The 100 Group
Financial Reporting Committee

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

18 September 2013

Dear Hans,

Exposure Draft – Leases ED/2013/6

I am pleased to submit The 100 Group's comments on the above proposals.

Who we are

The 100 Group is a non-political, not-for-profit organisation which represents the finance directors of the UK's largest companies, with membership drawn mainly, but not entirely, from the constituents of the UK FTSE100 Index. Our aim is to contribute positively to the development of UK and International policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. The views expressed in this letter are not necessarily those of our individual Members or their respective employers.

Background

In our comments on the Discussion Paper published in March 2009 and the initial Exposure draft published in August 2010, we made the point that the majority of the Board's constituents do not see the need for any radical reform of lease accounting. While we recognise that the existing standard, IAS 17 'Leases', is far from perfect, it is long-established and well-understood by both preparers and users of financial statements. We believe that the Board should have focused its efforts elsewhere. Nevertheless, the Board seems to be driven by an overwhelming desire to have all lease obligations recognised as a liability on the balance sheet. While this was of particular importance to your predecessor as Chairman, we had hoped that you would take the opportunity to defer or drop the project when you became Chairman in 2011.

As the Board will appreciate, its work on the conceptual framework is clearly relevant to a number of aspects of the leasing project, not least the definition of assets and liabilities. We would encourage the Board to defer finalisation of any new leases standard until it has completed its revisions to the conceptual framework.

As it seems inevitable that there will be significant change in the required accounting for leases, our objective now is to seek to ensure that the changes make sense (for we, as Finance Directors, are the ones who will have to explain the new accounting to our commercial colleagues) and, above all, are workable in practice for companies with significant lease portfolios. With that in mind, we welcome the revised proposals to the extent that the Board has addressed many of the concerns raised by The 100 Group and other commentators; notably, improved internal consistency (for example, between term

extension and purchase options) and removal of some of the ambiguity (for example, probabilistic average lease and variable payments). We believe, however, that the revised proposals have not gone far enough.

The proposed accounting model

No longer a single approach
We understood that the Board's objective was to have a single approach to accounting for all leases that would replace the long-established distinction between finance leases and operating leases. Under the revised proposals, leases could in fact be accounted for in *three* different ways, depending on whether they a categorised as Type A or Type B (on balance sheet) or have a term of less than 12 months (off-balance sheet).

Comparability under threat
We recognise that one of the Board's most important objectives is to achieve comparability between the financial statements of different companies. We note, however, that the definitions of Type A and Type B leases, is based on terms including 'insignificant', 'the major part' and 'substantially all'. We expect that the use of such highly judgemental terms in the definitions will lead to much greater diversity in the treatment of commercially similar leases than is the case under the existing standard, IAS 17 'Leases'. We also believe that the definitions of Type A and Type B leases, together with the different treatment of leases that have a term of less than 12 months will give rise to structuring opportunities.

Distinction between Type A and Type B leases
We recognise that some of the Board's constituents, in particular those in the property industry, found the 'front-end loading' of the overall lease expense to be unpalatable. We therefore understand the reasons why the Board has suggested the distinction between Type A and Type B leases but we are concerned that this fails one of the Board's principal objectives that its standards should be principles-based.

We understand that the default position is that that only property leases will be classified as Type B while all other leases are Type A. We believe that this important distinction should not be based primarily on the nature of the asset (i.e. property versus other assets) but that it should be principles-based. While it is true that some non-property leases could be classed as Type B this is only possible if the lease term is for an *insignificant* part of the total economic life of the underlying asset or the present value of the lease payments is *insignificant* relative to the fair value of the underlying asset. We note that the Application Guidance does not discuss the meaning of insignificant but the use of the word in English generally implies a low level of, say, less than 10%. In practice, therefore, many leases of plant and equipment that are currently classified as operating leases will be classified as Type A.

Furthermore, the mechanism that would be used to spread the overall lease expense of a Type B lease on a straight-line basis over the lease term is undoubtedly rather contrived. It is certainly not principles-based. We believe that if a right of use asset is to be recognised it should be amortised such that the use of the asset by the lessee is recognised in profit or loss.

What do we suggest?

We would prefer that the Board drops its proposals, but we suspect that this is unlikely. We have therefore sought to find a way in which the Board can meet its objective of having all lease obligations recognised on the balance sheet whilst minimising the additional cost to preparers.

Whilst we understand that the Board is keen to avoid using the terms 'finance lease' and 'operating lease', we believe that a useful principle on which to base the distinction between

Type A and Type B is whether the lease is in substance financing in nature or operating in nature. We are aware that some commentators have suggested that the Board retains the definitions of finance lease (for Type A) and operating lease (for Type B) that are contained in IAS 17 'Leases'. We support that suggestion but we recognise that the Board may find this difficult and may need to develop alternative terminology.

Assuming that the Board adopts this approach, we would like to suggest further amendments to the proposals that would simplify and make more consistent the accounting for all types of leases. For a Type B (operating) lease, the only significant difference between the established and the proposed accounting would be that a liability and an asset would be recognised on the balance sheet.

As the substance of a Type A (finance) lease would be financing, the accounting for Type A leases should feature a finance expense (similar to the accounting for finance leases today)

As the substance of a Type B (operating) lease would not be financing, the accounting for Type B leases should not feature a finance expense. In practice, this would mean simply that the lease rentals would be recognised as an *un*discounted liability and there would be an equal right of use asset that would be amortised against operating profit over the lease term. Provided disclosure of the maturity of the Type B lease rentals is required to be presented in the financial statements (similar to the disclosure of future operating lease rentals today), users of financial statements would have the information necessary to make the same adjustments in relation to the Type B leases as they do at present in relation to operating leases.

We further suggest that leases with a term of less than 12 months should be accounted for in the same way as Type B leases (lease rentals would be recognised as an *un*discounted liability and there would be an equal right of use asset that would be amortised against operating profit over the lease term).

We believe that our suggestions have the following advantages:

- Meet the Board's objective of having *all* lease obligations recognised as liabilities.
- Accounting for lease contracts would continue to reflect their commercial substance.
- Reduce incentive and opportunity for structuring compared with the current proposals.
- Greater consistency between companies of accounting for commercially similar leases compared with the current proposals.
- More workable in practice for companies with significant lease portfolios.

Costs outweigh benefits

We acknowledge that the Board has given some consideration to the relative costs and benefits of the proposals. However, we are not convinced that the Board really appreciates the magnitude of the implementation and ongoing costs, especially for companies with significant portfolios of leases over plant and equipment that are currently classified as operating leases.

For many companies, new systems and processes will need to be introduced to calculate the appropriate accounting entries for both Type A and Type B leases (in particular, the calculation of the initial lease obligation and the ongoing finance expense). It will also be necessary to undertake significant staff training and there is also likely to be an increase in audit costs.

We are mindful that this would create another example of a situation where significant effort is required not to meet any commercial purpose but solely to comply with a theoretical accounting construct (other examples include hedge accounting and accounting for share-based payments). Indeed, it may be necessary to maintain separate accounting records for compliance with local tax rules.

Under the Board's proposals, additional costs will arise not just on initial adoption of the proposals or on inception of a new lease. Many leases are not 'plain vanilla' in nature and any variable elements will require regular re-assessment under the current proposals, presenting many businesses with a significant operational challenge. While the changes to the proposals in relation to optional renewal periods and variable lease payments are helpful, there will still be a burden that will add time and costs.

We contend that these costs would be significantly reduced if the Board were to adopt our suggested approach to the accounting for Type B (operating) leases and leases with a term of less than 12 months becuase the accounting would simply be based on the future lease rentals.

Portfolio approach

We are particularly concerned about the disproportionate cost for large portfolios of relatively insignificant individual leases. We note that the transitional arrangements permit a portfolio approach for leases with similar characteristics (paragraph C9). We recommend that a portfolio approach should be permitted on an ongoing basis for such leases. It would, further, be helpful if the Basis for Conclusions considered materiality for lease portfolios as well as individual leases.

Taxation

In the UK and elsewhere, there is a strong relationship between the accounting treatment and taxation of leases.

If there are no consequential changes in tax legislation locally (or if there is a period between the change in the accounting rules and local tax rules), it will be necessary for companies to maintain separate accounting records for tax purposes. We believe that this would add to the cost burden and is likely to cause widespread confusion.

Changes to lease accounting could lead to higher tax costs for lessors that would be passed on to lessees, again resulting in higher costs.

Presentation and disclosure

We made clear in previous comment letters our concern that the disclosure requirements in IFRSs continue to increase inexorably. We support efforts to cut clutter in financial statements. While we therefore support the Board in suggesting that entities "shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of these disclosures", we are concerned that in practice preparers will come under pressure to add pages of disclosure to already weighty financial statements without clear, additional benefits to users.

We therefore recommend that the Board emphasises that separate reconciliation of right of use assets and lease obligations is required only for those leases, or categories of leases, that are individually material to the entity's financial statements.

Transition

We are concerned that the Board has not given an indication of when any new standard would become mandatory.

We would like to stress that for many companies, the implications of the Board's proposals for systems, processes and training necessitate a significant lead-time between the publication of the final standard and its implementation. Many companies are likely to need new or updated lease accounting modules for their accounting systems, and the software vendors will need time from the finalisation of the standard to develop these modules. Companies will then need time to assess, select, install and train users in these systems.

For SEC registrants and other companies that are required to present two comparative periods in their financial statements, the time pressure will be even greater because the beginning of the first comparative period will be one year earlier than for companies that are required to present only one comparative period in their financial statements.

As we are nearly into 2014, we do not believe that it would be realistic for the Board to require mandatory adoption before 2018.

Length and complexity

We have consistently expressed the concern that accounting standards are becoming too complex. In this context, we would ask the Board to reflect on why it feels it necessary to replace a standard that runs to 30 pages with one that runs to over 250 pages.

We would also ask the Board to reflect on whether the draft standard is written in such a way that that it will be readily understandable by those whose first language is not English and will readily translate into other languages.

Conclusion

We do not believe that the costs to preparers of adopting the current proposals are outweighed by the benefits to the users of financial statements. While the current proposals are in some respects an improvement on the previous proposals, we are unable to support the proposed differentiation between Type A and Type B leases.

We would prefer that the Board drops the proposals but, if this is not an alternative, we consider that the proposals are in need of further overhaul before they can be adopted as a workable accounting standard. We have suggested an alternative approach that we would be pleased to explore further with the Board.

Finally, if the Board continues with this project, we believe that it should commit to a realistic timetable that will enable orderly implementation of the new accounting standard.

Please feel free to contact me if you wish to discuss our comments on the proposals.

Yours sincerely

Chris Lucas
Chairman
The 100 Group - Financial Reporting Committee