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The Chairman
Australian Accounting Standards Board
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17 September 2013

Dear Mr Stevenson

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

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

Yours sincerely

Ernst & Young

Ernst & Young

Encl:

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Invitation to comment — Exposure Draft *Leases*

Dear Board members:

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

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

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

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

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

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

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

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

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

Scope/definition of a lease

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

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

While the ED lays out the general principle of control, it is not sufficiently developed to be applied in practice. For example, the ED does not provide adequate guidance for identifying which party controls the use of an identified asset (i.e., has the ability to direct the use of the identified asset and the ability to derive benefits from the use of the identified asset) and requires additional clarification. Given the

considerably different accounting proposed for lease contracts and typical service contracts, a well-defined principle of control, as well as appropriate application guidance, is critical. We believe a more thorough description of the control principle, coupled with clear application guidance (including illustrations), is necessary to mitigate the risk that similar transactions would be reported differently due to differing interpretations of the ED's scope.

Ability to direct the use of the identified asset

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

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

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

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

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

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

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

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

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

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

Ability to derive benefits from the use of the identified asset

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

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

- The asset is incidental to the delivery of services

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

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

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

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

Lease classification

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

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

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

Lessee accounting

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

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

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

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

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

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

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

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

Lessor accounting

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

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

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

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

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

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

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

Very truly yours,

Ernst + Young Global Limited

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

Question 1: identifying a lease

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

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

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

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset. Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

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

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

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

Ability to direct the use of the identified asset

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

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

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

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

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

If entities would be required to identify a party with the ability to direct the use of an asset when few, if any, decisions are made after the commencement date, we believe that additional application guidance is needed to make such a requirement operational. When there are few, if any, substantive decisions to be made after the lease commencement date, paragraph 15 [842-10-15-12] provides guidance that we believe indicates entities would attribute the predetermined decisions in the contract

to one of the parties even though the decisions were jointly agreed upon (i.e., both parties executed the contract). The requirement to attribute decisions may be inconsistent with how practice might evaluate similar circumstances under IFRS 10 [ASC 810-10] today. IFRS 10 [ASC 810-10] requires consideration of parties' involvement in the design of an entity but does not require a conclusion that a single party has the ability to make significant unilateral decisions in all cases (i.e., in some circumstances, no party consolidates an entity). It is not clear whether the ED, as drafted, would permit entities to reasonably conclude that neither party has the unilateral ability to direct the use of an identified asset.

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

- The types of customer involvement in the determination of contract terms and conditions that should be evaluated (e.g., how to consider whether a right within a contract is a participating right or protective right)
- How to determine which party to the contract is responsible for including a contract term or condition that is negotiated to its final form
- How a customer's (or supplier's) ability to change significant operating policies or procedures when circumstances arise, or upon the occurrence of an event, after lease commencement would be considered in the evaluation

Ability to derive benefits from the use of the identified asset

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

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

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

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

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

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

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

Transfer of title

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

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

Additional illustrations in application guidance

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

Question 2: lessee accounting

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

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

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

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

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

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

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

Question 3: lessor accounting

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

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

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

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

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

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

Question 4: classification of leases

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

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

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

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

Inclusion of the lease classification principle in the standard

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

Lease classification based on the nature of the underlying asset

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

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

Question 5: lease term

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

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

Reassessment

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

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

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

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

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

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

Question 6: variable lease payments

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

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

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

Reassessment

We are concerned that the requirement to reassess variable lease payments at the end of each reporting period may be overly burdensome and may not provide users with sufficient incremental information to justify the costs. For example, a contract with lease payments based on a reference interest rate that is a published weekly could result in remeasurement of a lease liability or receivable

multiple times within a single reporting period. We suggest that the Boards clarify that reassessments of the lease payments could be performed at periodic intervals, such as at a specific annual reassessment date or at an entity's annual financial reporting dates (also refer to our discussion above on re-assessment of the lease term in response to Question 5). We believe a periodic (e.g., annual) reassessment of lease payments would be more practical and mitigate costs to preparers, and it may still be responsive to the Boards' concerns about the decision-usefulness of information available to financial statement users.

Question 7: transition

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

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

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

Modified retrospective transition application issues

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

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

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

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

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

Question 8: disclosure

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

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

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

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

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

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

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

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

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

Question 9: (FASB-only): nonpublic entities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendix B

General comments about the Proposal

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

Executory costs

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

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

Reassessment of lease classification

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

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

[5] Refer to IAS 17.4.

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

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

Sale and leaseback transactions

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

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

Lessor put options in sale and leaseback transactions

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

Guidance about scope — extractive industries

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

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

Other comments about the proposed lessee accounting approach

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

Lessee allocation of contract consideration

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

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

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

Reassessment of the lease liability

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

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

Contingent lease incentives

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

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

Onerous contracts (FASB only)

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

Lease deposits

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

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

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

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

Other comments about the proposed lessor accounting approach

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

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

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

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

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

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

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

Lease payments structured as residual value guarantees

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

We agree with the Boards' conclusion that lease payments structured as residual value guarantees are economically the same as fixed lease payments. However, we believe that confusion could arise when lessors attempt to apply the proposed guidance to certain lease arrangements commonly referred to as synthetic leases. For example, consider a lease contract that includes a lessee's partial residual value guarantee. In this example, the lessee assumes the first $85 of the loss if the future selling price

of the underlying asset is less than the specified price of $100. The lessee would receive any appreciation above $100 (i.e., the lessee would keep any amounts above $100 if the underlying asset is sold for more than the specified price). In this circumstance, we believe the amount the lessor would receive at the end of the lease is not fixed because the lessor would absorb any losses in excess of $85. We believe the Boards should clearly articulate that the concept of including lease payments structured as residual value guarantees would apply only when the amount the lessor will receive is fully fixed. That is, residual value guarantees that introduce an element of variability would not be included in the lessor's lease payments. Absent such guidance, we believe entities might struggle to determine whether certain residual value guarantees should be included in lease payments. In addition, we believe the Boards should clarify why they believe this accounting is appropriate for lessors but not lessees (e.g., a lessee in an arrangement with a lease payment structured as a residual value guarantee may expect to pay zero under the residual value guarantee).

Type A lease approach complexity

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

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

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

Rate the lessor would charge the lessee upon reassessment

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

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

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

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

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

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

- Whether (and if so, how) lessors should consider unearned profit when remeasuring the residual asset

- Whether (and if so, how) lessors would consider the fair value of the underlying asset at the reassessment date when determining the revised amount that the lessor expects to derive from the underlying asset following the lease term

- Whether (and if so, how) lessors would consider the rate the lessor *would* charge the lessee when determining the adjustment that should be made to the carrying amount of the residual asset (see prior comments above regarding the discount rate to use upon reassessment)

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

Residual asset impairment

We believe application guidance is needed regarding the impairment of residual assets. For example, it is not clear how lessors would determine the appropriate rate at which to accrete the residual asset following an impairment. In the circumstance that a residual asset is impaired, the fair value of that asset would be determined using market participant considerations (including a market participant discount rate) as required by IAS 36 [ASC 360]. Because the adjusted carrying amount of the residual

asset would reflect market participant considerations, it is unclear whether the lessor would subsequently accrete the residual asset using the rate the lessor charges the lessee or a different rate. The Boards should clarify what rate the lessor would use to accrete the residual asset following an impairment and provide application guidance to assist lessors in applying that guidance.

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

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

Other comments about the proposed consequential amendments

Amendments to IFRS 1

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

Amendments to IFRS 3 and ASC 805

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

- The identifiable assets acquired and liabilities assumed meet the definitions of assets and liabilities in the Conceptual Framework [Concepts Statement 6] at the acquisition date.

- The identifiable assets acquired and liabilities assumed are part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions.

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

Amendments to IFRS 5

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

Amendments to IAS 7

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

Amendments to IAS 40

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

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

Amendments to IAS 41

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