Group Finance

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Dear Sir David

Exposure Draft ED/2010/9 Leases

Lloyds Banking Group plc welcome the opportunity to comment on the proposals contained in the above exposure draft (ED).

We acknowledge that there are shortcomings in the current lease accounting requirements set out in IAS 17, particularly the artificial distinction between operating and finance leases which leads to reduced comparability between entities. We are therefore supportive in principle of the Board's approach to lessee accounting, although we have conceptual concerns over the inclusion of renewal periods in the calculation of the right of use asset and lease liability.

However, we do not support the proposals for multiple approaches for lessors which we believe do not address the concern with the artificial distinction in IAS 17. Further we believe the performance obligation approach for lessors to be conceptually flawed.

Our comments on the specific questions in the ED are set out in Appendix 1. However, we would emphasise the following concerns we have with the proposals in contained in the ED:

- Lessor proposals. We do not agree with the proposed approach to accounting
 by lessors and do not believe there is a conceptual justification for having one
 approach for lessees and multiple approaches for lessors. As lessors would
 have to decide between applying the performance obligation and derecognition
 approaches, we believe this introduces scope for structuring opportunities and
 judgement which would lead to a lack of comparability between entities.
- Performance obligation approach. We strongly disagree with the performance obligation approach, where the lessor continues to recognise the underlying asset as well as a lease receivable. The lease receivable embodies part of the future cash flows that the underlying asset will generate for the lessor, therefore recognising it without derecognising part of the underlying asset in our view results in a double-counting of the same asset. Conceptually, the lessor has given up some of the economic benefits associated with the underlying asset (or



exchanged those economic benefits with a receivable) which is essentially a partial derecognition approach.

- Lease term. We do not agree that amounts due under renewal/extension options should be included in the lease liability as such amounts would not meet the definition of a liability. Further, for many leases, particularly specialised leases and property leases, significant management judgement will be required to determine the 'longest possible lease term that is more likely to occur than not' which will reduce comparability between entities.
- Contingent rentals. We do not believe that contingent rentals that are under the control of the lessee should be included as these do not meet the definition of assets or liabilities.
- Lease reassessment. The ED proposes that a detailed examination of every lease is not required unless there has been a change in facts or circumstances that would indicate that there is a significant change in the lease asset or lease liability. The term 'significant change' is not defined and the requirement to undertake periodic reassessment of individual lease terms would be a costly exercise. Further guidance as to what the Board considers to be a 'significant' change' would help to ensure comparability.
- Short-term leases. We do not believe that users would be provided with decision useful information from the recognition of assets and liabilities in respect of short term non-core assets (such as office equipment). As the cost to preparers of building systems, processes and controls to create and monitor such assets would likely outweigh the benefits to users, we would ask the Board to reconsider the relief provided in this area.
- Cost of compliance. The proposals will significantly increase the cost and complexity of accounting for leases for organisations that have significant leasing operations. The proposals will impose a significant burden on preparers for example, in determining the lease term and monitoring changes to the lease term and the expected contingent rentals. We would therefore ask the Board to consider offering practical expedients, such as permitting a portfolio based approach for leases that are of a similar nature to avoid the need for individual lease assessment, and, as noted above, excluding renewal periods from the lease term.

We would encourage the Board to continue its outreach activities with respect to these matters and, in particular, the approach to lessor accounting before concluding on a final standard.

Yours sincerely

David Joyce



Appendix1 Responses to questions in the ED

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, in principle, that a lessee should recognise a right-of-use (ROU) asset and a liability to make lease payments (LLP). Further, the removal of the distinction between finance leases and operating leases would improve comparability between entities.

The proposed accounting treatment of lease transactions and service arrangements is significantly different. Therefore, it is crucial that the definition of a lease be further improved to clearly distinguish leases from services.

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

In principle we agree that a lessee should recognise amortisation of the ROU asset and interest on the LLP.

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?
- (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?

We do not support the performance obligation approach for the reasons set out below:

Lessors will have the opportunity to apply different accounting approaches to leases which will reduce the comparability and provide structuring opportunities to achieve a particular accounting outcome. The Board have not provided a conceptual justification for having one model for lessees and two models for lessors. Paragraph BC25 of the ED states that one approach to lessor accounting would not be appropriate for all leases due to the differences in the economics of the transactions (or business models for different transactions). It can be argued that the same applies to lessees because some lease arrangements are entered into by lessees as an alternative way to finance the acquisition of the underlying asset while in other cases they merely intend to use an asset for a limited time.

Under the performance obligation approach, the lessor continues to recognise the underlying asset as well as a lease receivable. The lease receivable embodies part



of the future cash flows that the underlying asset will generate for the lessor, therefore recognising it without derecognising part of the underlying asset in our view results in a double counting of the same asset. The cash flows arising from the lease contract cannot simultaneously support both the underlying asset and the lease receivable. Further, this would lead to a conceptual difficulty undertaking impairment assessment of the right to receive lease payments asset (under IAS 39) and the underlying physical asset (IAS 36).

The performance obligation approach appears to be in conflict with the proposed approach to lessee accounting. Under the ED, the lessee records a ROU asset representing the right to use an underlying asset over the lease term. It logically follows that the lessor must have given up some of the economic benefits associated with the underlying asset (or exchanged those economic benefits with a receivable) which is essentially a partial derecognition approach. The performance obligation approach creates three assets between the lessee and lessor: an ROU asset (lessee), a lease receivable (lessor) and an underlying asset (lessor). The carrying value of the lessor's underlying asset therefore overstates the economic benefits that are represented by the lessee's ROU asset.

When an asset has been transferred under a contract, which obligates the lessee to pay rent, then the lessor should be able to derecognise the asset. If there is a lessor performance obligation that remains unfulfilled and its risk of performance is so high that it precludes the lessor from derecognising the asset transferred, then no receivable should be recorded by the lessor. Consequently we would encourage the Board to develop a single derecognition approach to accounting by lessors.

Question 3

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

- (a) at the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).
- (b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in profit or loss, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).(See also paragraphs BC41–BC46.)

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 note that the main criticism of the existing leasing standard (IAS 17) is with regard to long-term arrangements that involve core operating assets. Users do not seem to be concerned about short-term leases of non-core assets (photocopiers and printers etc.) not being recognised in the statement of financial position

Consequently, we do not believe that users would be provided with decision useful information from the recognition of asset and liabilities in the statement of financial position from short-term leases of non-core assets. Further we believe that, given the extensive use of short term leasing for non-core assets, the costs to preparers of building systems, processes and control mechanisms far outweigh any benefits to users.

We would ask the Board to provide greater relief in respect of short-term leases, such that the lease payments continue to be recognised in profit or loss over the lease term as required under the current standard (IAS 17).

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?

We agree with the definition of leases set out in the ED and note that it is consistent with IFRIC Interpretation 4 *Determining whether an Arrangement contains a Lease*. However, we would ask the Board to provide practical examples in the implementation guidance to illustrate, for consistency purposes, how the above definition should be applied in practice.

(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?

B9 and B10 refer to the need to satisfy both the transfer of 'control' and all but a trivial amount of the "risk and benefits'. The requirement to assess risks and benefits would appear to be inconsistent with the Board's ED "Revenue from Contracts with Customers" which only requires the transfer of control of goods and services in order to recognise revenue. We would ask the Board to reconsider the criteria in light of their deliberations on the above revenue ED and ensure there is conceptual consistency between the two standards.

We also believe the guidance in paragraph B31 (covering sale and leaseback transactions) is relevant to determining the distinction between a lease from a contract that represents a sale and would suggest that the criteria in B31 be added to B10.

Should the risk and benefits criterion remain, the Board should provide further guidance on the application of the word 'trivial'.

(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?

The guidance on distinguishing leases from service component is addressed under question 6 below.

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Question 5

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33-BC46).

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 that specialised assets should be excluded from the scope of proposed IFRS where they are accounted for under other IFRSs. However, we do not agree that intangible assets should be excluded. An intangible asset is like any other non-monetary asset except it does not have physical substance and we do not believe there is any conceptual reason to exclude intangible assets. We believe that the scope exclusion is a step back from IAS 17, which only excludes limited intangible assets such as certain exploration rights and licensing agreements.

Question 6

The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

- (a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.
- (b) the IASB proposes that:
 - (i) a lessee should apply the lease accounting requirements to the combined contract.
 - (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
 - (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.

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?

With respect to lessors, we do not agree with the performance obligation approach (refer to question 2 above). However, we agree with the Board's approach to service and lease components under the derecognition approach because in most instances, it would be rare that a lessor would not be able to identify service components within a contract that contains service and lease components. If the non-distinct service component was not accounted for in accordance with proposals in the ED "Revenue from Contracts with Customers", a lessor that applies the derecognition approach may recognise income from service components at a different time from the provision of that service.



With respect to lessees, we recognise that it may not be always practical for them to bifurcate the service component because the information may not be available or may require considerable judgement. However, we disagree with the Board's proposal to require lessess in such circumstances to apply the lease accounting requirements to the combined contract. Instead, we believe that the lessee should consider the economic rationale for the transaction in light of its business model to determine whether to account for it as a lease contract or as a service contract.

Question 7

- (i) The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).
- (ii) 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?
- (i) We agree that a lease contract should be considered terminated when the purchase option is exercised.
- (ii) We do not agree that that a lessee or a lessor should account for purchase options only when they are exercised. A purchase option is an integral part of the lease agreement and conceptually is no different to the option to renew. Therefore, there should be no difference in accounting for these two types of options.

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 agree with the Board's proposal that the lease term be considered 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 for two reasons:

- (i) The proposal to include amounts due under renewal options in the measurement of lease payable and receivable is inconsistent with the Conceptual Framework. Rentals payable in an extension period do not meet the definition of a liability to the lessees because the lessee does not have a present obligation to pay arising from past events until the option is exercised. Similarly, rentals receivable in an extension period do not meet the definition of an asset to the lessor as the lessor has neither an unconditional right to receive nor control over these amounts and there is no future benefit resulting from a past transaction until the option is exercised.
- (ii) Regardless of our conceptual concerns, we are concerned that for specialised leases and other longer term leases, such as property leases, predicting the probability of lease renewal after say ten or fifteen years with reasonable accuracy will be difficult in practice. Consequently, significant management judgement will be required as entities reassess the lease term and this will lead to increased volatility and a lack of comparability between entities.

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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 agree that residual value guarantees that are specified in the lease should be included in the measurement of lease assets and lease liabilities arising as these are unconditional rights and obligations albeit of uncertain amount.

However, we do not believe that contingent rentals that are under the control of the lessee should be included. Therefore early termination fees and, in the case of vehicle leases, items such as body damage and excess mileage charges should not be included in the calculation of ROU asset or lease liability as these are similar to extension options in that they are under the control of the lessee. Consequently, the recognition of a lease liability (and an asset by the lessor) for such amounts would not be consistent with the definition of a liability (and asset). Such items should be recognised in the period(s) in which these arise.

We believe disclosure in respect to contingent rentals and expected payments under term option penalties would suffice until such time that the payment of contingent rentals and expected payments under term option penalties become probable and can be reliably measured.

Many property leases are subject to rent review clauses. To determine the value of the ROU asset and the liability to make lease payments will require management to forecast potential rent increases over the term of the lease. At lease inception and at each subsequent reporting period this will be an additional complexity that will be extremely difficult to undertake. The IASB should provide further implementation guidance specific to rent review clauses.

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?

We agree that users of financial statements receive more relevant information when entities reassess the lease term at each reporting date because reassessment reflects current conditions (other than changes to the lease term and contingent payments referred to in the preceding paragraph).

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We are however concerned that reassessment of lease assets and liabilities could be costly for an entity, such as ours, with many leases. We note that under paragraphs 17, 39 and 56 remeasurement of every lease is not required unless there has been a change in facts or circumstances that would indicate that there is a 'significant' change in the lease asset or lease liability. Requiring remeasurement of individual leases only where there is an indication of a significant change is appropriate as it is less burdensome than requiring a periodic reassessment of all lease contracts. However, we believe that the Board should provide guidance as to what constitutes a 'significant' change.

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 agree with the criteria for classification as a sale and leaseback transaction. However, as noted in our response to question 2 above, we do not support the use of the performance obligation approach for transferees/lessors is a sale and leaseback arrangement.

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 agree with the presentation proposals in respect of the lessee's lease liabilities However, we note that ROU assets are not tangible assets and therefore do not agree that they should be presented as if they were tangible assets within property, plant and equipment or investment property as appropriate. We recommend that, depending on their materiality relative to other assets and liabilities, these assets should be disclosed separately either on the face of the statement of financial position or in the notes.

(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?

As addressed above, we do not support the performance obligation approach (refer to our response to question 2).



(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? (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?

We do not agree that residual assets are presented within property, plant and equipment. This is because the residual assets are an intrinsic consideration to the assessment of lease rentals at inception and therefore should be presented together with other elements of the leasing transaction.

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?

We agree lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss where it is material in the context of the financial statements and in the notes if it is not material.

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 agree cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows to the extent they are material.

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 generally agree that lessees and lessors should disclose quantitative and qualitative information about the leases recognised in their financial statements and the impact of those leases on future cash flows. However, we believe that the Board should clarify that the disclosures required by paragraph 73 are not mandatory. There is a risk that, as currently drafted, the ED will result in extensive disclosures arising from overly prescriptive disclosure requirements.

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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?
- (b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?
- (c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

A full retrospective approach would be overly onerous and a simplified retrospective approach is an appropriate solution.

In respect of the lessor transition arrangements, the use of the discount rate at the inception of the lease (adjusted for subsequent impairment) may not be simple to apply in practice, particularly for long term leases where such information may not be available. Consequently we would request that the Board consider additional relief in this area.

The proposals in the ED do not specifically address:

- arrangements that are currently classified as leases under IAS 17 which may not be leases under the proposals and may instead need to be accounted for as purchase or sale of the underlying asset; and
- the implications for sale and leaseback transactions that do not meet the conditions specified in paragraph 66.

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?

Whilst, we appreciate the right of use model for (committed) lease payments, we have significant concerns on the costs of the proposal in relation to its benefits. Significant costs would need to be incurred on upgrades of accounting systems and implementation of new processes and controls and in the ongoing reassessment of leases as proposed in the ED.

Further, we believe additional outreach activities are required with respect to the lessor proposals.

Question 18

Do you have any other comments on the proposals?

We set out our other comments below.

Paragraph 12 of the ED requires a lessee to measure the ROU asset initially at
the amount of the liability to make lease payments plus any initial direct costs
incurred by the lessee. Initial direct costs are defined as recoverable costs that
are directly attributable to negotiating and arranging a lease that would not have
been incurred had the lease transaction not been made. Incremental costs are
also addressed in a number of other EDs issued recently. The ED on Insurance

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Contracts requires including incremental acquisition costs in the present value of the fulfilment cash flows and excludes all other acquisition costs. The ED on Revenue from Contracts with Customers allows capitalising contract costs only if certain conditions are met, and requires expensing the cost of obtaining a contract (for example, the cost of selling, marketing, advertising, bid and proposals, and negotiations). It is unclear if the capitalisation requirements under the different proposals are meant to be equivalent and we believe that IFRS should be consistent in this area.

• The ED proposes that in measuring the lease liability, the incremental borrowing rate applicable to the lease or the rate the lessor charges the lessee if known should be used. Determining the appropriate discount rate for each lease will be onerous and complex and will involve judgement. For example, lease-specific interest rates for property leases are often not readily available to lessors requiring the involvement of property specialists to determine the appropriate discount rate. An alternative, pragmatic approach might be to allow lessees to stratify their property lease portfolios and apply consistent discount rates to those portfolios therefore minimising the administrative burden.

