

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

15 December 2010

Dear Sirs

### Response to the Invitation to Comment on ED/2010/09 Leases

We welcome the opportunity to respond to the above exposure draft.

Lease accounting, and in particular lessee accounting, has been criticised for many years and we acknowledge the boards' joint efforts to address these criticisms. The application of a right-to-use model by lessees could reduce the structuring opportunities available under IAS 17 and provides greater transparency to transactions that might otherwise be off-balance sheet.

However, we do not believe the current proposals would offer an effective improvement on IAS 17 for a number of reasons which are set out in detail in the appendix to this letter. Our main concerns relate to:

- The cost and complexity of compliance with the new proposals, and the inherent subjectivity and uncertainty in basing the model on a probability weighted average calculation. We believe this is likely to lead to unreliable financial information which, in some cases, might be seen to undermine the financial statements as a whole. We note that we have similar reservations with similar proposals in the revenue exposure draft.
- Inconsistencies with the accounting response to renewal options and contingent rentals and the
  definitions of assets and liabilities.
- The use of a hybrid model to lessor accounting, which is likely to create new structuring opportunities for lessors.
- Other inconsistencies with recent proposals, particularly with reference to the definitions of insubstance sales and purchases when compared to the recent revenue exposure draft, and the
  application of tests based ion the transfer of risks and benefits. We note that the board
  determined in drafting the revenue exposure draft that such an approach was not consistent with
  the definition of an asset and less likely to result in consistent application when compared with a
  control test.

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We urge the board to reflect on these proposals following further outreach activities to fully understand the costs of compliance, user needs and their appetite for financial information derived from potentially complex probabilistic models.

If you would like to discuss any of our concerns do not hesitate to contact me.

Kind regards

Anthony Appleton Technical Director

PKF (UK) LLP



• Appendix - Response to specific questions

#### 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?
- (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?

We agree that a lessee should recognise a right-of-use asset and a liability to make lease payments. Such an approach could, in principle, address many of the criticisms of the existing leasing model in IAS 17 especially in respect of the often arbitrary distinction between operating and financing leases.

However, we have significant concerns with the measurement of these assets and liabilities as considered further in our answers to questions 8 and 9. The proposed approach to determining the lease term and accounting for contingent rentals and the subsequent measurement of the asset and liability is tantamount to recognising assets and liabilities that do not meet the relevant definitions in the Framework.

Furthermore, the measurement model will require significant subjective estimation to an extent that the amounts recognised will not be reliable in respect of complex leases.

We agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments, subject to our significant concerns over the initial measurement of the asset and liability. However, further guidance should be provided on applying methods of amortising the right-of-use asset other than on a straight-line basis to ensure the expense recognition properly reflects the consumption of economic benefit. For example, contingent rentals may indicate the benefits received from use of the asset are not straight-line.

# **Question 2: Lessors**

- (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 agree with the boards' proposals for accounting by lessors and would urge the boards to fundamentally reconsider these proposals. The reasons for our disagreement are both conceptual and practical, but overall we do not believe these proposals are demonstrable improvements on the current model for lessor accounting under IAS 17.

One of the central objections to the current accounting model in IAS 17 is that it offers structuring opportunities for similar transactions to be accounted for differently. Retaining two distinct approaches to lessor accounting will not address this fundamental objection and continue to inhibit the comparability of financial statements.

The application of the respective approaches depends on an assessment of exposure to the significant risk and benefits. This is inconsistent with arguments put forward in other recent proposals, most notably in the Exposure Draft Revenue from contracts with customers, to the effect that only the application of a control test is consistent with the definition of an asset or is capable of ensuring consistent application. The application of a risks and rewards test in determining the appropriate accounting for leases throws into doubt the accuracy of those arguments.



Consistent with our responses to questions 1, 8 and 9 we also have conceptual and practical objections to the measurement of assets and liabilities under both models.

Of the two approaches we would prefer an approach based on the de-recognition model, or more accurately the "partial" de-recognition model as proposed. However, as discussed in our response to question 3, this would be subject to the total scoping out from the standard of short-term leases and, as discussed in our response to question 5, further consideration of the treatment of leased intangible assets when compared to the accounting proposed in the exposure draft on revenue recognition.

Our specific objections to the performance obligation approach include:

- It will lead to the double counting of the asset. Whilst a corresponding liability is also recognised
  mitigating the overall effect on equity, the fact remains that the total carrying value of assets
  represented by the leased asset will exceed the value-in-use of the asset. The novel, though
  most likely confusing, presentation of the net value of the two assets and one liability in the
  statement of financial position only highlights the absence of a conceptual foundation for this
  approach.
- Recognition by the lessor of a performance obligation is inconsistent with the recognition of a
  right-to-use asset and a liability by the lessee. If the lessee has an obligation to pay then this
  implies they have already received the asset, being the access to the underlying asset for the
  lease term. If the lessee has received the asset, then the lessor has satisfied its obligation and it
  is not at all clear what the lessor's performance obligation represents.
- Similarly, the recognition by both parties to a contract of substantially equal and opposite rights and obligations would imply that the lease is an executory contract. If so, and there was a conceptual basis for the performance obligation approach, it is not at all clear why other executory contracts such as employee or service contracts should not lead to similar assets and liabilities. The conceptual difference between leases and executory contracts that is made in the exposure draft is not sufficiently clear and is undermined further by the proposed accounting under this approach.

#### Question 3: Short-term leases

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 the statement of financial position, 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 agree that short term leases should be subject to simplified accounting requirements. However, we do not believe the proposed simplifications are sufficient.

Instead, we would propose that short term leases be outside the scope of the standard entirely or the same simplifications be available for both lessors and lessees, namely the accounting for rentals on an accrual basis similar to the current treatment of operating leases under IAS 17.

The simplification in the exposure draft for lessees represents relief from only the final step in the recognition and measurement of leases, namely the discounting of the balances which, in a short term lease, is unlikely to be material anyway.

The real costs for a lessee will be in the tracking and recording of short-term leases across an organisation. These might include short-term car rentals, hotel rooms, small tools and similar plant and machinery. Given these costs are highly likely to exceed any benefit from recognising equal and opposite gross assets and liabilities, we would urge the board to make the further simplifications we propose.

However, we do not believe these simplifications should be available on an asset by asset basis as this will reduce consistency within a single set of financial statements. If the boards do not choose to scope out short term leases from the standard entirely, nor to make the simplifications mandatory for all such leases, we would urge them to make any policy choice applicable to all short term leases.

#### 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?
- (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?
- (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?

Whilst we generally agree a lease is defined appropriately, we do believe further and clear guidance is needed in applying the definition. This is particularly relevant to distinguishing between leases, purchases/sales and service contracts.

In our opinion, the description of a purchase or sale of an underlying asset in paragraphs 8, B9 and B10, and in particular the reference to the transfer of all but a trivial amount of the risks and benefits associated with the underlying asset, is inconsistent with the current Exposure Draft ED/2010/06Revenue from contracts with customers and IFRIC 12 Service concession and arrangements and is therefore likely to lead to confusion.

The recognition of revenue under ED/2010/06 does not depend on the transfer of risks and rewards, but is entirely based on the transfer of control. By defining a sale as in paragraph 8, the implication is that a transfer of control of goods with, for example, a warranty or with a requirement for the buyer to share any subsequent disposal proceeds, is not a sale at all. This would clearly contradict ED/2010/06 which would consider a warranty for subsequent defects to be a separate performance obligation and additional subsequent sales proceeds as contingent revenue.

It might be argued that this inconsistency arises because control in isolation is not a sufficient recognition criterion for determining whether or not a sale has occurred, and it is *Revenue from contracts with customers* that should be revised, but in any case the two final standards should be consistent.

IFRIC 12 effectively requires an operator that constructs an infrastructure asset for a public body grantor to recognise a sale of the construction services if the grantor controls the services provided, prices charged etc and controls any significant residual interest "through ownership, beneficial entitlement or

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otherwise". It is not unusual for this control of significant residual interest to arise from the grantor having an option to purchase at a price that is *not* expected to be significantly lower than the fair value at the date it is expected to be exercisable; in fact it may be exercisable at fair value but is still considered by some preparers to meet the IFRIC 12 criterion. As a separate exercise, we would urge the IFRIC to revisit this IFRIC 12 issue separately, to confirm or refute that an option to purchase at fair value constitutes grantor control, as we are aware of some divergence in interpretation.

Paragraph B10 of this Exposure Draft implies that only an option to purchase an asset at significantly below the expected fair value (a bargain purchase option) at the end of an arrangement would result in the classification of the transaction as a sale or purchase. Clearly this is a much higher hurdle than control of significant residual interest by "beneficial entitlement or otherwise" per IFRIC 12.

The guidance in paragraphs B1-B4 substantially repeats that in IFRIC 4. Whilst we are generally in agreement with the principles underlying IFRIC 4, we are aware that it creates significant application challenges. We urge the boards to reconsider these paragraphs in light of the current issues facing prepares in applying IFRIC 4.

# Question 5: Scope exclusions

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 the scope of the standard should include subleases and exclude leases of biological assets and leases to explore for non-regenerative resources.

Whilst we understand the exclusion of lease of intangible assets was done in the name of expediency, we would urge the boards to complete their deliberations on such assets before finalising the standard as there is no conceptual difference between leases covering tangible assets and those covering intangible assets.

Furthermore, we are concerned that the proposals in the Exposure Draft Revenue from contracts with customers may result in changes in the accounting for intangible assets only for further changes to arise when they are finally brought within the scope of the leases standard. This concern arises from the different conceptual foundations of the two exposure drafts discussed above.

# Question 6: Contracts that contain service components and lease components

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?

We do not agree with either of the boards' proposals as we believe any service element should always be accounted for separately from the lease itself, whether they meet the current definition of distinct in the revenue exposure draft or not.

We are of this view because:

- We have concerns as to the practical application of the indicators of distinctness as set out in the revenue exposure draft. These and other concerns were expressed in our response to that exposure draft.
- A failure to separate the service element would be inconsistent with the treatment of other executory contracts where resultant rights and obligations are not currently recognised.
- Treating the entire contract as a lease may lead to a predominantly service contract being treated as a lease contract.

We would also urge the board to provide explicit guidance on how executory costs such as property taxes and insurance should be accounted for by both lessors and lessees. If these are not considered distinct services there is a danger that any final standard may have the unintended consequence of incorporating these into the lease accounting.

## Question 7: Purchase options

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).

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?

We do not believe that the boards have identified a robust conceptual argument for treating purchase options differently to renewal and other options. In the absence of such an argument, both types of options should be subject to consistent considerations. To treat them differently would be to create further structuring opportunities for economically similar contracts.

It is also unclear how purchase options would impact on the current proposals for determining the lease term if, for example, the option to purchase could be applied at any time before the end of the lease term. What would be the impact on the calculation of the expected lease payments if the exercise of the option would be considered a termination but the option price is not a lease payment?

We also refer the boards back to our response to question 4 where we express our concerns over this distinction made between leases and in-substance purchases/sales.

## Question 8: Lease term

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 that the lease term should be determined as the longest possible term that is more likely than not to occur.



Firstly, by analogy with IAS 32 definitions of financial liabilities, we do not believe a lessee has an unconditional obligation to exercise a renewal option and hence make lease payments beyond the renewal date. Similarly, a lessor does not have an unconditional right to receive lease payments beyond a renewal option date.

Secondly, on practical grounds, we believe the process for determining the longest possible term that is more likely than not to occur would, in may cases, be excessively complex, highly subjective and would result in unreliable estimates of the total lease payments.

We would recommend that a lease term be estimated by assuming only those renewal options which are reasonably certain to be exercised, or some similar high probability threshold. Such an approach would lead to less volatility in the estimated lease term, greater objectivity in such estimates and result in a measurement of assets and liabilities more conceptually consistent with the definitions of assets and liabilities in the Framework.

We note our view is broadly consistent with the alternative view of Stephen Cooper.

# Question 9: Lease payments

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 recognise that the inclusion of contingent rent clauses within a contract could be a source of structuring opportunities if all such rents were ignored in the measurement of assets and liabilities. However, we disagree that all such rents should be included. Consistent with our response to question 8, we believe the proposals will lead to the recognition of assets and liabilities that will not meet their Framework definitions and measurement models that are excessively complex, highly subjective and unlikely to lead to reliable estimates in some cases.

We agree with the observation made in the alternative view of Stephen Cooper that the concern for avoiding structuring opportunities can be addressed by establishing principles for identifying optional lease periods and contingent rental clauses that lack economic substance and represent disguised minimum rental payments.

We would urge the boards to consider stratifying contingent clauses in such a way that the amounts recognised are more reliable and closer reflect the definitions of assets and liabilities. This might be based on a consideration of control of future events – i.e. contrasting contingent rentals that are, in substance, within the control of the lessee, such as those based on asset usage, with those that are not within its control, such as those linked to a market index. Control in this context might be limited by economic or commercial realities.

Alternatively, an analysis that distinguishes between those that are highly probable or reasonably certain from those which are not might be used to avoid genuine structuring opportunities.

Whatever contingent rentals are included in the measurement of assets and liabilities, we do not agree with the probability weighted approach. This is unnecessarily complex and the reliance on highly subjective and inherently uncertain estimates of probabilities is as likely to offer opportunities for financial statement manipulation as the inclusion of contingent rental clauses in lease agreements. We have expressed similar concerns on the use of probability weighted average of forecasted future outcomes in our response to the revenue exposure draft.

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#### Question 10: Reassessment

Do you agree that lessees and lessors should re-measure 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 with the proposal that lease assets and liabilities should be subject to re-measurement. We would note that applying our proposals in respect of lease terms, options and contingent rentals, or those set out in the alternative view of Stephen Cooper, would lead to significantly less volatility on re-measurement than those in the Exposure Draft.

However, we believe the trigger of "significant changes since the last reporting period" could be better explained or alternatively replaced with a more systematic requirement to consider the measurements annually. The latter option would be significantly less onerous with more practical assessments of lease terms and rental payments as advocated in our responses to questions 8 and 9.

## **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 the boards to our response to question 4 where we highlight the inconsistencies in the conditions for determining a sale in this exposure draft with those in the revenue exposure draft. If either set of conditions is appropriate then it should be consistently applied in both standards.

Where the appropriate conditions for recognition of a sale have been met, further guidance is required on the treatment of any apparent profit or loss when comparing the sales proceeds with the carrying amount. Even if the sale and the future lease rentals are at fair value, the transaction can still be seen as primarily a financing transaction for the lease term. Given this analysis, it would not reflect the true economic substance to recognise the entire profit on sale, though an argument could be made for recognising a proportion in respect of the disposed residual interest.

# 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 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?
- (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?
- (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 an over-riding requirement to present any of this information on the face of the statement of financial position, in ignorance of its materiality in any specific situation, is justified. IAS 1 sets out general principles for determining whether a line item is sufficiently material to warrant separate presentation on the face of all primary financial statements.

We agree with the proposed presentation in the statement of financial position of a lessee, subject to it being sufficiently material to warrant separate presentation.

As explained above, the performance obligation approach is the least acceptable of the lessor models set out in the exposure draft. If it is applied we would be concerned that showing the separate balances gross on the statement of financial position would result in unnecessary clutter and complexity. The unusual decision to show the purportedly separate assets and liabilities in one section of the statement of financial position could be extended such that only the net balance is presented on the face, with the detailed analysis in the notes.

As explained above, we also have reservations about the de-recognition approach, but consider it superior to the performance obligation approach. If it is adopted then we agree with the proposed presentation in the statement of financial position, subject to the information being sufficiently material to warrant separate presentation.

Subject to our concerns over the lessor accounting models and to the information being sufficiently material to warrant separate presentation, we agree with the proposed presentation in the statement of financial position of subleases.

# Question 13: Statement of comprehensive income

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 with the separate presentation of lease income and expense, though this could be shown in the notes if not considered sufficiently material to warrant separate presentation on the fact of the statement of comprehensive income. This is consistent with the general requirements of IAS 1.

### Question 14: Statement of cash flows

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?

It is not clear why the standard should specify under which headings the cash flows arising from leases should be presented when the current form of IAS 7 does not similarly mandate the presentation of cash flows such as interest paid and received. We would recommend that any decision on the presentation of such cash flows be deferred until the financial statement presentation project is completed and, in the meantime, the leases standard includes similar guidance as IAS 7.



#### 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?

As we noted in our response to the revenue exposure draft, there are growing concerns that financial statements are becoming excessively long with unnecessary "clutter" and boiler plate disclosures. Such developments are likely to reduce the overall usefulness of financial statements and undermine their practical relevance.

Whilst we welcome paragraph 71 highlighting the need to avoid large amounts of insignificant detail and understand that all IFRSs are only mandatory in respect of material items, we would note that paragraphs 73 to 86 still set out mandatory disclosures that preparers "shall" provide. We would urge the boards to provide clear guidance, applicable to all IFRSs, to empower preparers to avoid unnecessary immaterial disclosures.

We would also note that many of the disclosures would be unnecessary if a simpler model for determining lease terms and measuring lease payments was mandated. This would reflect the reduced complexity and subjectivity in the assumptions and estimates needed.

#### **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?

We agree that prospective application of any new approach to only new leases should not be permitted as it will reduce comparability for many years as old leases progress to termination.

There are clearly advantages and disadvantages with the two alternatives noted in the question. The simplified retrospective approach will incur lower compliance costs but we agree with the alternative view of Stephen Cooper that such an approach may have significant impacts on reported earnings in the initial years of application given the method will effectively treat each lease as a new lease exacerbating the model's effect of front loading of expenses.

On the other hand, full retrospective application would mitigate this but would be costly and in some cases excessively so.

Therefore we would encourage the board to permit but not require full retrospective application. Given any additional costs of compliance in retrospective application would limit the "misleading and inappropriate reduction in profit" of the simplified retrospective approach, consideration should be given to permitting preparers to make the choice on a lease-by-lease basis.

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We welcome the boards' separate consultation in their Request for Views on transition and effective dates of all the new exposure drafts. We would stress that given the investment in new information systems, training etc that any new lease standard will require that their be a sufficiently long lead time for application such that the date of initial application (the start of the first comparative period) falls after the date the final standard is published.

#### **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 do not agree that the costs of implementing the current proposals would be outweighed by the benefits to users. Whilst we agree that an accounting model that results in a lessee recognising a right-to-use asset and a corresponding liability will be welcomed by users, we believe the subjectivity in measurement of those assets and liabilities will not be. Users require information that is relevant, reliable and comparable which the current proposals will not provide. The fact that such extensive disclosures are considered necessary to provide a context for the amounts recognised in the financial statements only highlights this fact.

Furthermore, the costs of compliance of the current proposals will be excessive. We would expect all but the largest of IFRS preparers to require expert external assistance in applying the proposals.

For these reasons, and those expressed elsewhere in our responses, we urge the boards to simplify the lease accounting models.

#### **Question 18**

### Do you have any other comments on the proposals?

There are numerous areas where further guidance should be provided. These include:

- The treatment of lease incentives, both monetary and non-monetary
- Lease modifications and whether or not they should be treated as new lease
- Events arising between the date of inception and commencement, including the payment of advances by the lessee and changes in asset valuations
- Clarification on the impact of lessor options to terminate a lease or to refuse renewals
- Impairments of the receivable and the underlying asset under the performance obligation approach