



**The Hundred Group**  
of Finance Directors

## **Financial Reporting Committee**

David Humphreys  
Practice Fellow  
International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

24 December 2010

Dear David

### **Exposure Draft – Leases**

We are pleased to submit our comments on the above proposals.

### **Who we are**

The Hundred Group represents the views of the finance directors of the UK's largest companies drawn largely, but not entirely, from the constituents of the FTSE100 Index. Our members are the finance directors of companies whose market capitalisation collectively represents over 80% of that of companies listed on the London Stock Exchange. The views expressed in this letter are not necessarily those of all of our individual members or of their respective employers.

### **Summary**

We set out our responses to the Board's specific questions in the Appendix to this letter.

We welcome the opportunity to provide comments on this exposure draft and in particular to contribute to the development of a new approach to lease accounting where aspects of the existing accounting have been subject to some criticism, particularly lessee accounting. In addition, we welcome the combined consultation by the IASB and FASB and the considerable outreach activities that the Board members have undertaken when deliberating their approach.

We continue to support a 'right of use' model for lessee accounting and the recognition of the associated assets and liabilities. We agree that this will provide a more consistent approach to accounting for leases and will be more aligned with current investor practice whereby investors typically make adjustments for assets held under operating leases when analysing the financial performance and position of our companies.

We have considerable concerns over some aspects of the Exposure Draft which we consider must be addressed by the Board if the benefits of the finalised standard are to outweigh the costs of implementation and application.

In particular:

1 We have concerns over the proposals for the inclusion of renewal options, contingent rentals and similar lease features. The recognition of assets and liabilities for options which

have not yet been exercised and payments contingent on events that have not yet occurred we believe would not meet the definitions of an asset and a liability set out in the Framework. Moreover, the application of the expected value approach to measuring these supposed assets and liabilities would in many cases provide unreliable estimates.

We refer the Board to our comment letters on its proposed replacement of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for an explanation of our disagreement with the recognition of contingent liabilities and contingent assets and the indiscriminate use of the expected value approach. In addition we are concerned by the significant increase in the level of judgement and subjectivity that would be introduced and the lack of comparability between entities that these requirements would create.

2 We do not agree with the 'hybrid' approach for lessors and rather support a derecognition approach. We do not believe that it is necessary to have an alternative performance obligation model because in our view the retention of significant risks and benefits by the lessor would be reflected under the derecognition model by there being a greater residual asset. Moreover, property companies who wish to retain leased investment property on their balance sheets will have the option to apply IAS 40 *Investment Property* and will therefore have no need of the performance obligation approach.

3 In previous comment letters we have voiced our concern about the volume of disclosures that have been proposed, and there is no exception on this occasion. While we support an approach where entities can "aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics" we are concerned that the current proposals might necessitate pages of disclosure to add to already weighty financial statements without clear additional benefits to the reader. We therefore recommend that the Board reconsider the proposed disclosure, perhaps with the requirements only applying to those leases, or categories of leases, that are individually material to the entity's financial statements.

4. For the reasons set out in the Alternative View, we are not convinced by the proposed transitional provisions. We concur with the Alternative View that either full retrospective application should be permitted or the transitional provisions adjusted so that the right-of-use asset is not necessarily set equal to the transition liability, but instead takes account of the impact of the remaining lease term compared to the original lease period.

5. While we acknowledge that the Board has considered the costs and benefits of the proposals, we are not persuaded that sufficient consideration has been given to the high cost of changing systems and processes to accommodate the proposed requirements, not just on initial adoption but on an ongoing basis, particular in respect to low value leases.

In the UK and elsewhere there is a strong relationship between the accounting treatment and taxation of leases. Changes to lease accounting could lead to higher tax costs for lessors that would be passed on to lessees resulting in higher costs. If the proposals are implemented there would need to be changes to tax legislation, or, if the authorities prefer the current approach, dual accounting by entities for tax and financial reporting purposes.

## **Conclusion**

While we support the overall aims of the Board in the exposure draft, we do not believe the Board has made a convincing case that the costs of the adoption of the current proposals are outweighed by the benefits to the users of financial statements.

While the recognition of assets and liabilities arising from lease contracts is aligned with the Framework, some of the measurement proposals outlined above are not. We also believe

that the proposals would result in increased complexity, reduced transparency and significant costs to preparers. We therefore believe that the proposals are in need of significant review before they can be adopted as a workable accounting standard.

We would therefore urge that the exposure draft be significantly amended prior to finalisation to remove the unnecessary complexity, at least some of the inconsistencies and to permit an appropriate adoption date to facilitate the implementation of the standard.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'C. Lucas', with a stylized flourish at the end.

**Chris Lucas**  
*Chairman*

***The Hundred Group - Financial Reporting Committee***

## APPENDIX

### **Question 1(a): Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?**

We agree that the right-of-use model establishes a financial accounting platform for lessee accounting consistent with the Framework.

For reasonably straightforward leases, the rights and obligations arising from the contract meet the definitions of assets and liabilities included in the Framework. However we have concerns about some elements of measurement. In particular we consider that, for more complex lease arrangements, the measurement approach could lead to assets and liabilities being recognised which do not meet the definition of assets and liabilities contained in the Framework.

### **Question 1 (b): Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?**

While we agree that this approach is consistent with the right-of-use model, we have concerns about some of the practical implications of replacing rental expense for leases currently classified as operating leases with a combination of amortisation and interest expense.

Our concerns include the usefulness of the information to the readers of the financial statements as the proposals will lead to significant changes to the presentation of the income statement impacting the profile of expenses, as well as many financial metrics and banking covenants. In our view, it is important to retain clear, transparent application which ensures that all leasing arrangements can be identified within the financial statements.

## **Lessors**

### **Question 2(a): Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?**

We do not agree with the proposed hybrid model for lessors. Allowing two alternative approaches replicates a number of the problems inherent in IAS 17 *Leases*, such as lack of comparability and the scope for structuring opportunities. It is also inconsistent with requiring a single approach for lessees.

We do not support the use of the performance obligation approach in any circumstances because it creates for the lessor a rental asset to receive rentals while at the same time retaining the leased asset on its balance sheet. We believe that this is misleading for users because it represents the double counting of the economic benefits attributable to a single asset. We believe that the retention of significant risks and benefits by the lessor would be reflected under the derecognition model by there being a greater residual asset. We therefore do not believe that it is necessary for there to be two approaches to accounting by lessors.

We note that property companies who wish to retain leased investment property on their balance sheets will retain the option apply IAS 40 *Investment Property* and will therefore have no need of the performance obligation approach.

We support a single approach for all leases based on the derecognition model. We believe that this approach is a logical reflection of the lessee's right-of-use. However, we believe that improvements could be made to the model proposed by the Board, on which we comment in response to Question 2(b) below.

We are also concerned that the proposals do not define what constitutes a 'significant risk transfer' especially where there are residual value guarantees where the risks attendant on the disposal of an asset are shared

**Question 2 (b): Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?**

As stated above, we support the use of the derecognition model for all leases. We broadly agree with the Board's proposals for the recognition of assets, liabilities, income and expenses under this model.

However, we disagree with the requirement not to remeasure the residual asset retained under the derecognition approach. We support the alternative view that the initial amount recognised should be accreted to reflect the time value of money. Failing to do so understates the profitability of the lessor during the lease term and creates an artificial one-off gain when the asset is sold at the end of the lease term.

We would also include an option to fair value the residual asset through other comprehensive income where an entity adopts such a policy for similar items of property, plant and equipment. This would allow lessors to apply a consistent approach for assets that they hold to use within their business and those which they lease to others. Although it is unlikely that many entities would take up this option, we believe that it should be made available for those who wish to do so, such as UK government bodies that are currently required to revalue the assets that they use in their own operations.

### **Short term leases**

**Question 3: Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?**

We welcome the Board's pragmatic approach to differentiate between short term leases and longer leases. This appropriately reflects the cost/benefit considerations that accounting standards reference.

We note however that, by proposing an approach which can be considered on a 'lease-by-lease' basis this introduces enhanced levels of divergence and reduced consistency.

### **Definition of a lease**

**Question 4 (a): Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?**

Whilst the definition of a lease is largely unchanged from IAS 17 *Leases*, more clarification is needed so that the boundaries between lease contracts, sale/purchase contracts and service contracts are more robustly defined.

**Question 4 (b): Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?**

We are concerned that the guidance is not clear enough in this area, or consistent with the Revenue ED.

We note that the exposure draft identifies sale/purchase contracts as those that transfer “control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset”. We are concerned that “all but a trivial amount” is not clearly defined.

At a higher level, we are concerned that these proposals are inconsistent with the revenue recognition proposals which only require the transfer of control as a condition to recognise a sale. A preferable approach would be for the leasing proposals to be consistent with the revenue recognition proposals so that if a contract meets the definition of a sale under the revenue recognition proposals, it should also be classified as a sale under the leasing proposals without additional reference to risks and benefits.

We are also concerned that there are some inconsistencies with IFRIC 12 *Service Concession Arrangements*. A grantor has control of infrastructure assets where it regulates what services the operator must provide, to whom it must provide them and at what price and it controls any significant residual interest. Control in this context is normally taken to exist where the grantor has any form of purchase option, not just a bargain. Contracts falling within IFRIC 12 are likely also to be either within the scope of the exposure draft (where there is a fair value option) or classified as ‘in-substance purchases’ (where there is a bargain purchase option or automatic transfer of ownership).

There is therefore likely to be some confusion over which standards to apply to these arrangements, particularly because the exposure draft, unlike IFRIC 4, does not specifically scope-out arrangements that also fall within IFRIC 12.

**Question 4 (c): Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?**

We are concerned that the guidance is not clear enough in this area.

We are not convinced that the criteria which have effectively been carried forward from IFRIC 4 provide a clear distinction between leases and service contracts. Again, failure to provide more clarity in this area will lead to inconsistencies and structuring opportunities.

We believe that the Board should take this opportunity to improve on what is currently contained within IFRIC 4 and address issues that are known to cause diversity in practice, including the following:

- The meaning of ‘fixed price’ or ‘fixed price per unit of output’.
- The meaning of ‘output’ and whether it should be viewed in a physical or economic context.
- Greater explanation of what are specific assets, especially in the context of exchangeable assets and an entity’s practice of exchanging them. This matter is of particular concern to entities in the outsourcing and telecommunications industries.

## Scope

### **Question 5: Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?**

We agree with the scope of the proposed IFRS.

Although we believe there is no conceptual reason why a lease accounting standard should exclude intangible assets, pragmatically we agree that it is best to do so as there would be significant impacts in certain sectors (for example, pharmaceuticals, media) if there was a change of scope. We would not support such a change unless a proper impact assessment was undertaken.

We agree that this issue should be returned to in the future when the Board considers accounting for intangibles in general.

## **Contracts that contain service components and lease components**

### **Question 6: Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?**

We support the IASB's viewpoint from both a lessee and lessor perspective as this approach provides more useful information and increases transparency for users. While in practice this approach may be difficult to apply for lessors adopting the derecognition model, we believe it is possible and the benefits are likely to outweigh the costs.

We believe that in practice there will not be many occasions where services will not be considered 'distinct'. For example, if we consider contracts in the property or automotive sectors it would appear that the service element meets the definition of distinct in most if not all cases. However, we recognise that there might be some cases (specifically regarding certain property and time charter shipping transactions) where the services are not considered distinct under the proposed criteria.

In practice we believe that lessors are more likely to be able to differentiate different elements of a contract, however lessees will have less information available over the elements of the arrangement so separation will likely be more subjective. With this in mind we would propose that the IASB might consider the FASB's approach to differentiation between leasing and service elements of an arrangement, whereby service elements that are not clearly distinct are accounted for alongside the lease arrangement.

## **Purchase options**

### **Question 7: Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?**

Yes. See our response to Question 8.

## **Measurement**

### **Lease term**

### **Question 8: Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?**

We do not support the proposed approach.

We believe that the proposed approach results in assets and liabilities being recognised by lessors and lessees respectively that do not meet the definitions of an asset and a liability as set out in the Framework. Indeed, owning an option to purchase an asset is not the same as owning the asset.

The current proposals would require entities to account for leases as if the option had already been exercised. The lessee does not have an unconditional obligation to pay rentals during an optional lease extension period unless the option is exercised. Therefore the lessee should not recognise a rental liability in respect of the extension period. Similarly, the lessor has neither an unconditional right to receive these payments nor control over them until the lessee exercises its option. Therefore the lessor should not recognise a rental asset in respect of the extension period. Consequently, the proposals do not provide useful information to the users of the financial statements.

In addition we are concerned with certain elements of the guidance in paragraph B18 when considering the length of the lease term to refer to contractual factors, non-contractual factors, business factors and other lessee-specific factors. In certain countries, including the UK, unless it is explicitly excluded, a tenant has a statutory right allowing them to renew a property lease at the end of its contractual term. It is not clear how a lease term is determined in such circumstances.

Moreover, we do not believe that the proposed accounting will reflect commercial substance. Options to extend or break a lease provide the lessee with flexibility to react and adapt to an evolving business environment. If these options are required to be included within the measurement of the lease we are concerned that this will lead to the counter-intuitive result where a 10-year lease is accounted for in the same way as a 5-year lease with a 5-year extension which is expected to be exercised, but may not be. We do not believe that this fairly represents the commitments made by the lessee or lessor.

Consistent with the existing approach under IAS17 *Leases* we suggest that an option to extend the lease should only be recognised when it is considered 'reasonably certain' that the lease will be extended, for example if the lease contains commercially advantageous terms for the extension period.

The Board's proposals include narrative disclosures about optional lease periods. We believe that accounting for the minimum lease term or the full term only where the option is reasonably certain to be exercised in conjunction with such disclosures will provide more useful information for the users of the financial statements.

We agree with many of the arguments set out in the alternative view.

## **Lease Payments**

**Question 9: Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?**



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

We do not agree that the lessee should include contingent rentals within the estimate of lease payments when measuring the lease liability and right-of-use asset at inception because we believe that it would be inconsistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to recognise cash flows that are contingent upon future events as liabilities or assets. Moreover, we do not believe that it is appropriate to apply the expected value approach to the measurement of contingent liabilities.

Our opposition to the recognition of contingent liabilities and contingent assets and to the indiscriminate use of the expected value approach to measuring them is set out in our comment letters on the IASB's proposals to replace IAS37 *Provisions, Contingent Liabilities and Contingent Assets* (on which we understand that the Board has now deferred its deliberations).

Our concerns about the use of the expected value approach are demonstrated very clearly in the context of contingent rentals because highly subjective judgements about future outcomes would, in many cases, need to be made over extremely long periods.

For example, in retail businesses it is not uncommon for retail outlet lease terms to be up to 25 years in length. Where the rental is contingent on future sales of the retail outlet the proposals, in their current form, would require the retailer to estimate sales up to 25 years in to the future. Given that the success of such outlets can be, to a large extent, dependent on the wider location's success (e.g. if a landlord develops and promotes a shopping complex, this is likely to increase sales in an individual leased outlet) such estimates can be complicated by factors beyond the lessee's control. Proper application of the expected value approach would then require probability weightings to be applied to what are by necessity highly judgemental estimates. We do not believe that it would be possible to reliably estimate the expected value of contingent lease rentals over such long periods. We also note that such estimates will be subject to frequent re-estimation.

We are concerned that estimation over such long periods will be open to abuse and manipulation and will not engender comparability between financial statements. We suggest that financial statements would be more transparent if disclosure was made of the sensitivity of rentals to contingent events.

Furthermore, we are concerned that the initial recognition of contingent rentals is likely to cause a mismatch between income and expenses. For example, consider a lease over a retail outlet where the rental is contingent on sales made at the outlet. Essentially, the estimated contingent rental on inception of the lease will be spread over the term of the lease. Accordingly, the rental expense recognised in each period will not reflect the sales actually made in the period. We believe that this contravenes the matching principle propounded by the Framework.

In conclusion, we consider that the change in lease rental payments under a contingent rental arrangement should be accounted for in the period in which it arises and applies, as this will ensure it matches the conditions or results which give rise to the change.

However, if the Board considers that contingent rentals are to be accounted we believe that they should be assessed on a best estimate basis using and over the period covered by management's forecasts and extrapolated over the lease term. Subsequent incremental changes in the rental should then be recognised in the discrete periods to which they relate.

## Reassessment

**Question 10: Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?**

As we noted in our responses to Questions 8 and 9, we do not support the Board's proposals regarding options to extend and contingent rentals. If the Board was to proceed with their proposals in these areas, we believe that the requirement to perform a reassessment at each reporting date would be very onerous. Therefore, while we would prefer that such options are not included in the assets and liabilities created by the lease contract, we support the proposal that reassessment should only be carried out in the limited circumstances where there is a significant change.

However we are concerned that the process of determining whether a reassessment is required will be a matter of considerable judgement. In particular, we are concerned that 'significant change' is not clearly defined and could therefore be interpreted inconsistently in practice. We would propose that similar guidance to that included in IAS36 *Impairment of Assets* for requirements of assessment, e.g., the identification of trigger events, would be a helpful addition.

A reassessment may involve a significant amount of work, especially if a large number of leases are affected by similar factors. In such circumstances, we would suggest that the reassessment can be undertaken on a portfolio basis. In some cases this may be the only feasible way of implementing the proposed requirements.

We emphasise that we believe that the reassessment should be based on management's best estimate of the expected cash flows, rather than using the expected value approach suggested by the proposals.

We agree that where changes to lessees' estimates of contingent rentals arise which relate to current or prior periods, they should be recorded in the income statement and where they relate to future periods, they should be recorded as an adjustment to the carrying amount of the right-of-use asset and the rental liability.

We believe that lessors should apply the derecognition approach in all cases, and, in that context, we agree that the impact of changes to estimates of contingent rentals should be recorded in the income statement.

If lease extension options are only be taken into account when 'reasonably certain' to be exercised, we believe that changes in estimates of lease term will be rare. However, where they do occur we agree with the Board's view that the impact should be adjusted to the lessee's right-of-use asset and to the lessor's residual asset.

## Sale and Leaseback

**Question 11: Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?**

We refer to our concerns raised in response to question 4(b) above. In particular, we believe that there is a need for more clarity as to the boundary between sale/purchase contracts and lease agreements.

We do not believe that there should be a higher threshold applied to sale and leaseback transactions when determining whether a sale has taken place (as described in paragraph B31) as compared to separate lease transactions (paragraphs B9 and B10). In both cases we believe there should be a consistent definition of what constitutes a sale/purchase and our preference is for the approach set out in the Board's revenue recognition proposals, that is, a sale is dependent on transfer of control.

We are surprised that the proposals do not include any transitional relief for 'failed' sale and leaseback transactions that fall to be accounted for as financing transactions and encourage the Board to reconsider whether this is needed.

## Presentation

**Question 12 (a): Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?**

We do not believe that a lessee's obligation to pay rentals should always be presented separately on the face of the balance sheet. Disclosure in the notes is sufficient in most cases. We believe there is sufficient guidance in IAS 1 *Presentation of Financial Statements* as to what should be disclosed on the face of the primary statements and do not support cluttering these statements with additional categories of assets and liabilities that can be satisfactorily disclosed in the notes.

We agree that the right-of-use asset should be presented according to the nature of the underlying leased item, that is, included within property, plant and equipment or investment properties rather than, as some propose, as a separate intangible. Again mandatory disclosure on the face of the statement of financial position is not necessary. Leased and owned items should be separately disclosed in the notes.

**Question 12 (b): Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?**

Generally we do not support the performance obligation approach. However, if the Board decides to pursue this option then we agree that the proposed 'linked presentation' is the preferred option.

We have similar concerns to those cited in our response to 12(a) above regarding cluttering of the primary statements and would prefer disclosures generally to be in the notes instead.

**Question 12 (c): Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?**

We have similar concerns to those cited in our response to 12 (a) above regarding cluttering of the primary statements with potentially immaterial items and believe that the required disclosures should be permitted to be presented in the notes.

**Question 12 (d): Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?**

Where there are separate arrangements, we agree that the position should be presented gross. In cases where there is an agency or pass through arrangement, we believe a net presentation is more appropriate.

We have similar concerns to those cited in our response to 12(a) above regarding cluttering of the primary statements and believe that the required disclosures should be permitted to be presented in the notes.

### **Statement of Comprehensive Income**

**Question 13: Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?**

As noted in our response to question 12(a) above, we believe there is sufficient guidance in IAS 1 *Presentation of Financial Statements* as to what should be disclosed on the face of the primary statements and do not support cluttering these statements with potentially immaterial items, consistent with our recent response to the proposed amendment to IAS 1 *Presentation of Financial Statements*. We would prefer disclosures generally to be in the notes instead unless separate presentation is relevant to an understanding of an entity's financial performance.

### **Statement of Cash Flows**

**Question 14: Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?**

We have similar concerns to those raised in our responses to questions 12(a)-(d) and 13 above regarding cluttering of the primary statements.

We are concerned about the requirement to classify lessee cash flows as financing cash flows. In practice entities enter into leases for many reasons, sometimes as an alternative source of finance and sometimes for operational reasons. There is an argument that they would be better classified as operating or even investing cash flows and the Board has acknowledged this debate in their deliberations concerning financial statement presentation. In our view, the interest component should be treated in a manner consistent with other interest cash flows.

## Disclosure

**Question 15: Do you agree that lessees and lessors should disclose quantitative and qualitative information that (a) identifies and explains the amounts recognised in the financial statements arising from leases; and (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?**

We welcome the requirement to disclose relevant quantitative and qualitative information as this will provide useful information to users of the financial statements and enhance their understanding of the role and impact of lease arrangements on the entity.

Individually each proposed disclosure has some merit but if entities were to comply with all of the proposed requirements not only would the preparation of the disclosures be onerous but they would add significantly to the volume of the financial statements which has already grown to be excessive in many cases.

We welcome the requirement in paragraph 71 that “an entity shall consider the level of detail necessary to satisfy the disclosure requirements... and how much emphasis to place on each of these requirements”. However, we are concerned that in practice companies will be pressurised to make all the disclosures. We therefore recommend that the Board makes an explicit statement to the effect that the disclosures listed should not be regarded as mandatory in all situations.

We also note that paragraph 71 allows entities to “aggregate or disaggregate disclosures”. We welcome this too, on the understanding that this would allow entities to apply a portfolio approach to disclosures.

We suggest that consideration is given to requiring some of the disclosures only for individually material lease arrangements rather than for all lease arrangements (particularly those set out in paragraph 73).

We welcome the proposals in paragraph 77 whereby a lessee is required to disclose a reconciliation of opening and closing balances of right-of-use assets and liabilities to make lease payments as we believe that they will be particularly helpful to users of the financial statements.

## Transition

**Question 16 (a): The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?**

We agree that mandatory full retrospective application could be onerous in many cases and we therefore agree that some simplified transitional arrangements are necessary. However, we believe that what the Board is proposing is not a suitable solution.

We share the concerns raised in the alternative view that the proposed approach will lead to a misleading reduction in lessees' profits on transition and increased profit growth in subsequent periods with the opposite effect for lessors. In common with the alternative view, we believe other transitional provisions should be considered for both lessees and lessors.

Full retrospective application should be permitted or the transitional provisions adjusted so that the right-of-use asset is not necessarily set equal to the transition liability, but instead

takes account of the impact of the remaining lease term compared to the original lease period.

**Question 16 (b): Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?**

Yes, for the reasons above, but on an optional rather than mandatory basis.

**Question 16 (c): Are there any additional transitional issues the boards need to consider? If yes, which ones and why?**

As noted in our response to Question 11 above, we believe additional transitional relief is needed for 'failed' sale and leaseback transactions.

## **Benefit and Costs**

**Question 17: Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?**

We are concerned that insufficient work has been done to collect information about the costs and benefits of the proposed requirements. We believe that implementation of a standard based on the current exposure draft would result in costs for preparers, both on implementation and ongoing application, that are likely to exceed the benefits for users. Entities do not capture much of the required data systematically and much would have to be created.

We are concerned that users may not place reliance on the amounts included and continue to make their own adjustments based on their view of an entity's position, particularly if contingent rentals and renewal options are included. Users may derive greater benefit from adequate disclosure of these terms to enable them to adjust the balance sheet amounts to their own specifications.

We are also concerned that there has been limited impact assessment of the wider affect of these proposals on the economic effects of their implementation on businesses, such as the potentially significant impact on metrics, key performance indicators, employee remuneration, bank covenants, regulatory capital, taxation, audit costs and so forth. In addition, consideration should be given to the possibly high cost of changing systems and processes to accommodate the proposed requirements, especially as the proposals will introduce a need in many cases to look beyond management's regular business planning cycle when making judgements.

For a significant number of leases, pricing depends on favourable tax treatments that may not be available if the accounting for leases changes – since 2006, the tax treatment of leases has followed the treatment in the financial statements, at least in the UK. If corresponding legislation is not changed, then entities will have to dual account - for the tax authorities and then for financial reporting purposes.

We are also, however, conscious of the overarching timetable of the Board. Consequently, if the Board feels the need to quickly progress towards an approved standard, we would strongly recommend a consideration of this more simplified approach coupled with an extended implementation period. We will respond to the Board's consultation on transition dates in due course.

## Other Comments

### Question 18: Do you have any other comments on the proposals?

The following matters are not dealt with in the exposure draft. We believe it is important that the Board address these matters in order to reduce the risk of a proliferation of application issues in the years following adoption.

- Incremental borrowing rate. Where the interest rate implicit in the lease is not clear, the entity uses its incremental cost of borrowing, which (according to B12) should reflect the transaction and the specific terms of the lease. In many cases the funding of the purchase of an equivalent asset might not be entirely debt funded. One interpretation of B12 is that it therefore requires the use of weighted average cost of capital – the eventual standard should clarify whether this is intended or not.
- What constitutes a lease payment? Whilst the exposure draft defines lease payments in terms of ‘payments arising under a lease’, the detail of the proposed model demonstrates that the Board has focussed on cash payments by a lessee to a lessor.

The Board does not appear to have addressed the accounting for a number of other types of payments arising from lease contracts, such as non-monetary lease incentives, key money and security deposits. We believe that the Board should clarify how to account for each of these common payments in the final standard.

- How do you account for a modification of a lease? Should it be treated as an extinguishment of one lease and recognition of a new lease, or as an extension of an existing lease with revised terms?

Existing guidance in IAS 39 *Financial Instruments: Measurement* is used to determine whether there has been an extinguishment or modification of a financial liability. The Board could use such guidance as a basis for developing specific lease modification guidance and to clarify that both qualitative and quantitative factors should be considered.

- There are many issues concerning the passage of time between lease inception and commencement. How is the time value of money reflected? What if there are rental payments or modifications during the period? How are assets under construction dealt with?
- The exposure draft proposes that a lessee measures the right-to-use asset initially at the amount of the liability to make lease payments, plus any initial direct costs incurred. Meanwhile a lessor includes initial direct costs in its initial measurement of its lease receivable.
- We observe that the accounting treatment of costs of obtaining a contract is not unique to leases. The recently issued exposure draft for insurance contracts requires inclusion of incremental acquisition costs in the present value of the fulfilment cash flows and exclusion of all other acquisition costs.

The revenue recognition exposure draft, on the other hand, allows capitalisation of certain contract costs, but requires that the costs of securing a contract are expensed as incurred.

In view of the different approaches proposed for these three projects, we would urge the Board to undertake a more comprehensive project on costs to ensure consistency.