

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

Tuesday, 14 December 2010

Dear Sir/Madam

## **International Accounting Standards Board Exposure Draft: ED/2010/9 Leases**

We appreciate the opportunity to respond to the International Accounting Standards Board's (IASB's) exposure draft of proposals regarding accounting for leases. Our operations relevant to this exposure draft are primarily that of lessee, although we do to a lesser extent operate as lessor. This letter focuses primarily on our position as lessee.

We are supportive of many of the principles included within the exposure draft and are supportive of the wish to bring leases currently categorised as operating leases, which are often significant commitments, into the measurement and recognition process. This will create a more complete picture of the liabilities a company is committed to and remove inconsistencies allowed under current accounting standards which enables certain leasing liabilities to remain wholly unaccounted for within a company's balance sheet. In principle we agree that this exposure draft will lead to a fairer and more realistic reflection of the total assets and liabilities held by a company and the gearing and net debt position that it operates under.

The exposure draft as currently written requires a significant amount of judgement to be exercised over various items particularly concerning lease length, variable rental payments and discount rate. There is potential for companies to select a wide range of assumptions for any given lease. We strongly feel that the level of subjectivity in key measurement assumptions must be reduced in the final standard. This is necessary in order to promote consistency in both application and financial reporting across companies and sectors and to provide information that is of benefit to the users of the accounts. Our primary suggestions are as follows:

- **Lease length** should be defined based on periods 'reasonably certain' rather than 'more likely than not' to occur;
- Variable rental payments should be covered as part of the application notes in more detail providing more structured guidance on common areas to promote consistency of application;
- **Discount rate** should be linked to the average life of the lease liability portfolio by category of asset. We believe the standard will need to be more specific on how the board believe the incremental rate of borrowing should be calculated; and



• **Presentation** of assets and liabilities should be made in the notes to the financial statements rather than on the face of the balance sheet to avoid undue prominence being given to leases.

Finally, we strongly believe that the transition rules should be revised to allow full retrospective application, with the exception that the discount rate is set at the date of transition rather than the start date of each lease. We believe this approach will provide a more balanced transitional impact on the income statement. In contrast the current exposure draft proposals would cause significantly inflated income statement charges in the early years of transition and would have a distorting impact on the financial results.

The above summarises our main comments on the exposure draft. The focus of our suggestions is to reduce the degree to which balance sheet assets and liabilities and consequent interest charges and amortisation might be open to manipulation, there by reducing the effectiveness of the standard. However, as part of reaching this assessment we have also answered selected questions posed in the exposure draft which are relevant to our business, primarily as a lessee. Our response to these questions has been laid out in the appendix to this letter.

If you have any questions about our comments or wish to discuss any of these matters further, please contact me, at the Company's registered address.

Yours sincerely

Richard Pennycook

**Group Finance Director** 



# **Appendix**

# **Question 1 – Lessees**

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?

## Response

We agree with the principles contained in the exposure draft proposal. Under current IFRS, there is a mismatch in treatment of operating leases compared to other financial liabilities held at the balance sheet date. This does not appear to be appropriate. Although operating leases are kept off balance sheet, they form part of a company's financial obligation to continue operating and therefore we agree that it is appropriate to bring those items onto the balance sheet as a recognised liability in order to fairly reflect the total financing base of the company.

We also agree that it is appropriate to recognise a right-of-use asset as it would be inappropriate to recognise a liability without recognising the asset which is intrinsically linked to it and as economic benefit is expected to flow to the entity as a result of its use of the asset.

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?

### Response

We agree that the proposals laid out in the exposure draft are appropriate, given that we feel all leases are a form of financing for a company. All financing obligations have a cost of borrowing attached which is linked to the outstanding obligation at any point in time. It is therefore appropriate that an interest charge should be reported within the company's results over the life of the lease to reflect that outstanding obligation. Amortisation of the asset is also appropriate as it matches the usage pattern of the asset in the company's results and is consistent with the treatment of other tangible fixed assets.

We have observed that measurement of these items as required in the current draft will result in the overall expense for an individual lease, split between amortisation and interest, being higher in the earlier years of a lease and lower at the end, which is due to the calculation of interest on the outstanding liability to make lease payments. While this is consistent with the treatment of current finance leases, it represents a fundamental change in accounting for current operating leases. Operating lease expenses are currently accounted for on a straight line basis, although in the case of property there is often an upwards adjustment made at each rent review date and therefore a greater annual expense can be experienced at the end of the lease rather than the beginning. For the reasons laid out above we believe the new proposal is a more appropriate accounting treatment.



## **Question 2 – Lessors**

Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks and 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 model would you propose and why?

## Response

We are supportive of the approach adopted in the exposure draft for two possible recognition methods for lessors. Where the significant risks and rewards of ownership are retained by the landlord, it would be inappropriate to dispose of the underlying lease asset from property, plant and equipment as that would not reflect the substance of the leasing arrangement. Similarly, where those risks and rewards of ownership are not retained, it would not be appropriate to continue recognising the full underlying asset for the same reasons. We do not feel that a single method of accounting for lessor arrangements would suitably capture this underlying difference. 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?

## Response

We agree with the proposals and feel that they are consistent with the economic substance of the transactions as explained in our response above.

### **Ouestion 3 – Short term leases**

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?

### Response

We are of the opinion that the exposure draft's proposal for lessees to account for short term leases (leases under 12 months in life) undiscounted does not provide enough practical relief to companies. Given the short life of the assets, the likelihood is that any right of use asset would be immaterial in nature and amount and therefore we suggest that a company should have the right to make an accounting policy choice to account for such leases off balance sheet and recognise expense in the income statement on a straight line basis, consistent to the current operating lease treatment. Further, this would make the lessee accounting treatment more consistent with the proposed approach for lessor short term leases.

Disclosure of the accounting policy choice should be made in the accounting policy note to the financial statements.



#### **Question 8 – Lease term**

Do you agree that a lessee or 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, what alternative model would you propose and why?

## Response

We do not agree that the lease term should be defined as the 'longest possible term that is more likely than not to occur' as we feel that this could significantly overstate assets and liabilities. Instead we feel that only those options that are 'reasonably certain' to be exercised should be taken into account as is the case in the current leasing standard.

In order to make the decision as to whether a lease term is 'more likely than not' in relation to longer term leases such as property, it would require forecasting decisions that are not to be made until future trading periods including beyond normal operational forecasting periods. This also leads to a greater risk of significant volatility in asset and liability values at each reassessment point as this represents a lower threshold to be met for change in the assumption. We feel that this would make the interpretation of a company's balance sheet position very difficult year on year and in comparison to a company's peers, and would not enhance the information available to users.

Options and break clauses are built into leases to provide flexibility to the holder in order to enable them to make decisions on lease term according to circumstances at a future date. At inception of the lease the only true financial commitment relates to the minimum lease term to option date. We agree that there is a benefit of assessing the future potential period under option in the lease. However, we are firmly of the belief that the true financial commitment length should only be extended where there is reasonable certainty that the commitment will be extended.

### **Question 9 – Lease payments**

a) 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?

# Response

We agree that contingent rentals and other expected payments under term option penalties and residual value guarantees should be included in the measurement of assets and liabilities.

If contingent payments were excluded from the calculation and two leases for identical properties were measured, differing only in that one was based on fixed rentals and the other primarily on contingent rental (such as based on turnover levels), the balance sheet liability recognised for the property with contingent rental could be significantly lower than that for the property with fixed rentals. Therefore key measurement metrics such as net debt and gearing will not be stated on a consistent basis. This would be the case even though ultimately the level of cash expense



experienced under both agreements could be very similar. We do therefore believe that all contingent payments must be included in the measurement calculation.

However, we remain concerned that the subjectivity in determining appropriate assumptions for these payments, particularly in relation to long dated cash flows, could cause significant variation in the treatments adopted by different companies reducing the comparability of different sets of accounts and ultimately therefore the usefulness of the accounts to readers. We believe that this will be partially mitigated if the board adopts a 'reasonably certain' approach to options in leases as discussed in our response to question 8 as this would reduce the overall time horizon for forecasts in at least some cases. Beyond this, we also feel that the final standard should include further guidance on application, particularly in generating appropriate assumptions beyond a company's usual detailed forecasting periods, for common areas of variable payment.

## **Question 10 - Reassessment**

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts and 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?

### Response

The measurement of assets and liabilities in line with the requirements of the exposure draft requires a number of assumptions covering most of the key inputs into the calculation, namely lease length and rental amount. There is likely to be various uncertainties around these. It would be inappropriate not to remeasure these when a change in circumstances suggests this to be necessary as this would not be consistent with other standards issued requiring estimates and may lead to assets and liabilities being carried at amounts which do not fairly reflect the company's current expectations and intentions.

### **Question 12 – Statement of financial position**

- 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 the lessee does not lease? Why or why not? If not, do you think the lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?
- b) Do you agree that the 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 liability? 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?

## Response

We agree that the balance sheet items for both lessees and lessors should be separately disclosed from other assets and liabilities in the same categories because they are sufficiently different in nature. However inclusion on the face of the balance sheet is considered to be unnecessary and in some cases could give undue prominence to leases due to the number of individual lines proposed for inclusion. This is particularly true where a company is a lessor, lessee and engages in sub lease arrangements and hence must include information for each of these activities. We feel disclosure in the notes provides sufficient information for users of the accounts.

## **Question 15 – Disclosure**

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

Why or why not? If not, how would you amend the objectives and why?

## Response

We understand the need for increased disclosure given some of the judgements that will have to be made when accounting for leases in order to ensure that the user of the financial statements understands the basis of the calculations. However we are concerned that the level of disclosure proposed could lead to a disproportionate level of disclosure when the relative value of any potential right of use asset is compared to the rest of the balance sheet. The level of disclosure could be reduced if the level of subjectivity required in measurement was reduced.

## **Question 16 – Transition**

- 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. Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
- b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

### Response

We agree with the proposal to use a simplified retrospective approach on transition, although it is our strong opinion that there should be an option to take the approach further than currently drafted. We do think full retrospective application is appropriate, with the exception that the discount rate is set at the transition date for the standard, rather than determined individually according to the start date of each lease which will not be feasible in all cases. This will result in an adjustment to opening reserves on transition.



Our reason for this is that this allows a more balanced transitional impact on the income statement reflecting the true ongoing impact of the lease obligations for leases existing at date of transition. In contrast the current exposure draft proposals would cause significantly inflated income statement charges in the early years of transition and would have a distorting impact on the financial results.

We believe our proposed approach should only be an option as it may not always be practical for all companies to apply a full retrospective approach, particularly where companies have a number of old leases.

### **Question 18 – Other comments**

Do you have any other comments on the proposals?

## Response

We understand and support the proposal to use a company's incremental borrowing rate as a discount rate where the interest rate implicit in the lease agreement is not readily available. However it is our opinion that there needs to be further guidance on the definition of 'incremental borrowing rate' in order to ensure a consistent approach by all companies. We would suggest that companies should apply a borrowing rate that links to the average life of their lease portfolio by category of asset. We think this is necessary in order to reflect the true borrowing cost of obtaining the leased asset. We believe the standard will need to be more specific on how the incremental borrowing rate should be calculated.