ITC 20 sub 10

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers
ABN 52 780 433 757

Darling Park Tower 2
201 Sussex Street
GPO BOX 2650
SYDNEY NSW 1171
DX 77 Sydney
Australia
www.pwc.com/au
Telephone +61 2 8266 0000
Facsimile +61 2 8266 9999
Direct Phone 02 8266 8099

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

27 July 2009

Dear Kevin

ITC 20 Request for Comment on IASB Discussion Paper DP/2009/1 *Leases - Preliminary Views*

I am enclosing a copy of the PricewaterhouseCoopers response to the International Accounting Standards Board's (IASB) Discussion Paper DP/2009/1 *Leases – Preliminary Views.* The letter reflects the views of the PricewaterhouseCoopers network of firms and as such includes our own comments on the matters raised in the Exposure Draft.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (02) 8266 8099 if you would like to discuss this further.

Yours sincerely

Wayne Andrews

Wayne Andrews
Partner
Assurance

k:\sara\wayne\pwc comments aasb itc 20.doc

Liability limited by a scheme approved under Professional Standards Legislation

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
400 Campus Dr.
Florham Park NJ 07932
Telephone (973) 236 4000
Facsimile (973) 236 5000
www.pwc.com

17 July, 2009

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

Technical Director - File Reference No. 1680-100
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Leases: Preliminary Views - Discussion Paper

Dear Sir or Madam:

We are responding to the invitation of the IASB/FASB ('the boards') to comment on the above-referenced Discussion Paper on behalf of PricewaterhouseCoopers. This response is based on the views of member firms of the PricewaterhouseCoopers network of firms that commented on the Discussion Paper. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We appreciate the opportunity to comment on the Discussion Paper. We agree with the Boards' objective to improve the accounting for leases, by enhancing transparency to the economics and comparability for users, and by reducing the complexity of the accounting model. The existing accounting model for leases has long been criticised for failing to meet the needs of financial statement users. We believe the proposed model addresses a number of these criticisms and advances the debate surrounding the accounting for leases.

We support the boards' objective to recognise the rights and obligations arising in a lease, and believe that the proposed right-of-use approach accomplishes this objective in a principled manner.

A simple lease

The boards describe in the Discussion Paper how, for a simple lease, both the right to use the asset and the obligation to pay rentals meet the definitions of assets and liabilities, respectively, and we agree that these definitions are met.

While we acknowledge that the 'whole asset' approach aligns the presentation of leasing decisions to those of buying decisions, we do not support this approach because it overstates assets and liabilities, particularly for short-term leases. A lessee has no right to the residual asset after the period covered by the lease. Accordingly, the lessee has no asset or liability corresponding to that residual portion of the underlying leased asset.

A complex lease

Many leases are more complex than a simple lease; they may include, for example, renewal options and contingent payments. Nevertheless, we believe that the rights and obligations under such leases that would be recognised under the proposed right-of-use model are consistent with the definitions of assets and liabilities. This is based on our belief that lease agreements involve an inextricable linkage between an asset and a liability under a single contract.

When a lessee gains possession of the leased property, the lessee acquires an asset: the service potential of that property. Once the lessee possesses the leased property, features of the lease contract that provide the lessee with the right to obtain additional benefits from the leased property increase the service potential under the control of the lessee. No other party, including the lessor, is in a position to obtain the benefits conveyed by that right so long as the lessee possesses the property and has the right to exercise the option. We therefore agree with the boards that the period covered by a renewal option should be included in the right-of-use asset recognised when the lessee expects to utilise the service potential inherent in the option. Furthermore, because the asset and liability are linked under a single contract, we agree that a liability should be recognised for all payments required under the lease in exchange for the service potential inherent in the recognised asset.

We note, however, that the Discussion Paper does not describe the basis for the conclusions that renewal options and contingent payments should be recognised. We recommend that the boards clearly explain their rationale in any subsequent exposure draft of a proposed standard.

PRICEWATERHOUSECOOPERS

Measurement and remeasurement

We believe that the lease should initially be recorded based on the best estimate of the lessee's expected cash flows, including the best estimates of expected lease term, contingent rental payments, and payments pursuant to guarantees. Because this approach results in recognising the portion of the service potential that the lessee expects to use, it generally will improve transparency by reflecting the best estimate of the economics of the lease. At the same time, starting with the best estimate of the expected outcome has the practical benefit of minimising both the need for and potential magnitude of future remeasurements and, thus, will be simpler for preparers to apply. As explained more fully in the appendix to this letter, in using the term 'best estimate,' we do not support either the 'most likely' or 'probability-weighted' approaches to estimation proposed by the boards.

Clearly, initial estimates will need to be reassessed, and liabilities adjusted, as new facts and circumstances come to light. As the boards appreciate based on their deliberations, there is no easy answer to the question of where the offset to adjustments to the lease liability should be recorded. The boards discussed two alternatives in the context of contingent rentals: taking all adjustments to either the right-of-use asset or profit and loss. Speaking more broadly to all changes in estimates, a third alternative would be some sort of mixed model. Based on our analysis, valid arguments can be made in support of each of these alternatives, but other equally valid arguments and real-world fact patterns raise legitimate concerns about each.

We have concluded that recognising all changes in estimates as adjustments to the carrying value of the right-of-use asset would best balance the many conceptual and practical issues and concerns. As discussed in more detail in our answer to Question 20, we believe that this approach (i) is consistent with the boards' decision to measure the asset at cost rather than fair value, (ii) appropriately reflects the linkage between the asset and liability that exists in a lease contact, (iii) is consistent with existing depreciation and amortisation standards where, absent impairment issues, changes in estimate are accounted for prospectively, and (iv) would obviate the need for detailed rules regarding which changes should be recognised as an adjustment to the carrying value of the asset and which should be recognised in profit or loss.

Scope

We believe that the scope of a new lease accounting standard should include any arrangement that permits a lessee the right to use the service potential of an asset, regardless of whether that asset is tangible or intangible. The difficulty is determining whether a lessee has obtained the right to use an asset from a lessor or whether it has entered into an executory contract. Because including arrangements involving certain intangible assets in the scope of a new lease accounting standard would be a significant change in practice in some industries, we encourage the boards to explore the question of when an arrangement should be accounted for as a lease of an intangible asset or as an executory contract.

Many of the concepts explored in the Discussion Paper (such as contract boundary, control, and asset derecognition) are relevant for other projects that are currently on the boards' agendas. We believe that it is important that economically similar transactions be treated similarly, regardless of the project in which they are addressed. Accordingly, the fundamental principles in the Discussion Paper should be aligned to the extent possible with similar concepts in other projects, including projects dealing with revenue recognition, asset derecognition, and accounting for insurance contracts.

A single, comprehensive standard

We appreciate that many of the criticisms of the existing lease accounting model relate to the lessee's accounting treatment, rather than the lessor's (although we understand that users also have some concerns about the current lessor model, such as the lack of transparency of residual value risk). Nevertheless, because of the unique nature of a lease arrangement, where both lessee and lessor have a claim to the underlying asset, we believe that the boards should address the accounting for lessees and lessors in a comprehensive fashion. We do not believe it is prudent to separately address the accounting by lessors. As is often the case with developing an accounting model, the unintended consequences of an isolated decision are most likely to be detected when a model is reviewed comprehensively, as opposed to a piecemeal approach. For lessor accounting, this requires consistency not only with lessee accounting but also with some of the issues debated by the boards in the other projects mentioned above.

* * * * *

Our answers to the specific questions in the Discussion Paper are attached in the appendix to this letter.

We would be pleased to discuss our comments or answer any questions that the boards may have. Please contact Richard Keys (+44 20 7212 4555), Michael Gallagher (+1 973 236 4328), John Gribble (+1 973 236 7215) or Peter Hogarth, (+44 20 7213 1654) regarding our submission.

Yours faithfully,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

PRICEWATERHOUSECOOPERS

APPENDIX

Detailed responses to the questions in the Discussion Paper

Question 1
The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach?
If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

As the boards are aware, the scopes of the existing standards on lease accounting are different, and the boards should reconcile those differences.

Conceptually, all rights to use an asset should be within the scope of a leasing standard, regardless of whether the underlying asset is tangible or intangible. On balance, we believe that IAS 17, which includes within its scope certain leases of intangible assets, represents a preferable starting point for a converged standard. However, IAS 17 excludes the following from its scope:

- Leases to explore for or use minerals, oil, natural gas, and similar non-regenerative resources.
- Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents, and copyrights.

We believe that the scope of a new lease accounting standard should include any arrangement whereby a lessee obtains the right to use the service potential of an asset. The difficulty is determining whether a lessee has obtained the right to use an asset from a lessor or whether it has entered into an executory contract. Because including arrangements involving certain intangible assets in the scope of a new lease accounting standard would be a significant change in practice in some industries, we encourage the boards to explore the question of when an arrangement should be accounted for as a lease of an intangible asset or as an executory contract.

Additionally, unlike the U.S. standard, the international standard currently excludes investment properties from its scope. We support excluding investment properties, if they are accounted for at fair value, from the scope of a leasing standard, because we believe that fair value information about investment properties is more relevant and useful for users and, therefore, that it would be a step backward to remove fair value accounting for investment properties.

Finally, the boards should ensure that guidance similar to that contained in ASC 840-10-15-6 through 15-21 (EITF 01-8) and IFRIC 4 is included within the scope of any new standard. The boards may find it appropriate to redeliberate that guidance to ensure that it is conceptually consistent with the guidance in any new standard. For example, should a purchaser account for a supply arrangement as a lease if it takes substantially all of the expected output of a specific asset? Does the purchaser have an obligation arising from past events and has the supplier in that example already met its performance obligation? Is the 'substantially all' threshold to determine if an arrangement contains a lease consistent with the proposed right-of-use approach?

Currently, preparers often do not regard as critical the distinction between the lease and non-lease elements of an arrangement, if the consideration payable is contingent, because the accounting for those elements may be similar. Under the boards' proposed approach where, for example, a lease asset and liability would be recognised, the accounting for the lease element and the non-lease element will diverge. We believe that the distinction between a service arrangement and a lease may become the new 'bright line' around which some transactions may be structured. (See also Question 24(d) for additional comments related to this guidance.)

Question 2
Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why.
Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

We believe that it would be difficult to establish workable exclusions for either non-core assets or short-term leases that would be objective and promote comparability. As noted by the boards, some short-term leases and some leases of non-core assets may be immaterial to the lessee, and we believe that it will be sufficient to approach such items under existing principles regarding materiality.

A new leasing standard would presumably not apply to immaterial items, but the boards may want to (i) provide explicit guidance about high volumes of low-value leases (that is, groups of similar leases that are immaterial individually but material in the aggregate) and (ii) consider whether some lease terms are so short that a practical exclusion could be provided.

Question 3
Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

Yes, we agree with the boards' analysis.

Question 4
The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:
(a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)

(b) a liability for its obligation to pay rentals.
Appendix C describes some possible accounting approaches that were rejected by the boards.
Do you support the proposed approach?
If you support an alternative approach, please describe the approach and explain why you support it.

We support the proposed approach. We agree with the boards that the rights and obligations that arise in a simple lease meet the characteristics of assets and liabilities, respectively. As a result, we believe that the proposed 'right-of- use' approach would provide a better underpinning for a new standard than the alternative approaches the boards considered and rejected.

We agree with the boards' rejection of the 'whole asset' approach. While the 'whole asset' approach would align the presentation of lease assets and liabilities with the presentation of purchased assets and the related liabilities, we agree with the boards that it would overstate assets and liabilities, especially for short-term leases. A lessee has no right to the residual asset absent a renewal option or a purchase option. Accordingly, the lessee has no asset or liability corresponding to that residual portion of the underlying leased asset.

We believe that the 'executory contract' approach is flawed because it would continue to support off-balance sheet treatment for rights and obligations that we agree are assets and liabilities. In a simple lease, a lessor fulfills its performance obligation upon transferring the leased asset to a lessee, so that the lessee's obligation to pay rentals should be recognised as a liability. We acknowledge, however, that this raises questions regarding the existence of performance obligations that need to be addressed by the boards in their deliberation of lessor accounting and in their revenue recognition project.

Question 5
The boards tentatively decided not to adopt a components approach to lease contracts.
Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:
(a) a single right-of-use asset that includes rights acquired under options
(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.
Do you support this proposed approach? If not, why?

Yes, we agree with the boards' conclusion. A components approach would not faithfully portray the interdependency of the contractual rights and obligations, nor is it likely to be understood by financial statement users because market participants normally regard a lease contract as a single unit of account. Furthermore, a components approach would present a variety of difficulties for preparers and users that would not necessarily improve the accounting. For example, determining the fair value of renewal options would be very difficult and may not provide useful information to users. An out-of-the-money renewal option may have minimal value under a components approach even though the lessee expects to exercise the option for entity-specific reasons (for example, implicit penalties arising from a loss of potential business).

As stated in our cover letter, lease agreements are unique in that the asset and liability are inextricably linked under a single contract. Just as we believe that the asset cannot be considered to the exclusion of the liability, we believe that potential components cannot be considered in isolation. The lessee is acquiring the service potential of the leased asset over the lease term in exchange for payments specified in the lease contract. A lease renewal option is not a financial asset; it cannot be separated from, and can be settled only through use of, a non-financial asset over time. Likewise, as discussed further in our response to Question 11 below, a renewal option does not represent a standalone financial liability.

Question 6
Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?
If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

Although fair value measurement of lease liabilities may have conceptual appeal, we agree with boards that the present value approach, using the incremental borrowing rate, is preferable. While the implicit rate is known in certain leases, adopting a single convention is more practical and better supports comparability.

Question 7
Do you agree with the boards' tentative decision to initially measure the lessee's right of use asset at cost?
If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

We support the boards' preliminary view. We believe that the measurement of the lessee's right-of-use asset should be consistent with the initial measurement of other non-financial assets. See also our response to Question 5 regarding the impracticality of measuring the right-of-use asset associated with a complex lease at fair value.

Question 8
The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset.
Do you agree with this proposed approach?
If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

We agree with the boards' views. We believe that the accounting for right-of-use and owned assets should be aligned. In addition, while lease liabilities are different than standalone financial liabilities, we believe that it would be helpful to users if they were measured similarly.

Question 9
Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

Although we do not object to allowing the option to measure the obligation to pay rentals at fair value, subject to the same conditions as set out in existing standards, we believe it would be difficult (for the reasons set forth in our response to Question 5) for financial statement preparers to apply and for users to understand. Therefore, we expect preparers would rarely apply a fair value option.

Question 10
Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.
If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

As noted in our response to Question 8 above, we believe that lease liabilities should be measured similarly to standalone financial liabilities which, absent a fair value election, would not be subsequently adjusted for changes in the borrower's incremental borrowing rate. If the boards do decide to require reassessment of the incremental borrowing rate, we would recommend reassessment only upon a change in estimated cash flows.

Question 11
In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.
Do you agree with the proposed approach taken by the boards?
If you disagree, please explain why.

We agree with the boards' approach. Notwithstanding our view that it would be helpful for them to be measured similarly (see our responses to Questions 8 and 10 above), lease obligations are not the same as standalone financial liabilities. Substantive differences exist, including the inextricable linkage to the right-of-use asset under a single lease contract; the characteristics of a complex lease, such as contingent rentals, renewal options, purchase options and residual value guarantees; and the lack of a market for similar liabilities.

Question 12

Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.

Would you support this approach? If so, for which leases? Please explain your reasons.

We do not support this approach. Recognising the decrease in the right-of-use asset as something other than amortisation or depreciation would be inconsistent with the conclusion reached for recognising that right as an asset. Furthermore, the 'rent' described in the question would differ from 'rent' as contemplated in existing standards, where it includes both a cost recovery component and a financing component. To refer to the cost recovery component alone as rent could potentially be misleading.

Question 13

The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, i.e. in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals.

The boards tentatively decided that the lease term should be the most likely lease term.

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

We believe that renewal options should be included in the lease term, at a term that is contractually possible[1], but not through the 'most likely lease term' approach specifically proposed.

We agree that the right to use the asset and the obligation to pay rentals meet the definitions of assets and liabilities not only for the non-cancelable term, but also for periods covered by renewal options expected to be exercised. This is based on our belief that lease agreements are unique in that the asset and liability are inextricably linked under a single contract. Some think about a lease starting with the asset and others start with the liability, but neither can be considered to the exclusion of the other. Our thinking starts with the asset. When a lessee gains possession of the leased property, the lessee acquires an asset: the service potential of that property. Possession, along with the right to obtain benefits under the lease, gives the lessee control over the asset's service potential. While we acknowledge that an option differs from a commitment, no other party, including the lessor, is in a position to obtain the benefits conveyed by that right so long as the lessee possesses the property and has the right to exercise the option. We therefore agree with the boards that the period covered by a renewal option should be included in the right-of-use asset recognised when the lessee expects to utilise the service potential inherent in the option. Furthermore, because the asset and liability are linked under a single contract, we

---

[1] For example, for a lease with a five-year initial term and a single three-year renewal option, the only 'contractually possible' lease terms are five and eight years.

agree that a liability should be recognised for all payments required under the lease in exchange for the service potential inherent in the recognised asset.

Accepting this premise, we support recognition based on the best estimate of the expected lease term. While some may argue that applying a probability threshold better aligns with the characteristics of assets, we agree with the boards that there is no conceptually correct probability threshold to apply. Absent a conceptually correct threshold, a best estimate approach would be most consistent with the expected economics of the lease. At the same time, starting with the best estimate of the expected outcome has the practical benefit of minimising both the need for and potential magnitude of future remeasurements. Therefore, we believe that periods covered by renewal options should be included in the lease term when the lessee's best estimate is that it will utilise the service potential inherent in the option.

All relevant facts and circumstances should be considered in determining the lease term, including contractual, non-contractual, and business factors. There are often valid economic reasons underlying a lessee's 'intentions and past practices.' Proscribing consideration of past practices may have the unintended consequence of suggesting to lessees that they may ignore the underlying economics.

We support this approach knowing that it may present practical difficulties in the case of some leases. For example, we are aware of some real estate leases in Europe where a lessee has a statutory right to renew every three years in perpetuity. While the initial lease period may appear short, a lessee may sometimes retain the property for many decades. Making a best estimate of such a lease term will be challenging. When one also considers the proposed accounting for contingent rentals (see our response to Question 20), we can understand why many property lessees are concerned by the boards' preliminary views.

Question 14

The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

We agree with the boards' preliminary view that initial estimates should be reassessed based on new facts or circumstances. In light of our view that measurements should be based on best estimates, we believe that estimates of the lease term should be reassessed if changes occur in the circumstances upon which the estimate was previously based, or as a result of new information or more experience, and not necessarily at each reporting date. (If, however, a new standard were to adopt the 'most likely lease term' approach, we believe that more frequent reassessment would be appropriate because the most likely lease term (that is, the mode) will differ more often from the actual service potential by the lessee.)

As discussed in our cover letter and in our response to Question 20, we believe that all changes in the estimated lease term and cash flows should be recognised as an adjustment to the carrying value of the right-of-use asset. A change in estimated lease term is perhaps the least controversial because the adjustment clearly reflects an expected change in the portion of the asset the lessee will have the right to use.

Reassessing and truing up ensures that reported amounts always reflect best estimates based on current facts and circumstances. In addition, reassessing the lease term would be beneficial for users as this may signal a change in management views regarding plans for the business. For example, an across-the-board reduction in expected lease terms might indicate uncertainty about trading prospects or plans to purchase assets in the future.

Question 15

The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease.
Do you agree with the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

We agree that purchase options should be accounted for in the same way as options to extend or terminate the lease. (See our response to Question 13 above.)

Question 16

The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements.
Do you support the proposed approach?
If you disagree with the proposed approach, what alternative approach would you recommend and why?

As noted in our cover letter and in our response to Question 13 above, we agree that the right to use the asset and the obligation to pay rentals meet the definitions of assets and liabilities, even for more complex leases containing, for example, renewal options or contingent payments. Because the asset and liability are inextricably linked under a single contract, payments required under the lease in exchange for the service potential should be recognised. For example, a lease with a fixed two percent annual increase in rentals should be accounted for similarly to one with a cost of living inflator (for example, CPI) and an expected annual inflation rate of two percent.

We also note that this approach is consistent with the current treatment of contingent payments attached to debt instruments under IFRS.

Question 17

The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.
Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

As noted previously, we support a 'best estimate' approach. We would support a probability-weighted calculation only when it results in an amount that the lessee may actually pay. Unlike renewal options, where a probability-weighted approach can result in a term that is not contractually possible, contingent rentals typically have a continuum of possible outcomes. In these and similar circumstances, a probability-weighted calculation could provide the best estimate of the expected outcome.

Question 18

The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.
Do you support the proposed approach? Please explain your reasons.

No. As noted previously, we believe that the best estimate of contingent rentals expected to be paid should be included in the liability.

Question 19

The boards tentatively decided to require remeasurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.
Do you support the proposed approach? If not, please explain why.

Consistent with the treatment of changes in estimates generally and our response to Question 14, we believe that that initial estimates should be changed when warranted by new facts or circumstances.

Question 20

The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:
(a) recognise any change in the liability in profit or loss
(b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.
Which of these two approaches do you support? Please explain your reasons.

If you support neither approach, please describe any alternative approach you would prefer and why.

As we stated in our cover letter, there is no easy answer to this question. We believe that valid arguments support each of these alternatives, but other, equally valid arguments raise legitimate concerns about each.

Much depends on one's starting point. The boards concluded that the right-of-use asset should initially be measured at cost. Accordingly, some believe that changes in the estimate of cost should be recognised as an adjustment to the carrying value of the asset because, had foresight been perfect at the inception of the lease, that is the cost basis of the asset that would have been recognised. Others believe that cost is fixed at inception and that any changes in estimates of the lease liability, other than a change in the amount of service potential to be purchased, should be recognised in profit or loss. Supporters of a mixed model believe that different drivers of the change should lead some adjustments to be taken to the asset and others to profit or loss. We considered a number of mixed models, including the following:

- Usage-based model. Adjust the carrying amount of the right-of-use asset when the change in estimate relates to a change in the expected service potential of the leased asset to be consumed; otherwise, reflect the adjustment in profit or loss.
- Control-based model. Adjust the carrying amount of the right-of-use asset when the contingency is within the lessee's control; otherwise, reflect the adjustment in profit or loss.
- Period-based model. Adjust the carrying amount of the right-of-use asset when the change in estimate relates to future periods; reflect the adjustment in profit or loss if the change relates to the current period.

While there are arguments in support of each of these mixed models, it was difficult to associate each model with an overarching conceptual principle that would make sense if consistently applied to various types of leases. Moreover, as the examples below illustrate, our attempts to apply these models to a representative portfolio of common lease fact patterns led us to conclude that none was adequate in all scenarios.

We recommend an approach that would recognise all changes in the lease liability as adjustments to the carrying value of the right-of-use asset. This would apply not only to changes in estimates of contingent rentals, but also to changes in lease term (see our response to Question 14) and payments under residual value guarantees (see our response to Question 21).

In all cases, we believe that an adjustment to the right-of-use asset should be subject to existing standards for impairment and depreciation or amortisation.

The following examples illustrate why finding a simple answer to this question is so difficult.

Contingent rentals that increase based on a change in a stated index. Assume that a lease has a fixed term and payments that are fixed other than that they increase based on changes in a stated index. At inception, the lessee estimated that the index would increase two percent per year. The lessee now expects the index to increase three percent per year. In this example, the portion of the service potential of the asset expected to be used has not changed, but the amount that the lessee expects to pay has increased.

Those who support recognising all changes in estimate as an adjustment to the carrying value of the asset argue that this is a measurement issue only; the obligation existed at the inception of the lease and true-ups from estimate to actual should be recognised as an adjustment of the right-of-use asset. Supporters argue that the liability has always existed and, had the lessee had better foresight, it would have assumed a three percent per year change in index in measuring the initial cost of the asset.

Those who support recognising all changes in estimate as an adjustment to profit or loss believe that cost is fixed at inception and that subsequent market adjustments to the liability should be reflected in profit or loss.

Those who support a usage-based model where only those changes in estimate that reflect a change in the lessee's use of the asset should be recognised as an adjustment to the carrying value of the asset also would reflect this change in estimate in profit or loss.

Similarly, those who support a control-based model would recognise this change in estimate in profit or loss because it cannot be avoided.

Supporters of a model based on the period impacted would recognise the difference to date between actual and estimate in profit or loss, but defer the change related to future periods by recognising that portion of the change in the liability as an adjustment of the carrying value of the right-of-use asset. Supporters of this model believe that current results should not be affected by a change in the cost of the asset's use in future periods.

Contingent rentals based on percentage rent. Assume that a lease of a retail store includes rental payments that depend on the amount of the store's sales. At lease inception, consistent with the boards' preliminary views, the right-of-use asset recorded by the lessee included estimated percentage rents payable. The store has performed better than expected, however, and the lessee now expects its percentage rent will be higher than initially estimated.

Supporters of a usage-based model might recognise this change in estimate as a loss, arguing that any incremental consumption of the retail space due to the increased traffic that will drive higher sales will presumably be minor. On the other hand, if the leased asset were equipment, rather than real estate, supporters of a usage-based model might recognise the change in estimate as an adjustment to the carrying value of the asset, because more of the service potential of the leased asset has been acquired. Those who do not support a usage-based model believe that this example illustrates a flaw in that model. They believe that more or less usage clearly results in more or less wear on the equipment over a fixed term lease and they do not believe that the loss should be deferred by recognising the change in estimate as an adjustment to the carrying value of the asset.

Supporters of a control-based model might recognise the change in estimate as an adjustment to the carrying value of the asset to the extent that the lease permits the lessee to, for example, close the store and avoid the percentage rent payments. In our experience, most leases would preclude the store from 'going dark,' particularly if the percentage rent factor is expected to be significant. When that is the case, some might consider the contingent rentals to be unavoidable and, as a result, conclude that any change in the liability should be recognised as an adjustment to profit or loss under this model.

As in the prior example, supporters of a model based on the period impacted would recognise the difference to date between actual and estimate in profit or loss but defer the change related to future years by recognising that portion of the change in the liability as an adjustment to the carrying value of the right-of-use asset. Under that approach, an increased depreciation or amortisation expense would be recognised in future periods when the additional revenues are earned, although not necessarily in the same pattern.

Estimated lease term and contingent payment both change. Our experience indicates that relatively few leases are for fixed payments over a fixed period. Most contain a feature that will require estimation under the proposed right-of-use model, and many of those leases will contain more than one of these features (that is, both the lease term and cash flows may vary). Features often interact, sometimes in ways that are complementary and other times in ways that preclude them from being operational simultaneously. Because of these interactions, if a mixed model is followed, the standard will need to include guidance on what to do when estimates of more than one feature change at the same time. Should the change in estimate of one feature always be considered before another? If not, how should the combined impact be allocated when the sum of the parts does not equal the whole? We suspect that the guidance that would be necessary would require arbitrary decisions to be made as to which element to measure first, and represent rules instead of principles.

Consider, for example, a lease that includes both a renewal option and a residual value guarantee. At lease inception, the lessee neither expects to exercise the renewal option nor perform under the guarantee. After several years, however, the lessee concludes that, if it returns the leased asset at the end of the initial noncancelable term, it would have to perform under the residual value guarantee. The lessee now considers exercising the renewal option to be more attractive, because the incremental cost of renewing the lease (and continuing to benefit from the asset) versus returning the asset (and making a payment under the guarantee) is reduced. In this fact pattern, the required payment under the guarantee is a sunk cost and, considering the only two alternatives available to the lessee, the incremental cost of renewing the lease and continuing to benefit from the asset may now be a bargain.

In this example, several approaches could purport to reflect the substance of the transaction. Should the lessee recognise the increase in the lease liability as an adjustment to the carrying value of the right-of-use asset on the basis that the lessee has decided to purchase additional usage? Should the lessee recognise a loss for the full increase in the liability on the basis that the economics have deteriorated? Should the lessee attempt to split the adjustment by recognising the increased liability relating to the residual value guarantee as an immediate loss, and the remaining increase in the liability as an adjustment to the carrying value of the right-of-use asset? The decision of how to allocate the adjustment may be complicated further by considering whether the decline in residual value arises from (i) the lessee using the equipment more than originally contemplated, in which case a balance sheet adjustment may be more appropriate, or (ii) from a general market decline in the residual value of similar assets, in which case recognising a loss may be more appropriate.

We believe that recognising all changes in estimates as adjustments to the carrying value of the right-of-use asset would best balance the many conceptual and practical issues and concerns. This approach would obviate the need for detailed rules, that would likely be arbitrary, regarding which changes should be allocated to the carrying value of the asset and which should be recognised in profit or loss.

The boards have concluded that the right-of-use asset should be measured at cost, not fair value. Accordingly, we believe that remeasurement of the liability should be recognised by adjusting the cost of the right-of-use asset. This is consistent with the approach taken in ASC 410 (Asset Retirement and Environmental Obligations) to changes in estimates relating to the use of a non-financial asset and in IFRIC 1 to changes in estimates of decommissioning and similar liabilities. We contrast this with a model in which the asset was recorded initially at its fair value. In that case, it would be more appropriate to recognise subsequent changes in the liability in profit or loss.

The close linkage between the asset and the liability in a lease provides additional support for our recommended approach. This can be seen in the approach that the boards have chosen to measure the liability. The decision to include certain periods covered by renewal options in the lease term suggests that the asset to be valued is determined first; the liability recognised then follows from the determination of the asset. We agree with this approach. As noted in our response to Question 13, because the asset and liability are linked under a single contract, we agree that all payments required under the lease in exchange for the service potential should be recognised. We believe recognising all changes in estimates as an adjustment to the carrying value of the asset has more merit under this approach.

Recognising all changes in the liability in profit or loss would be more supportable (i) if the right-of-use asset were initially measured at fair value, (ii) if there were not a close link between the non-financial asset and the liability under a single contract, or (iii) if the liability were measured at fair value. Furthermore, like proponents of the various mixed models, we are troubled by recognising all changes in estimate in profit or loss, particularly those that reflect a change in the service potential of the leased asset that the lessee will consume; those that relate to variable payments that the lessee can choose to avoid; and those that relate to future, as opposed to past, periods.

We recognise that the model that we prefer is not without its flaws, especially, for example, where a payment is predicated on market changes. However, the carrying value of the right-of-use asset will be subject to existing standards for impairment and depreciation or amortisation of similar owned assets, which would mitigate these concerns. We also believe that this model is entirely consistent with existing depreciation and amortisation standards where, absent impairment issues, changes in estimate are accounted for prospectively through adjustments of depreciation or amortisation rates and/or the estimated residual value.

We also see practical benefits from this approach. The model we support will be familiar to preparers in that the impairment and depreciation or amortisation guidance will be the same as that applicable to assets that they own. In addition, the recordkeeping burden clearly will be less than any of the mixed models.

Question 21

The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives.
Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

We agree with the boards' proposed approach. Contingent rentals and residual value guarantees are too similar to be accounted for differently. Residual value guarantees, for example, typically protect a lessor from a decline in the fair value of the leased property resulting from two causes: (i) property-specific changes resulting from consumption or wear of the leased property and (ii) general market conditions relating to the leased property and similar assets. The property-specific aspect functions similar to a contingent rent for additional usage and should be accounted for in the same way. While some believe that payments arising from general market conditions should be treated as losses that should be recognised in profit or loss, it is impractical to distinguish between the two causes without creating rules. Therefore, we believe that remeasurement of a residual value guarantee should be recognised in the same manner as remeasurement of contingent rentals.

Question 22

Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons.
What additional information would separate presentation provide?

We agree with the IASB view that separate presentation is not required. Disclosure in the notes should normally suffice. Please see our response to Question 24(e) for additional suggestions regarding disclosure.

In addition, as explained in our response to Question 13 above, the approach to accounting for more complex leases with extension options may be viewed from the perspective of the asset or the liability, although neither can be considered to the exclusion from the other. However, if the liability is considered in isolation, there are strong arguments that a lessee has no obligation to make payments and hence no liability until an option to extend a lease is exercised. Even if the question of lease extension options is approached from the perspective of the asset, as we have done, the nature of the liability relating to the minimum lease term and to any term extensions is different. Notwithstanding our view, expressed above, that separate presentation of a lessee's obligation to pay rentals is normally not required, we suggest that the boards consider whether there may be circumstances in which the relative magnitude of the liability relating to term extensions is so great that separate presentation of those amounts may be necessary for an understanding of the lessee's financial position.

Question 23

This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position.
How should the right-of-use asset be presented in the statement of financial position? Please explain your reasons.
What additional disclosures (if any) do you think are necessary under each of the approaches?

We agree with the boards' preliminary view to present the right-of-use asset based on the nature of the leased item. We also agree that a lease conveys rights that are fundamentally different than outright ownership (for example, a lessee generally cannot sell the leased asset). As such, the rights derived under these contracts should be clearly distinguished in the notes to the financial statements from similar assets owned outright. Separate presentation on the face of the statement of financial position will normally not be necessary. We believe that existing standards on financial statement presentation provide adequate guidance as to when that may be the case, but the boards may want to consider whether, in certain circumstances, it may be appropriate to present right-of-use assets separately on the face of the statement of financial position.

We also encourage the boards to consider the implications of the selected presentation approach compared with the accounting models for owned assets, and be mindful of potential inconsistencies. Consider, for example, that intangible assets may be amortised in a manner that differs from how equipment may be depreciated. Also, we observe that IAS 16 uses a components approach for depreciation, while U.S. standards do not. It has been observed by some that lease accounting as described in the Discussion Paper would obviate the need for applying componentisation for depreciation purposes under IAS 16. We are not of that view.

Also, regarding 'in-substance purchases,' we believe that an understanding of the rights and obligations can be adequately conveyed to the users through robust disclosures of the principal provisions of the lease and, therefore, that there is no need to highlight 'in-substance purchases' through a separate disclosure requirement.

Question 24
Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

When the Discussion Paper was published, the boards had not yet discussed:

a. timing of initial recognition
b. sale-leaseback transactions
c. initial direct costs
d. leases that include service arrangements
e. disclosure.

Additional lessee issues include:

1. lease incentives
2. obligations related to lease-related executory costs
3. transition.

We recommend that each of these subjects be addressed in the project and express our views on each below.

a. Timing - We believe that lease recognition and measurement should occur when the lessee obtains control of the asset. This would usually occur when the leased asset is capable of being used by the lessee and would be consistent with other standards (for example, IFRS 3R and ASC 805 (Business Combinations)) and with the characteristics of an asset and liability. This would also be consistent with the boards' proposals for revenue recognition set out in their recent discussion paper.

b. Sale-leaseback transactions - We believe that the seller in a sale-leaseback transaction has only relinquished its right to the residual and that it has merely financed the portion of the asset it retained. Accordingly, the portion of the asset retained should not be remeasured. Consider, for example, if an entity sold an asset then leased it back for its entire remaining life. That sale should not result in recognition of a gain or loss; rather, the transaction should be accounted for as a financing. Similarly, a sale-leaseback that is, in essence, a financing of the retained portion of the asset should not result in recognition of a gain or loss. Only the residual portion of the asset should be derecognised, and the asset retained should not be remeasured.

Derecognition of the residual should be subject to other standards for revenue recognition. If a sale is not recognised, the entire transaction should be accounted for as a financing. If a sale of the residual is recognised, then both the transaction proceeds and the asset basis should be allocated between the financing and the proceeds from the sale of the residual.

We suggest that two approaches be considered for allocating the transaction proceeds:

i. Measure the proceeds relating to the financing using the new standard's guidance for measuring a lease obligation, and assign the remaining proceeds to the sale of the residual.
ii. Allocate transaction proceeds based on the relative fair values of the portion of the asset retained and the residual sold.

An advantage of the first approach is that it does not require any additional guidance. However, while a lessee in an ordinary lease begins its accounting with a recognition decision, a lessee in a sale-leaseback transaction begins its accounting with a derecognition decision. Accordingly, the resulting asset and liability in a sale-leaseback may be different than the asset or liability recognised in a comparable lease because a seller-lessee may not be able to recognise a sale of the portion of the asset covered by a renewal option.

Consider, for example, a lease for a building with a 30-year remaining useful life, and the lease has a five-year non-cancelable lease term and a five-year extension option. The lessee may conclude that its best estimate is that it will lease the building for five years and, in an ordinary lease, recognise a liability for the obligation to pay rentals for five years and record a corresponding right-of-use asset. If, however, the transaction were a sale-leaseback, the lessee would derecognise only the residual sold, corresponding to the final 20 years of the asset's useful life (not 25 years), as it retains the unilateral right to use the asset for ten years. Some would accept these differences because sale-leaseback transactions differ inherently from ordinary leases in that the whole asset was already on the balance sheet prior to a sale-leaseback. Furthermore, a larger obligation also means a lower gain, which some might feel is appropriately conservative.

Supporters of the second approach believe that the sale proceeds and rents should be at 'market' rates. For example, in the lease model, the obligation would include an initial estimate of contingent rentals. For allocation purposes, it may make more sense to use fixed-equivalent rents to determine the obligation in order to limit the risk of overstating the gain (notwithstanding that, for purposes of measuring a right-of-use asset, the boards acknowledged that it is difficult to determine the fair value of a lease contract).

c. Initial direct costs - As we mention in our response to Question 8, we believe that the accounting for right-of-use and owned assets should be aligned and, while lease liabilities are different than standalone financial liabilities, we believe that it would be helpful to users if they were measured similarly. Our views on initial direct costs are consistent with this thinking. Accordingly, we believe that initial direct costs should be accounted for under existing models for asset acquisition costs and debt issuance costs, as appropriate. Costs that directly relate to the asset acquisition should be accounted for as asset acquisition costs and the remainder should be accounted for as debt issuance costs. We note that similar allocation judgments are performed, for example, when a company concurrently issues debt and equity or concurrently enters into a business combination and related financing.

d. Leases that include service arrangements - Assuming that the guidance in ASC 840 regarding Arrangements that Qualify as Leases (EITF 01-8) and in IFRIC 4 are retained (see our response to Question 1), the boards might take this opportunity to clarify that guidance.

   Areas where we believe that there is currently diversity in practice and which the boards might clarify include:

   i. Whether such arrangements may also contain a financial derivative associated with the leased asset.
   ii. What is meant by the term 'output.'
   iii. Whether 'output' is measured in terms of volume or value in assessing an 'insignificant amount.'
   iv. How to interpret the word 'fixed' in determining whether 'the price that purchaser (lessee) will pay for the output is... contractually fixed per unit of output....'
   v. How consideration should be allocated between the lease element and the non-lease elements.

We believe that these differences should be addressed and guidance converged.

e. Disclosure - Good disclosure should provide users with information regarding the significant assumptions the preparer used to develop its accounts and their sensitivity to change. It should also provide information distinguishing unavoidable payments from payments that the lessee has the discretion to avoid. This may be accomplished by providing the following:

- Significant amounts and line items of lease-related balances included in the balance sheet and income statement.
- Major categories of leased assets (for example, real estate or equipment).
- A table presenting lease-related assets and liabilities by:
  - Current lease term - fixed payments
  - Current lease term - contingent payments
  - Extension terms - fixed payments
  - Extension terms - contingent payments
- Descriptions of residual value guarantees and the related exposures.
- The weighted average discount rates of recorded lease liabilities.
- Amounts recorded in the period resulting from changes in assumptions. This may be accomplished by presenting a roll-forward of balances, supplemented by qualitative disclosure of the significant causes of changes. We believe that disclosing remeasurements encourages preparers to use the most accurate estimates possible.

1. Lease incentives - While incentives in the form of a reduced rental could be reflected in the measurement of the right-of-use asset and lease obligation, other incentives (such as leasehold improvements or settlement of preexisting lease commitments) would need to be addressed. Similarly, the boards should consider the corollary whereby a new tenant makes payments to an existing tenant upon entering into a lease ('key money').

2. Executory costs - A new standard should provide guidance related to allocation and accounting for executory costs and costs for services and taxes paid by the lessor.

3. Transition guidance - While we would not expect the boards to address transition guidance at the Discussion Paper stage, they will need to consider how a future leasing standard is introduced.

   Considering the passage of time since the inception of many longer-term arrangements, preparers may find that certain information that would have been utilised at inception may no longer be available and, accordingly, more pragmatic transition approaches may be appropriate. Preparers will need time to address the potential changes to financial statement presentation and certain metrics, including many that tie directly into debt covenants or compensation arrangements. While the practical simplicity of recognising an equal asset and liability upon adoption is appealing, it would only reflect the economics of the transaction when the cash flows are fixed and ratable over the lease term. Similarly, there may be other assets or liabilities on the balance sheet relating to operating leases (for example, resulting from lease incentives) that need to be considered in the transition guidance.

While we previously addressed concerns related to ASC 840 regarding Arrangements that Qualify as Leases (EITF 01-8) or IFRIC 4 above and in our response to Question 1, we note that those interpretations themselves had different transition arrangements, which may need to be reconciled in a converged standard.

Finally, the boards should consider providing transition guidance for existing capital (finance) leases that considers the cost/benefit of applying new, inherently subjective estimates to items that are already recorded on the lessee's balance sheet.

Question 25
Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

For a simple lease, we believe that a lessor has a symmetrical asset to the liability recognised by the lessee. For a more complex lease, however, that may not always be the case. For example, when a lessee has an option to renew a lease, it is more difficult to justify recognition of an asset by the lessor.

Similarly, the boards will need to deliberate the treatment of contingent rentals. We note that the boards have recently discussed uncertain consideration in connection with the revenue recognition project. We believe it is important that the boards address measurement of contingent rentals by lessors at the same time they deliberate the measurement of contingent revenue arising from other contracts.

Question 26
This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor or (b) recognition of a performance obligation by the lessor.
Which of these two approaches do you support? Please explain your reasons.

We support derecognition of the leased item, with the portion of the asset transferred to the lessee shown as a financing receivable and the residual value of the asset shown as a separately identified non-financial asset. We do not believe that grossing up the balance sheet will provide meaningful information to users. Our preferred approach is consistent with the boards' rationale in supporting the right-of-use model, and rejecting an executory contract model, in that the lessor does not have a performance obligation.

Some of the concepts that are relevant for lessor accounting arise in the boards' project on revenue recognition and the IASB project on derecognition. As the boards make progress on these projects, as well as leases, it is important that consistent conclusions are reached.

Question 27
Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

Yes. While we believe that the revenue recognition project should provide the framework to address this matter, it is important that the boards acknowledge the importance of this matter for both projects. If the criteria for recognising revenue have been met, we can see no conceptual justification for not recognising revenue solely because the service potential of the underlying asset has been conveyed to the counterparty by way of a lease as opposed to an outright sale.

Question 28
Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

No, when measured at fair value. IAS 40 provides for an election to account for investment property under cost methods or at fair value and IAS 17 excludes from its scope property leasehold interests when the lessee accounts for the property as investment property at fair value under IAS 40. (As noted in our response to Question 1 above, U.S. GAAP currently has no equivalent investment property classification and, in turn, no exclusion within its leasing standard.) In general, we believe that fair value accounting for investment property provides users of financial statements with more decision-useful information. We further believe that it would be a step backward to change in any way the fair value accounting for investment properties. Accordingly, investment properties should be excluded from the scope of a new leasing standard when measured at fair value.

Question 29
Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

See our response to Question 24 regarding lessees.