinguishing between a lease and a service contract. As further explained in our response to question 4, we believe it is critical that the definition of a lease be further improved to address this issue.

(b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We agree that if the 'right-of-use' model is adopted, a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments.

However, the application of the proposals might reduce the income statement's usefulness to many users. We understand that some users may therefore continue to make adjustments to reported amounts. Specifically, a number of preparers and users have expressed concerns regarding the front-loading of expenses because rental expense will be replaced by a combination of amortisation and interest expense. Some have proposed that the amortisation of the right-of-use asset should mirror the incidence of the interest on the liability to make lease payments. For example, if the interest expense arises in the pattern 9, 8, 7 in the first three years of a lease, the amortisation of the right-of-use asset would be in the pattern 1, 2, 3, therefore always resulting in a total expense of 10. Some refer to this as a 'linked approach' to expense recognition. We acknowledge that the proposals in the exposure draft will result in front-loading of expenses and that some users may continue to adjust the reported



numbers as a result; however we believe a lease is substantially equivalent to the purchase of the asset with a concurrent financing, and therefore the resulting accounting is appropriate.

We believe that the boards' proposal to require a simplified retrospective approach on transition exacerbates this front-loading issue by effectively treating all leases in place at the initial application date as if they were new leases; in reality, the lease portfolio will contain leases in different stages of their life cycle. This concern is addressed in more detail in our response to question 16.

We have specific concerns regarding measurement issues in connection with more complex leases containing renewal options or contingent rentals. These concerns are addressed in more detail in our responses to question 8 and 9.

Question 2

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

We disagree with the boards' proposals for lessor accounting. We acknowledge the boards' aim to develop a consistent model for both lessees and lessors. However, we do not believe that the proposed 'hybrid approach' to lessor accounting achieves this aim. We also do not believe that the 'hybrid approach' is a demonstrative improvement on current lessor accounting in accordance with IAS 17/ASC 840. We therefore propose that lessor accounting should not be amended at this time but should be revisited in the future. We realise that this will create some complications (for example with sub-leasing and sale/leaseback type arrangements); however, we believe these issues can be adequately addressed in the interim.

We believe that the performance obligation approach is not consistent conceptually with lessee accounting. Under the proposals, a lessee recognises an asset representing its right-of-use of the underlying leased item. This asset is a consequence of the lessor having performed under the lease on the lease commencement date by making the leased asset available to the lessee. It is therefore inconsistent to require a lessor to recognise a performance obligation liability on the same date as this suggests that the lessor has still to perform throughout the lease period. We also believe that the performance obligation approach results in double-counting of the asset. A lessor continues to recognise the whole underlying asset but is also required to recognise a lease receivable. This lease receivable represents part of the future cash flows that the underlying asset will generate for the lessor. Recognising these while not derecognising that part of the underlying asset that has been leased appears therefore to result in the double counting of the same cash flow potential. The presentation of the performance obligation (a credit balance) together in the statement of financial position with the underlying asset and right to receive lease payments reduces the effect of this double counting, but we do not believe it sufficiently eliminates this concern.

We also do not support the derecognition approach. We acknowledge that the derecognition approach is consistent with the right-of-use model, but it is not entirely consistent with the proposed revenue standard, specifically the accounting for certain leases/licences of intangible assets. If an entity grants rights that are not exclusive, the promised rights give rise to a single performance obligation that the



entity satisfies when the customer is able to use and benefit from that right. This would appear to be consistent with the derecognition approach where the performance obligation is satisfied at the start of the lease. However, divergence from the derecognition model occurs with respect to certain exclusive use contracts. Where an exclusive licence is for the entire life of the underlying intangible asset, again the performance obligation is satisfied at the start of the licence period, which is therefore consistent with the derecognition approach. However, in situations where the customer does not obtain control of substantially all the rights associated with an entity's intellectual property - that is, the licence is not for the intellectual property's entire life - the boards propose that the entity has a performance obligation that it satisfies continuously during the licence period. This is inconsistent with the lease of a tangible asset for less than the entire life of that asset under the proposed leasing standard. In this tangible lease scenario, applying the derecognition approach would conclude that the lessor has performed at the start of the lease and has no ongoing performance obligation during the life of the lease.

Furthermore, we believe that there are practical issues of applying the derecognition approach for certain leases where only a portion of the asset is leased or where the lease term is for a period substantially less than the life of the asset, including real estate leases (other than those measured at fair value under IAS 40, for which there is a scope exemption), time charter shipping and certain types of equipment lease (for example, rail cars). We urge the boards to consult further on these practical issues which would be more prevalent if the FASB were not concurrently to adopt an investment property standard requiring a fair value model in the US to some or all real estate lessors. This concern is addressed in more detail in our response to question 5 below.

We agree with the boards' acknowledgement that many of the problems associated with existing lease requirements relate to the treatment of operating leases in the financial statements of lessees. In our comment letter on the discussion paper, we stated that the boards should address the accounting by lessees and lessors in a comprehensive fashion. However, we have concerns regarding the proposed 'hybrid model' and the numerous projects the boards aim to complete over the next year resulting in limited time to develop and improve the lessor model. We therefore believe lessor accounting should be revisited in the future. As an interim solution, as noted above, we would support continuing with existing lessor accounting in accordance with IAS 17/ASC 840. This proposal would allow the boards time to ensure that the lessor accounting model is consistent with lessee accounting and with revenue recognition, specifically the accounting for leases/licences of intangible assets. In the meantime in the case of the latter, we are aware that there is currently diversity in practice; we therefore accept that these be dealt with through the model proposed in the revenue exposure draft as a pragmatic interim solution to accounting for leases/licences of intangible assets.

We acknowledge that our proposal to maintain current accounting for lessors may cause presentation issues in respect of subleases under a right-of-use model for lessees. However, we believe these can be addressed through enhanced disclosure. The issue arises primarily where the sub-leases meet the definition of an operating lease under IAS 17/ASC 840. In this circumstance, the intermediate party will recognise a right-to-use asset and obligation to make lease payments under the right-of-use model proposed by the boards, but will not recognise a lease receivable under current IAS 17/ASC 840 accounting (although it will continue to recognise the underlying right-of-use asset). Although the lease liability is economically offset by the lease receivable in full or partially, this is not reflected in the resulting accounting. We believe this issue can be mitigated through disclosure of the lease receivable and lease liability in a sub-lease to enable to user to understand the economics of the sub-lease transaction.



(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

See our response to question 2(a). We do not support the proposed 'hybrid approach', or either the performance obligation approach or derecognition approach in isolation.

FASB ONLY

(c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

As more fully addressed in our response to question 2(a), we are not supportive of the proposed 'hybrid approach', or either the 'performance obligation approach' or 'derecognition approach' in isolation. However, if the boards were to continue with the 'hybrid approach', we agree that there should not be yet another approach - that is, leveraged lease accounting.

As indicated in our response to question 2(a), we support continuing with existing lessor accounting in accordance with IAS 17/ASC 840. This proposal would remove the requirement to implement a new model as an interim solution and would allow the boards time to ensure that the lessor accounting model is consistent with lessee accounting and with revenue recognition, specifically the accounting for leases/licences of intangible assets. For US GAAP, this recommendation would include continuing with existing leveraged lease accounting until a final comprehensive lessor solution is adopted.

Question 3

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in profit or loss, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other guidance and would recognise lease payments in profit or loss over the lease term (paragraph 65). (See also paragraphs BC41–BC46.)



Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

We believe that both lessees and lessors should be able to apply simplified requirements to their short-term leases. We agree with the boards' proposed simplifications for lessors, but we do not believe that the boards' proposals for lessees go far enough. We believe the main burden for a lessee is the cost of identifying and tracking a large number of short-term leases (for example, to identify each employee using a hotel room or rental car at the end of each reporting period), rather than the cost of measuring their present value. Further, if the goal of the standard is to provide users with more information on the long-term obligations of a reporting entity, we believe that there is little incremental informational value provided by grossing up the lessee's statement of financial position to include short-term lease assets and liabilities. In short, although we accept that the value of these short-term leases may in some cases be significant in aggregate, we do not believe that they are normally material to the economic decisions made by users.

We therefore propose that the simplified requirements for lessees should mirror those of the lessor such that lease rentals are recognised on an accruals basis similar to the current operating lease accounting by lessees under IAS 17/ASC 840. The exposure draft does not describe how these lease payments should be characterised (as 'rent' or as amortisation) or their recognition pattern in the income statement (straight line or as they fall due); we encourage the boards to clarify this in the final standard.

We acknowledge that this proposal may result in assets and liabilities not being recognised on the lessee's statement of financial position. However, we feel that the costs of complying with the boards' proposed requirements will far outweigh the benefits to users, which could be just as well served through disclosure. For example, there could be disclosure of the annual expense relating to short-term leases, which would give users information about the magnitude of such leases without the lessee incurring substantial cost and effort to estimate the remaining rental payments due.

Question 4

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

As the definition of a lease is substantially carried forward from IAS 17/ASC 840, we generally agree that a lease is defined appropriately. However, we believe that the boards need to provide further guidance to assist preparers in applying the definition to their lease contracts. See our response to question 4(c).

We believe the boundary of a lease contract should be based on the contractual and legal terms, including statutory laws, consistent with the guidance in IAS 32, 'Financial instruments: Presentation'. This point particularly applies to the lease term. These concerns are discussed in more detail in our responses to question 8.



(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

We do not agree with the proposals in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale. We are concerned that the sale/purchase guidance contained in the leasing exposure draft is inconsistent with the proposed revenue standard. We believe the inconsistencies could result in a number of 'failed sale' transactions where the in-substance sale criteria are met in the proposed leases standard but do not meet the definition of a sale in the proposed revenue standard. An example of this would be where the lease contract contains a bargain purchase option. Bargain purchase options would meet the definition of a sale/purchase following the guidance in the leasing exposure draft and would therefore fall outside the leasing exposure draft. However, such options might not meet the sale criteria under the proposed revenue standard, resulting in a failed sale.

To avoid any inconsistency, we recommend that a lease transaction that meets the definition of a sale as set out in the proposed revenue standard is accounted for under that standard. Otherwise it should fall within the scope of the proposed lease standard. There should be no further criteria in the lease standard to account for a transaction as an in-substance sale/purchase.

For IFRS reporters, the concept of control of infrastructure assets is already defined in IFRIC 12, 'Service concessions'. The grantor has control of those assets where it regulates what services the operator must provide, to whom it must provide them and at what price, and it controls any significant residual interest. Control in this context normally exists where the grantor has any form of purchase option, not just a bargain purchase option. The potential existence of three different sets of criteria for determining whether a sale or transfer has occurred (IFRIC 12, the lease proposals and the revenue proposals) adds significant complexity and will inevitably cause diversity in practice.

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

We do not believe the guidance in paragraphs B1-B4 is sufficient for distinguishing leases from service contracts. The guidance resembles the existing provisions of IFRIC 4, 'Determining whether an arrangement contains a lease', and ASC 840-10-15-6 through 15-21 (formerly EITF 01-8). Under IFRIC 4/EITF 01-8, unless the lease was a finance/capital lease, distinguishing between an operating lease and a service contract did not have significant accounting implications. This is because, in many cases, the expense recognition pattern is similar. However, under the proposed standard, the consequence of concluding whether a transaction represents a lease or a service contract is more pronounced, as all leases would be recognised on the statement of financial position and as a result of the expense front-loading issue explained in our response to question 1(b).

We are aware that preparers have found it challenging to apply the criteria in IFRIC 4 and EITF 01-8. We urge the boards to take this opportunity to address many of the known issues with IFRIC 4/EITF 01-8 as part of this proposed standard. These issues include the following:

- The meaning of fixed price or fixed price per unit of output. For example, in certain power supply contracts there is diversity in practice regarding whether the criterion should be interpreted literally (that is, there is a stated single price for the entire term) or in a broader sense,



encompassing arrangements under which the price per unit of output is predetermined (that is, there is a series of stated prices that varies with time).

- The meaning of 'output or other utility' and whether it should be viewed in a physical or economic context. For example, again considering power supply contracts, there is diversity in practice regarding whether the output of a power station is just the physical outputs it produces (that is, electricity, steam and heat as primary products or by-products, depending on the purchaser's needs), or includes other economic benefits such as renewable energy certificates and similar carbon credits.
- The meaning of 'ability or right to operate', which can be unclear, for example, in the context of outsourcing and certain time charter shipping transactions.
- Greater exploration of what 'specific assets' are, especially in the context of fungible assets and an entity's practice, or not, of switching assets. This matter is of particular concern to entities in the outsourcing and telecommunications industries, or to entities that provide their customers with products using their own movable equipment at the customer's site.

We would welcome the opportunity to meet with the boards and share our knowledge of the issues in applying IFRIC 4 and EITF 01-8 in practice.

Question 5

The exposure draft proposes that a lessee or a lessor should apply the proposed guidance to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

We support the scope exclusion for leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources.

We also agree with the proposal to exclude intangible assets as a pragmatic short-term solution, as to include them would significantly increase the project's timeframe to enable the boards to undertake a proper impact assessment. We believe that the accounting for licences of intangible assets and leases of tangible assets should be consistent, as these arrangements are economically similar. Some contracts may include leases/licences of both tangible and intangible assets - for example, in the information technology industry. These types of contract bring into sharp focus the inconsistencies between the proposed leasing and revenue standards, and we encourage the boards to reconcile the accounting between these two models.

IASB ONLY

We support the scope exclusion for investment property measured at fair value in accordance with IAS 40, 'Investment property'. We agree with the board that certain consequential amendments to IAS 40 will be necessary to remove the references to operating leases and finance leases. The proposed amendment states that lease income should be recognised on a straight-line basis. We encourage the IASB to consider proposing that recognition should be on a contract accrual basis and not on straight-line basis.



FASB ONLY

We encourage the FASB provide a similar scope exclusion to entities already accounting for investment real estate on a fair value basis today (that is, pension funds and certain real estate investment funds). We understand that the FASB is also considering a convergence project for fair valuing real estate investment property for certain types of reporting entities, which presumably would result in a scope exemption from the lease standard for those real estate investment properties measured at fair value. This may also solve some of the practical issues faced by the US real estate industry in applying the derecognition approach to lessor accounting.

We observe that the guidance in SOP 98-1, 'Accounting for the costs of computer software developed or obtained for internal use', analogises to the current US leasing literature. In view of the boards' conclusion that licences of intangible assets should be outside the scope of the leasing standard for the time being, and our support for that view, we encourage the FASB to remove this reference.

Question 6

The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) the IASB proposes that:

(i) a lessee should apply the lease accounting requirements to the combined contract.

(ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.

(iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We agree with the boards' proposal that distinct services components should be accounted for in accordance with the proposals in the revenue exposure draft. However, we believe that the current guidance of what constitutes a 'distinct service' could result in the inclusion of certain executory costs and other similar costs as part of the lease payments. This may have significant implications for certain asset classes, most significantly real estate leases, which we discuss in greater detail below, and for certain time charter shipping transactions.

As we have stated in our comment letter on the revenue exposure draft, we believe that something is distinct if it represents a discrete offering by a vendor or a discrete purchasing decision by the customer. Indicators that a performance obligation is distinct could include:



- The goods or services are sold separately by the entity or other entities in the entity's principle market or similar market.
- The goods or services are delivered to the customer at different times.
- The performance obligation can be satisfied independently from other performance obligations in the contract.
- The goods or services are not highly interrelated.

We also suggest clarifying that no single indicator determines whether a performance obligation is distinct, and that the indicators should be considered in their entirety.

As we have stated in our response to Question 2, we do not agree with the boards' proposals for either the performance obligation or derecognition approach for lessor accounting at this time. However, if the boards continue with their proposed hybrid approach, we would support separating both distinct and non-distinct service components from the lease in order to avoid recognising revenue, and interest income on services that have not yet been provided regardless of which approach is taken.

Real estate executory/common operating costs

'Executory costs' in today's lease accounting guidance includes insurance, maintenance and taxes. In practice, this term is often extended also to apply to other common cost allocations including common area maintenance, utilities, snow ploughing, security, landscaping and other similar shared operating costs. These costs are frequently included in the quoted lease terms (especially for real estate). There are several different types of lease that are common, and each may have some unique issues to be addressed. These include net, modified gross ('base year') or gross leases.

It is unclear if these common real estate service/executory costs would meet the 'distinct service' definition. For example, it would be difficult to say that real estate tax reimbursement meets the definition or that a tenant in multi-tenant building paying a pro rata portion of landscaping or snow removal meets the definition. In addition, items that might meet the definition of a distinct service might be intertwined with those that do not meet the definition. For example, the cost reimbursement for an increase in a modified gross lease is not for each individual expense but rather for the entire pool of expenses; increases in some may be offset by decreases in others. In this case, the non-distinct elements included may make the whole pool non-distinct.

Notwithstanding that they may not meet the definition contained in the exposure draft, we believe that these service/executory costs should be excluded from the payments the lessee uses in measuring the lease asset and obligation, as failure to do so would not meet the stated desire to put leasing on parity with owning the asset. For example, when purchasing a real estate asset outright an entity does not capitalise the present value of expected future operating costs such as real estate taxes, so why would it capitalise them as part of the lease accounting?

Assuming the final standard requires that these common real estate service/executory costs should be excluded, management would then need to segregate out the portion of these included in the rent amounts under modified gross and gross leases. Stripping out these executory/operating costs was not significant in many cases under the current lease accounting guidance because there was no balance sheet effect in operating leases, and the income statement recognition pattern was similar or identical. However, this distinction will become significant under the proposed leasing model because of the



impact their inclusion would have on the balance sheet and the impact on the recognition pattern in the statement of operations.

We believe the boards should clarify explicitly that executory/common operating costs are also considered distinct for purposes of applying the proposed standard. We believe this is consistent with the boards' view that leasing is a form of financing and that the outcome of owning and leasing should be similar.

Question 7

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

We disagree. We believe there should be no difference in the accounting treatment between a purchase option and a lease extension option as they both can be used by a lessee to provide some level of control over the asset beyond the initial lease term. One can view a contract that contains renewal options for the whole of the useful economic life of an asset as no different in substance to a purchase option. We are concerned that if the final standard contains guidance regarding purchase options that would result in very different accounting from that for renewal options, this could result in significant structuring opportunities. We believe that there should be consistent accounting between purchase options and extension options included in a lease contract. We believe, consistent with our proposals for lease extension options, that purchase options should be included if it is virtually certain they will be exercised. See our response to question 8 regarding our detailed views on how lease extension options and hence purchase options should be reflected.

Question 8

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

We agree that options should not be separated from the underlying lease contract. However, we believe conceptually that payments that would become due if an option were to be exercised should only be recognised where the definition of a liability is met in the case of lessees and the definition of an asset is met in the case of lessors. We believe an option is fundamentally different from an asset and liability. As with other options in financial accounting, we believe lease term extension options should not be accounted for as if they were exercised.

We therefore disagree with the boards' proposals that the lease term should be the 'longest possible term that is more likely than not to occur' taking into account the effect of any options to extend or terminate the lease. We believe that the boards' proposals would result in entities recognising assets



and liabilities associated with extension option periods that do not meet the definitions in the conceptual framework with respect to the relevant portions of the lease liability for lessees or the right to receive lease payments for lessors. Instead, we believe that the lease term should include only those extension periods in respect of which the exercise of an extension option is virtually certain.

Before determining how to recognise and measure extension options, it is important to determine which extension options should be analysed. There has been some confusion over the wording in the exposure draft regarding whether it is only those options written within the contract that should be analysed, or whether a broader view is taken such that implied extension options are also considered (that is, those not within the contract but implied through common business practice). As we explained in our response to question 4, we believe that extension options should only be taken into consideration where the lessee is contractually and legally entitled to extend, including by statutory law, and can do so unilaterally. This is particularly important in certain jurisdictions, such as India, where lease extension options are not permitted by law. We propose that the term 'contract' is consistent with the guidance in IAS 32, 'Financial instruments: Presentation', which states that 'contract' or 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law.

After establishing which extension options should be considered, the issue of recognition and measurement needs to be addressed. Conceptually, we believe that options (renewal or purchase) contained within lease contracts should be accounted for separately. That is not to say that such options are embedded derivatives to be accounted for separately at fair value, but we recognise that leases containing options are priced differently from those that do not contain options. Accordingly, in principle the amount paid for the right to extend the lease term should be identified upon initial recognition and subsequently measured at cost. However, we understand that there is limited appetite for this information from users and recognise that separately identifying and accounting for such options may be difficult in practice. We therefore agree with the boards' proposal that options contained within lease contracts should not be separated. As a consequence, we acknowledge that amounts paid for optionality during the initial, non-cancellable lease periods will be included in the overall measurement of the right-of-use asset and obligation to make lease payments.

Beyond the initial, non-cancellable lease period, the treatment of extension options (and hence the determination of lease term) is influenced by the perspective from which the lease contract is viewed. Some think about lease accounting starting with the asset and others start with the liability, but neither can be considered to the exclusion of the other. In our comment letter responding to the boards' discussion paper, we based our thinking on an asset perspective. Thus, when a lessee gains possession of leased property, the lessee acquires an asset: the service potential of that property. Possession, along with the right to obtain benefits under the lease, gives the lessee control over the asset's service potential. It follows from this logic that the period covered by a renewal option should be included in measuring the right-of-use asset when the lessee expects to utilise the service potential inherent in the option. However, this view contrasts with a liability perspective, under which the amounts recognised on the statement of financial position represent an entity's obligations. From our outreach over the past year, it has become clear to us that most stakeholders approach lease accounting from the liability perspective and are concerned that the boards' proposals will result in an entity recognising liabilities that do not meet the definition of liabilities. We have now come to the same conclusion.



We believe that potential payments during optional extension periods should be included in the calculation of the obligation to make lease payments, and hence the right-of-use asset, only where the terms of the lease and the nature of the leased item mean that exercise of the extension option is virtually certain - in other words, where economically the lessee does not have any choice but to extend the lease. We acknowledge that there is a tension between creating an accounting framework that minimises structuring opportunities whilst still meeting the definition of a liability. We therefore believe that establishing the hurdle at a 'virtually certain' level is a better solution to this tension than either moving to the 'more likely than not' standard described in the exposure draft or retaining the current hurdle of reasonably certain/assured. Establishing the hurdle at this higher level also results in further benefits. Specifically, at the higher hurdle, there will be less frequent need to remeasure and therefore, less associated volatility. It will also reduce the amount of estimates and judgements involved in determining the right-of-use asset and obligation to make lease payments for lessees and, as a result, reduce the costs of implementing the new standard for a preparer.

The boards' aim was to provide users with information about the amounts, timing and uncertainty of cash flows, but we believe that this aim with respect to extension options would be better achieved through disclosure than through recognition on the statement of financial position. Our response to question 15 expands on our view of the disclosure requirements. We believe the proposed narrative disclosure requirements relating to options will adequately address users' need to understand the optionality contained within a lease contract.

Question 9

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

We agree that many (but not all) contingent rentals and residual value guarantees should be included in the measurement of assets and liabilities arising from a lease. However, we believe that only those contingent payments that are **not within the control** of the lessee should be included in the calculation of lease payments. Contingent payments that **are within the control** of the lessee should not be included in the lease payments. This is consistent with the treatment of contingent interest payments on debt instruments accounted for in accordance with IAS 32, 'Financial instruments: Presentation'.

Our position is similar in some ways to the alternative view put forward in the IASB's exposure draft by Stephen Cooper and we agree with many of his arguments. Where we differ is in relation to performance-based contingent payments. We believe that index-based or **performance-based** contingent payments are generally outside the control of the lessee as that term is used in IAS 32. These types of contingent payment should therefore be included in the measurement of lease assets and liabilities. For example, a retailer should generally include contingent rentals where the lease



payments are contingent on a retail store's turnover, as IAS 32 states that contingencies such as turnover and net income are not within the control of the contracting party. It is our view that the guidance for financial liabilities should be consistently applied to the lessee's lease obligation. Similarly, certain **usage**-based contingent payments, such as car lease payments linked to mileage, should not be included in the measurement of lease assets and liabilities as these are considered to be within the control of the lessee. We realise that certain leases might have payments that are contingent on both usage and performance. For example, payments in respect of a retail store lease might be fully contingent on sales, as described above, but the lessee might also be able to close the store and hence control its usage without penalty. We believe that the important factor is to determine whether the contingent payments are, or are not, within the control of the lessee. We view usage-based contingencies as similar to options and, as with other options in financial accounting, we believe they should not be accounted for as if they were exercised.

We acknowledge that the inclusion of contingent payments outside the control of the lessee in the measurement of lease assets and liabilities will add complexity and cost to preparers compared to current IAS 17/ASC 840. However, we believe that excluding contingencies outside the control of the lessee would reduce comparability and present easy structuring opportunities that could detract from users' needs. For example, taken to the extreme, lease contracts could be structured with terms that appear on the surface to be entirely contingent, when both sides clearly believe that substantial payments will be made in the normal course of operations.

We also do not agree with the proposed 'probability weighted' approach for measuring contingent rentals. We support a best estimate approach, which would not necessarily include the requirement to compute multiple scenarios and assign probabilities. The probability weighted approach described in the exposure draft would, in our view, be unduly complex especially for large portfolios of leases.

In some cases, the lease term might extend beyond an entity's planning horizon resulting in issues around the reliability of measurement. In these situations, while we believe it is inappropriate to record nothing, we would propose looking to other guidance, such as IAS 36, 'Impairment of assets', regarding where amounts are included in cash flow forecasts for periods that go beyond an entity's normal planning horizon.

Our support for including contingent rentals in the measurement of lease assets and liabilities as described above is predicated on the boards clarifying the amortisation principle within IAS 38, 'Intangible assets' (ASC 350), as it applies to right-of-use assets. IAS 38 today includes guidance that states that 'the amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity'. There are ongoing dialogues and differences of views as to how to apply that guidance to an asset that is consumed by the passage of time but is expected to produce significantly greater economic benefits in later periods. Applying a straight-line or time-based amortisation approach will produce higher expense in the earlier periods of lower revenue. Including contingent rentals in the right-of-use asset brings this issue into sharp focus.

We believe that the contingent component of a right-of-use asset should be amortised on a basis that reflects the future economic **benefit** flowing from that component. The nature of many contingent payments is such that only where the underlying contingency is met will a payment be made and a corresponding benefit arise. Where this is the case, we believe there is a direct linkage between the contingency and benefit and that amortisation based on the benefit, rather than the passage of time, is therefore the only methodology that will reflect the economics of the arrangement. An example of the



direct linkage between a contingent payment and related benefit would be a retailer who has rental payments linked to the store's turnover. Whether or not intangible assets should be amortised on a basis that reflects the benefits that flow from them seems to be an important point of principle. We suggest that the boards clarify this principle.

Notwithstanding our response to question 2 above, should the boards continue with their proposals to change lessor accounting, we note certain historic failures of leasing entities and are aware of user concern regarding revenue recognition and residual value risk. Furthermore, for certain types of contingent rentals (such as payments based on net income or projected sales), the lessor will have access to less information than the lessee. For those reasons, we support the proposal that lessors should recognise contingent rentals only when they can be measured reliably.

Question 10

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

We agree that there should be reassessment of estimates of both lease term and contingent payments. We agree with the boards' assessment in the basis of conclusion that users of financial statements receive more relevant information when entities reassess the lease term at each reporting date because reassessment reflects current market conditions and not doing so could lead to misleading results. However, we observe that the lower the inclusion threshold ultimately selected by the boards for options, the greater the complexity of the reassessment, resulting in more frequent revisions and more volatility. We believe our proposal for including only those lease extension options that are virtually certain to be exercised still meets the aim of providing relevant and current information while minimising the cost and complexity for preparers. See our response to question 17 for more discussion around the benefits and costs of the proposed standard.

We do not believe the proposal to require reassessment where there has been a 'significant change' in each leased asset is useful. Given the level of judgment involved in assessing what is significant, we propose, similar to impairment analysis, that the requirement should be supplemented by a presumption that reassessment should occur based on certain triggering or reconsideration events and, at a minimum, on an annual basis. This will help reduce the risk that changes are recorded in an incorrect accounting period.

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

We have already expressed our concerns about the in-substance sales/purchases criteria in our response to question 4b above. Consistent with our response to that question, we propose that sale and



leaseback accounting should only result in a sale if the criteria within the proposed revenue standard are met.

We believe that the seller in a sale and leaseback transaction only relinquishes its right to the residual and that it has merely financed the portion of the asset it retains. We observe that in many cases, the seller retains the rights to utilise the property for a substantial portion of its life, and that this retained period represents a substantial portion of the asset's value. We therefore support recognition of profit only on the residual that has been sold and not the whole asset. Guidance would then need to be provided on how to record the unrecognised gain. We believe that the right-to-use asset should be reduced, which would effectively represent the pro-rata carrying value of the retained rights.

Although the exposure draft contains guidance on linked transactions in the context of sale and leaseback transactions, we believe that the proposed standard should include general guidance in this area. Such guidance is already proposed in the revenue exposure draft (paragraph 12-13) and, for IFRS reporters, paragraph IG B6 of IAS 39, 'Financial instruments: Measurement'. Similar guidance should be included within the leasing standard. This 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, 'Evaluating the substance of transactions involving the legal form of a lease'.

Question 12

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

We agree that an entity should present the obligation to make lease payments separately from other financial liabilities and the right-of-use asset separately from owned property, plant and equipment. In many respects, the right-of-use asset is treated as an intangible asset (for example, guidance with respect to amortisation and impairment), but many users and preparers believe these are more closely akin to property, plant and equipment in most cases. We therefore agree that right-of-use assets should be presented as if they were tangible assets within property, plant and equipment in the statement of financial position.

However, with respect to reflecting the lease liabilities and right-of-use assets separately, we believe for IFRS reporters there is sufficient guidance in IAS 1, 'Presentation of financial statements', as to what should be disclosed on the face of the primary statements based upon materiality and what should be included in the notes. We do not therefore support including any further guidance within the proposed leasing standard. We acknowledge that there is no direct equivalent to IAS 1 in US GAAP, but believe that the same principles as contained in IAS 1 should be applied, and would naturally be applied in practice if allowed.



(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

As more fully explained in our response to question 2, we do not support a 'hybrid' approach for lessors.

However, if the boards were to continue with the 'hybrid approach', we would agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability.

In addition, we believe that the boards should also clarify the manner in which the net asset/liability under this approach should be presented in the current or non-current section of a classified statement of financial position.

Similar to our response to question 12(a), we believe there is sufficient guidance in IAS 1 for IFRS preparers. We believe that an entity should decide whether separate presentation is necessary in the primary statements or whether it is adequate to provide the information in the notes based upon materiality. We acknowledge that there is no direct equivalent to IAS 1 in US GAAP, but believe that the same principles as contained in IAS 1 should be applied.

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

As explained in our response to question 2, we do not support the 'hybrid' approach for lessors. However, if the boards go ahead with derecognition accounting for lessors then, similar to our response to question 12(a), we believe there is sufficient guidance in IAS 1 for IFRS preparers. We believe that an entity should decide whether the separate presentation is necessary in the primary statements or whether it is adequate to provide the information in the notes based upon materiality. We acknowledge that there is no direct equivalent to IAS 1 in US GAAP, but believe that the same principles as contained in IAS 1 should be applied.

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

As explained in our response to question 2, we do not support a 'hybrid' approach for lessors. However, if the boards continue with the proposed lessor accounting guidance provided in the exposure draft, we observe that most sub-leases are likely to be reflected under the performance



obligation approach (except where the terms and amounts of the lease in nearly match those of the lease out, in which case the derecognition approach might be appropriate).

With respect to whether the intermediate lessor should separately distinguish assets and liabilities arising from the sub-lease in the statement of financial position, similar to our response to question 12(a), we believe there is sufficient guidance in IAS 1 for IFRS preparers. We believe that an entity should decide whether separate presentation is necessary in the primary statements or whether it is adequate to provide the information in the notes based upon materiality. We acknowledge that there is no direct equivalent to IAS 1 in US GAAP, but believe that the same principles as contained in IAS 1 should be applied.

Question 13

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

Similar to our response to question 12(a), we believe there is sufficient guidance in IAS 1 for IFRS preparers. We believe that an entity should decide whether separate presentation is necessary in the primary statements or whether it is adequate to provide the information in the notes based upon materiality. We acknowledge that there is no direct equivalent to IAS 1 in US GAAP, but believe that the same principles as contained in IAS 1 should be applied.

Question 14

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Similar to our response to question 12(a), we believe there is sufficient guidance in IAS 1, in conjunction with IAS 7, 'Statement of cash flows', for IFRS preparers. We believe that an entity should decide whether separate presentation is necessary in the primary statements or whether it is adequate to provide the information in the notes based upon materiality. We acknowledge that there is no direct equivalent to IAS 1 in US GAAP, but believe that the same principles as contained in IAS 1 should be applied.

We do not believe that lease cash flows should necessarily be classified entirely as financing. In practice entities enter into leases for many reasons, sometimes as an alternative source of finance and sometimes for operational reasons. There has been recognition of this dichotomy in the boards' deliberations concerning financial statement presentation. There is also some variation in current practice. In the US, lessees typically are required to reflect the 'principal' portions of outflow payments on capital leases as part of financing activities, and lessors would typically be required to reflect the 'principal' portion of inflow payments on capital leases as part of investing activities. Meanwhile, under IFRS, following the 2008 improvements to IAS 7 and IAS 16, 'Property, plant and equipment', cash payments to manufacture or acquire assets held for rental to others and subsequently held for



sale are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

We believe that the model proposed by the boards approaches leases as purchases of assets financed by a specific debt, which may not be how preparers and users view all leases. This may be an issue for the boards to pick up in their project on financial statement presentation; in the meantime, we are willing to accept presentation as financing cash flow as an interim measure.

However, we also believe the interest component (if identified) should be treated in a manner consistent with other interest cash flows. In this regard, we observe that IAS 7 states that interest cash flows may be classified as operating, investing or financing while ASC 230-10-20 indicates that transactions that enter into the determination of net income should be classified as operating activities.

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

(a) identifies and explains the amounts recognised in the financial statements arising from leases; and

(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

We agree with the disclosure principles outlined in the exposure draft and believe that they could enhance the information provided to users compared to the current requirements of IAS 17/ASC 840. The list of qualitative and quantitative information required in the exposure draft (paragraph 73-86) is extensive. If it was made mandatory, without regard to the significance of the leases to a particular lessee or lessor, it could result in boilerplate disclosure of information that is not relevant or material to a user of the financial statements. Given this concern we welcome the requirement in the exposure draft (paragraph 71) that an entity should consider the level of disclosure appropriate to satisfy the objectives in paragraph 70. We believe it is important that the overarching requirement is consistent with the boards' objective that an entity provides sufficient disclosure to allow a user to understand the amounts, timing and uncertainty of the cash flows arising from its lease portfolio.

We note that the boards have proposed that entities can 'aggregate or disaggregate' disclosures, presumably to ease the burden of providing extensive disclosure and allow a portfolio approach. We welcome this and believe the boards should be more explicit to avoid confusion. We believe the overarching requirement should be for a preparer to provide sufficient granularity about the lease portfolio to enable a user to understand the significance of the lease transactions to an entity's business and the related amount, timing and uncertainty of cash flows.



Question 16

(a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186– BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

We agree that a simplified approach to transition is necessary. However, we do not believe the proposed simplified retrospective approach is as simplified as it should be, nor necessarily the best presentation in all cases.

We agree with many of the points articulated by Stephen Cooper in his alternative view (paragraphs AV9 and 10). We have concerns about the misleading reduction in lessees' profits on transition. The expense front-loading issue outlined in question 1 is further exacerbated by applying the simplified retrospective approach in transition. For further discussion, see our response to question 16(b) below.

(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

Yes. We believe there should be the option to use the full retrospective approach to transition. While the application of a right-of-use model creates a front-loading of expenses viewed on an individual lease basis, over a larger portfolio of leases in varying stages of their life cycle, the effects would be more normalised (for example, some leases in the portfolio with higher relative expense in their early phases and others in lower relative expenses in their later phases). The simplified retrospective approach effectively treats the lease portfolio at the initial date of application as if the entire portfolio were new leases at that date, with this entire group in a higher relative expense level. For longer dated average lease portfolios, the number of periods until 'normalisation' occurs may be extreme. While we believe that the simplified retrospective approach may be appropriate and cost effective for many, we do not believe that a full retrospective approach should be precluded, as it would represent a more faithful comparative presentation of the economics for those willing to undertake the exercise.

(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

The proposed leasing standard provides no transition guidance for transactions that were previously 'failed sales' where neither the sale nor the leaseback are recognised as sales or leases. Similarly, if the exposure draft were applied as it now stands, for qualified sale and leaseback transactions that were consummated before the initial adoption, many are concerned that the deferred gains resulting from sales currently being recognised over the lease term will just be reflected in a transition adjustment to equity (that is, they will never go through the income statement). As we observe in our response to question 11, we do not believe that the gain associated with the portion of the proceeds relating to the period of use retained should be recognised; rather, it should be reflected as part of the right-of-use asset.

In addition, there are other areas where we believe that the boards should provide transition guidance, such as in-substance purchases and sales. If the boards continue with their 'hybrid model' for lessors, consideration of which approach to lessor accounting should be adopted. In each of these cases, the



proposals require judgements at lease inception in respect of information that may be unavailable or difficult to obtain at the transition date.

Because we believe that for lessees the new guidance would be an improvement in financial reporting, we believe that preparers should be allowed to adopt early if they wish.

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In respect to leveraged leases, see our response to question 2(c). If the boards were to continue with the 'hybrid approach', we agree that there should not be yet another approach - that is, leveraged lease accounting. The FASB will need to provide guidance as to the appropriate treatment of these types of transactions in transition, including the recognition of the related non-recourse debt and any associated tax consequences that are currently embedded in the accounting. We believe the FASB should also clarify that the existing grandfathering of EITF 01-8 leases entered into or committed to before 23 May 2003 will not be carried forward.

Question 17

Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

With respect to lessors, as outlined in our response to question 2, we do not support the current proposed 'hybrid approach' in the exposure draft, as it fails to meet users' needs and does not represent a significant enough improvement over the existing model to justify the costs of implementation.

With respect to lessees, as outlined in our response to question 1, we support the proposed right-of-use model for lessees. The existing leasing model in IAS 17/ASC 840 fails to meet the needs of users as it does not provide a faithful representation of leasing transactions. We therefore support the boards' aim to develop a new approach to lease accounting that would ensure all assets and liabilities arising under leases are recognised in the statement of financial position.

We agree with the boards' analysis of the benefits to users outlined in paragraph BC204. Recognising all leases on the statement of financial position will be viewed as an improvement by users who will no longer need to make adjustments to recognise assets and liabilities in respect of operating leases. This will make the reported information more useful for decision making and will increase comparability.

However, while we acknowledge that the proposals address the primary concern - that is, the recognition of assets and liabilities arising out of lease contracts - we understand from outreach that investment professionals use this information in different ways, and we believe they will continue to make adjustments to the numbers reported by an entity. We also understand that many investment professionals say it is 'the journey not the final destination' that is important. Therefore, they would rather have disclosure around the amount, timing and uncertainty of cash flows than a single number recognised in the financial statements on the basis of significant management estimates and judgements. Specifically, we are aware that many investment professionals are still proposing to make adjustments under the proposed model, both in relation to these estimates and judgements and to adjust for the front-loading issue outlined in our response to question 1(b).



For the reasons outlined above, we believe the benefit to users is limited to the boards' proposals to bring all leases on to the statement of financial position, supplemented by the suite of disclosures that will provide investment professionals with information about the amounts, timing and uncertainty of cash flows.

We recommend that the boards weigh up this benefit against the potentially extensive costs imposed on preparers of adopting and applying the proposed model. We believe if the boards were to adopt the proposals to modify the guidance in the exposure draft that we outline in this comment letter (most significantly those relating to extension options and contingent payments), the costs to preparers would be significantly reduced, while not reducing the benefits to the user community.

We agree with the boards' analysis of costs identified for preparers, but we do not believe the boards have captured all of the costs associated with the proposals. We have summarised the key areas in which we believe preparer costs will be significant.

Contracts with business partners

The proposed standard may trigger or even require the re-negotiation of contracts with suppliers, lenders, vendors and employees. Financing arrangements with lenders, credit arrangements with suppliers and other legal agreements containing financial covenants will need to be assessed to enable management to discuss potential changes in good time. The effect of the proposed standard on financial ratios and performance measures may also require revisions to agreements to redefine these targets.

Human capital

Employee compensation arrangements, such as bonuses and share-based payments based on existing performance measures, may need to be revised to be consistent with the spirit of originally expected performance levels.

Despite automated solutions for accounting for leases, resource requirements may increase to cope with the levels of judgement and documentation required by the proposed standard. The estimates required for renewal options, contingent rents and residual value guarantees, including periodic re-assessment, may strain an entity's existing resources. Additional training may also be required to ensure employees understand how to comply with new requirements, as well as changed processes and controls.

Accounting systems

Lease accounting systems in the marketplace are based on the existing risks and rewards concept; they will need to be modified to reflect the proposed right-of-use concept. Obviously, systems designed to meet entities' future needs in light of the proposed rules have not yet been created and need to be developed. New systems or upgrades will need to be implemented to ensure entities can capture and report new data or summarise existing data in new ways. Entities will need new information technology solutions that can capture data, continuously track individual lease agreements, support the process of developing and reassessing estimates for renewal options and contingent rents, and report certainly newly required disclosures.



Internal controls and processes

Many entities in the past have not needed robust processes and controls for leases as existing lease accounting models (absent a modification or exercise of an extension) did not require leases to be periodically revisited. Initial recording and periodic reassessment of lease terms and payment estimates may require significant and complex changes to existing processes and internal controls, including support for significant management assumptions. This will require new or updated documentation of processes and internal controls.

Information gathering

The proposed model does not permit grandfathering of existing leases. Management will need to catalogue existing leases and gather data about lease terms, renewal options, contingent payments and guarantees in order to measure the amounts to be included in the statement of financial position. If an entity has a significant number of leases, locating and reviewing agreements that were negotiated decades ago and obtaining the relevant lease documentation could be challenging and time-consuming. Gathering and analysing the information could take considerable time and effort, depending on the number of leases, inception dates and records available.

Tax impact

The proposed model might have a broad impact on the tax treatment of leasing transactions, as tax accounting for leases is often based on accounting principles. Given that there is no uniform leasing concept for tax purposes, the effect of the proposed lease accounting model will vary significantly, depending on the jurisdiction, and could result in the need to change local tax law.

Stakeholder communication

As outlined above, the proposals may impact an entity's relationship with its business partners. The investment community is likely to rely on entities to explain the effects on key financial ratios and performance measures. Timely and clear communication will help avoid any misunderstanding by users of financial statements.

Capital requirements for regulated financial institutions

Lessors and lessees that are regulated banks and investment firms will need to look again at the proposed models' regulatory capital implications. For the lessors, the impact of the changes could be limited, as the existing capital treatment (set by the Basel Committee of global banking supervisors) is independent of the accounting. For lessees, however, the impact could be more difficult; the new model increases balance sheet assets, with the likelihood that the regulators will require more capital to be set aside. Banks are particularly concerned that if the assets are treated literally as 'intangible' assets, regulators might treat them in a similar way to other intangibles as a deduction of capital. This would have severe repercussions for the banking sector. Alternatively, and perhaps more likely, the regulators might treat the assets in the same way as other tangible fixed assets, with a risk-weighting of 100%, which would still have an impact on bank's capital requirements, but not to the same degree.



At the same time as the new accounting approach is developed and implemented, the regulators are developing 'Basel 3', the new global regime of regulation to reflect the lessons of the last two years. This could impact the capital treatment of leases in some cases, but that is not the main focus - other factors will come into play as well. In particular, the regulators are likely to introduce a 'leverage ratio' that limits the gross size of a bank's balance sheet total as a multiple of capital. An 'on-balance sheet' treatment for leases could significantly increase the size of some banks' statements of financial position (particularly lessees) and trigger bank-wide leverage ratio concerns (although this can be addressed in the calibration of the leverage ratio).

There are also various proposals for levies to be raised on banks. Where such a levy is based on balance sheet assets or liabilities, the proposals could significantly increase the impact. We believe that users and preparers will factor this into their cost-benefit analysis of the proposals.

Question 18

Do you have any other comments on the proposals?

There are a number of items that have not been addressed in the exposure draft. We believe it is important that the boards address these matters in order to reduce the risk of a proliferation of application issues in the years following adoption. Each of these items will need to be addressed, even if the boards adopt our proposals outlined above. We would welcome the opportunity to meet with the board to provide assistance as they work through these issues.

What constitutes a lease payment?

The exposure draft defines lease payments in terms of 'payments arising under a lease', but the detail of the proposed model demonstrates that the boards have focused on cash payments by a lessee to a lessor. The boards do not appear to have addressed the accounting for a number of other types of payments relating to lease contracts, such as non-monetary lease incentives, key money, 'make good' provisions and security deposits. We believe that the boards should clarify how to account for each of these common payments in the final standard.

Discount rate

We believe that the definition of the incremental borrowing rate should be amended. The proposed standard defines the incremental borrowing rate as 'the rate of interest that, at the date of inception of the lease, the lessee would have to pay to borrow over a similar term, and with similar security, the funds necessary to purchase a similar underlying asset'. Notwithstanding our response to question 8, we believe that it should be clarified that the rate should take account of any optionality. For example, borrowing for five years with a three-year extension option will be priced differently from an eight-year borrowing. If the lease is a five-year lease with a three-year extension option, we believe that the incremental borrowing rate should also be based on borrowing funds for five years with a three-year extension option.

We also believe that there is confusion regarding what is meant by 'the rate the lessor charges the lessee'. We would encourage the boards to provide clarification regarding this term.



Lease modifications vs. extinguishment

We note that the proposed standard does not include guidance on how a lessee and lessor should account for a lease modification. Should it be treated as an extinguishment of one lease and recognition of a new lease, or as an extension of an existing lease with revised terms? Existing literature in IAS 39, 'Financial instruments: Measurement' and ASC 470-50/470-60 is used to determine whether there has been an extinguishment or modification of financial liabilities. The boards could use such literature as a basis for developing lease modification guidance and clarify that both qualitative and quantitative factors should be considered.

Lease inception vs. commencement date accounting

There are many issues concerning the passage of time between lease inception and commencement, which in some cases can be significant. How is the time value of money reflected? What if there are modifications during the period? How are build-to-suit leases dealt with? We believe the boards could address these issues by means of application guidance.

Initial direct costs

The exposure draft proposes that a lessee measures the right-to-use asset initially at the amount of the liability to make lease payments, plus any initial direct costs incurred by the lessee. We observe that the accounting treatment of costs of obtaining a contract is not unique to leases. The recently issued exposure draft for insurance contracts requires inclusion of incremental acquisition costs in the present value of the fulfilment cash flows and exclusion of all other acquisition costs. The revenue exposure draft, on the other hand, allows capitalisation of certain contract costs but requires the costs of securing a contract to be expensed as incurred.

In our comment letter responding to the revenue exposure draft, we pointed out that the proposal to expense costs of obtaining a contract might contradict existing guidance for intangible assets in some situations. At that time, we recommended that the boards consider all relevant guidance to determine whether consideration paid to acquire a customer contract creates an intangible asset. In view of the different approaches proposed for these three projects, we would urge the boards to undertake a more comprehensive project on costs to ensure consistency or to explain why differences are justified.

Embedded derivatives

We believe the boards should consider adding guidance to clarify that contingent lease payments should be analysed using the guidance in IAS 39, 'Financial instruments: Measurement', and ASC 815-15 to determine whether they need meet the definition of an embedded derivative and thus require separate accounting. This guidance was in the discussion paper, but it appears to have been omitted from the exposure draft. In its absence, a reader could form a view that any payments under a lease should be accounted for under the leasing standard and, therefore, the embedded derivative guidance does not need to be considered. We believe that not be the boards' intention, and we urge the boards to clarify that in the final standard.



Term option penalties

We do not believe it is clear what the boards meant by 'term option penalty' and how these would be taken into consideration in measuring the right-of-use asset and obligation to make lease payments. We believe the boards should define the term and clarify whether the payment should be accounted as a payment associated with the lease term or as a contingent rent.

FASB ONLY

Question 19

Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organisations)? If so, which requirement (s) and why?

We do not believe there are any substantive reasons for different accounting by non-public entities, be they private or not-for-profit.