

INTERNATIONAL ACCOUNTING STANDARDS BOARD

ED: LEASES

CBI RESPONSE

DECEMBER 2010

I INTRODUCTION AND SUMMARY

1. The Confederation of British Industry (CBI) is pleased to respond to the Board's consultation on its Exposure Draft.

IASB BACKGROUND TO EXPOSURE DRAFT

- 2. The IASB acknowledges that leasing is an important source of finance. Therefore, it is important that lease accounting should provide users of financial statements with a complete and understandable picture of an entity's leasing activities. The existing accounting models for leases require lessees to classify their leases as either finance leases or operating leases. However, those models have been criticised for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions. In particular, they omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the Board's conceptual framework. The models also lead to a lack of comparability and undue complexity because of the sharp 'bright-line' distinction between finance leases and operating leases. As a result, many users of financial statements adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.
- 3. The exposure draft proposes that lessees and lessors should apply a right-of-use model in accounting for all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties.
- 4. For leases within the scope of the draft IFRS, this means that:
- (a) a lessee would recognise an asset representing its right to use the leased ('underlying') asset for the lease term (the 'right-of-use' asset) and a liability to make lease payments.
- (b) a lessor would recognise an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either:



Clive Edrupt Competitive Markets **DL:** 0207 395 8042 **E:** clive.edrupt@cbi.org.uk

1850-100 Comment Letter No. 679

- (i) recognise a lease liability while continuing to recognise the underlying asset (a performance obligation approach); or
- (ii) derecognise the rights in the underlying asset that it transfers to the lessee and continue to recognise a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach).
- 5. Assets and liabilities recognised by lessees and lessors would be measured on a basis that:
- (a) assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- (b) uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- (c) is updated when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.
- 6. For contracts that combine service and lease components, the right to receive lease payments and the liability to make lease payments would exclude payments arising from distinct service components and non-distinct service components for lessors that apply the derecognition approach.
- 7. For leases of twelve months or less, lessees and lessors would be able to apply simplified requirements.
- 8. The exposure draft also proposes disclosures based on stated objectives, including disclosures about the amounts recognised in the financial statements arising from leases and the amount, timing and uncertainty of cash flows arising from those contracts.

SUMMARY OF CBI POSITION

- 9. Leases are a very important class of transaction, and an important source of financing for business. Whilst accounting for leases has been criticized over the years, and the Board has been right to review it, nevertheless we are unable to support the Board's proposals in their current form.
- 10. The proposed changes will add a substantial administrative burden on lessees. This will involve an overhaul of accounting systems, controls and processes as well as a very significant data collection exercise. The initial implementation for businesses with a large portfolio of leased property will be particularly onerous.
- 11. The proposed accounting treatment will have an immediate impact on the balance sheet, and could significantly increase liabilities for some companies, affecting their financial ratios and banking covenants.
- 12. This could make leasing less attractive and force property occupiers to consider whether they are better off owning rather than leasing property and other assets.

13. CBI members consider that

- whilst the underpinning approach of a recognition of a right-to-use asset is attractive in principle, it is not practical to apply even if the proposals on contingent rentals and lease terms were revised, and is unlikely to address the issues users have with lease accounting
- accounting for leases should be based on the minimum contractual lease term and optional lease terms should not be included on a more likely than not basis
- the inclusion of contingent rentals in the measurement of the asset or the liability on the weighted probability basis is inappropriate
- the explanations of the boundaries between service and lease contracts are inadequate and impractical to apply
- the transitional arrangements seem to give rise to anomalous results.
- 14. We have considerable sympathy for many of the comments expressed in the Alternative View, and we refer to them further below in our responses to the consultation questions.
- 15. We are also concerned that the Board's impact assessment has not gone wide enough and that the cost benefit analysis set out in the basis of conclusions is inadequate. In particular
 - whilst it is noted that users recognise that the proposed model is an improvement over the current approach, there is no recognition that users will continue to rework the accounting model to establish the information they require
 - there is no recognition of concerns for preparers outside of the costs of information generation and maintenance, for example, the significant one-off costs arising from redrafting covenant arrangements and banking agreements
 - the wider impact on society arising from the inevitable change in financing products and tax considerations.

16. In summary, we do not believe that the proposals represent an improvement in financial reporting and are concerned that the timetable the Board is working to will not allow for the development of a hioghj quality standard. We comment in detail on these issues overleaf in our responses to the consultation questions.

II RESPONSES TO CONSULTATION QUESTIONS

THE ACCOUNTING MODEL

The exposure draft proposes a new accounting model for leases in which:

- (a) a lessee would recognise an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortise the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.
- (b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23–BC27).

LESSEES

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?

Whilst we understand the underpinning approach of a recognition of a right-to-use asset is attractive in principle, we do not believe it is practical. In addition, we are not convinced that the definitions of assets and liabilities are met for elements of more complex lease arrangements. We have raised a number of concerns about certain aspects of the model in our responses below, in particular to Question 8 (lease term), Question 9 (lease payments) and Question 10 (reassessment) but should note that, even if these areas are addressed, significant practicality issues remain.

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, as noted elsewhere, we do 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.

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, such as lack of comparability and the scope for structuring opportunities. It is also inconsistent with requiring a single approach for lessees.

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 do not support the use of the performance obligation approach in any circumstances. We are particularly concerned that the performance obligation approach creates for the lessor an asset to receive rentals while at the same time retaining the leased asset in property, plant and equipment.

We do not believe that these assets are distinct, and in our view this leads to double counting of cash flow potential of a single asset. Moreover, the effect is that the same asset is capitalised by both lessee and lessor.

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. Whilst we understand the proposals reflect the non-monetary nature of the asset, particularly for cases of partial derecognition, we believe the alternative view is more appropriate and is consistent with the requirements of IAS 16.

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.

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).

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?

The proposed simplified approach offers little relief in practice for lessees, particularly for entities with large numbers of short-term leases and, accordingly, we do not believe that the proposed model is the best solution.

We would instead propose that the existing requirements of IAS 17 relating to operating leases should be applied to short-term leases, as is proposed for lessors.

We would recommend, however, that where an entity (either a lessor or lessee)elects to apply the simplified approach it should do so for all short-term leases.

DEFINITION OF A LEASE

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

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, more clarification is needed so that the boundaries between lease contracts, sale/purchase contracts and service contracts are more robustly defined.

Failure to do so would create structuring opportunities and lead to inconsistencies similar to those seen today due to the distinction between operating and finance leases.

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.

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. Unless this is clarified, it could be interpreted inconsistently. Moreover, contracts could be structured to achieve a particular accounting outcome.

More widely, 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 per the revenue recognition proposals, it should also be classified as a sale per 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 scopeout 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:

1850-100 Comment Letter No. 679

- The meaning of 'fixed price' or 'fixed price per unit of output'. For example, in certain power supply contracts there is diversity in practice regarding whether the criterion should be interpreted literally (that is, there is a stated single price for the entire term) or in a broader sense encompassing arrangements under which the price per unit of output is predetermined (that is, there is a series of stated prices that varies with time).
- The meaning of 'output' and whether it should be viewed in a physical or economic context. For example, again considering power supply contracts, there is diversity in practice regarding whether the output of a power station is just the energy it produces, or includes also byproducts like steam and heat, or includes other economic benefits such as renewable energy certificates and similar carbon credits.
- 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

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).

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, subject to our comments on IFRIC 12 above.

In particular, whilst we believe it is important to address intangible assets, we agree that in the current circumstances the pragmatic approach proposed is appropriate, understanding that this issue should be returned to in the future when the Board considers accounting for intangibles more broadly.

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*.

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 would, however, question whether a lessee will be able to sustain an argument that the service component is not distinct if the lessor has effectively been required to split the information out. We believe that in practice there will not be many occasions where services will not be considered 'distinct'.

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).

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?

See our response to Question 8 below regarding options generally.

We do not believe options should be reflected in the lease obligation and do not understand the apparent inconsistency between purchase and extension options contained in the proposals.

MEASUREMENT

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

- (a) assumes 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 (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).
- (b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.
- (c) is updated 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 (paragraphs 17, 39, 56 and BC132–BC135).

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 agree with the alternative view and believe that the proposals result in assets and liabilities being recognised by lessors and lessees respectively that do not meet the definitions thereof set out in the Conceptual Framework. More significantly, we do not believe the proposals represent faithfully the economic reality of lease with extension options.

The lessee does not have an unconditional obligation to pay rentals during an optional lease extension period unless the option is exercised. Therefore it should not recognise a liability. Similarly, the lessor has neither an unconditional right to receive these payments nor control over them until the lessee exercises its options. Therefore it should not recognise an asset. Consequently, the proposals do not provide useful information to the users of the financial statements.

We suggest that the lease term should be limited to the minimum lease term, with the option to extend only recognised when it is considered 'reasonably certain' that the lease will be extended. Currently IAS 17 takes a lease extension into account where it is 'reasonably certain' that the option will be exercised. We support a similar threshold such that an entity would only include the option to extend where it is considered inevitable that it will be exercised.

The Board's proposals include narrative disclosures about optional lease periods. We believe that the approach we propose above alongside such disclosures will provide more useful information for the users of the financial statements than recognising spurious assets or liabilities on the statement of financial position.

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 avoidable contingent rentals (for example, those that are revenue based) should be included within the estimate of lease payments when measuring the lease liability and right-of-use asset at inception as it would not reflect economic reality and will lead to costs not being matched with income.

The inclusion of contingent rentals would require highly judgemental forward looking assumptions which will be difficult to audit. Furthermore, the determination of the lease payment will involve applying an estimated probability weighting to an amount which is already estimated. This would undoubtedly lead to less comparability across businesses (particularly between those that are more prudent and those that are less so) to the resulting detriment of users of financial statements. The proposals are also subject to manipulation and abuse – whilst the Board should not set guidance solely to address potential areas of abuse, it should be mindful of heightened risks from proposed guidance.

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. We do, however, agree with the alternative view that unavoidable contingent rentals (for example, those based on an underlying index) should be included.

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 have said 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 were to proceed with their proposals in these areas, we feel that the requirement to perform a reassessment at each reporting date would be very onerous. Therefore, we support the proposal that reassessment should only be carried out in the limited circumstances where there is a significant change.

1850-100 Comment Letter No. 679

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.

In particular, we are also concerned that the only effective way to determine whether a change in facts or circumstances will have a significant impact will be to undertake detailed calculations, which may ultimately prove to be of little benefit. 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 agree that where the impact of changes to lessees' estimates of contingent rentals from 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.

For lessors, they should apply the derecognition approach in all cases, and 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 in the manner proposed.

SALE AND LEASEBACK

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

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 reiterate that 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 transations that fall to be accounted for as financing transactions and encourage the Board to reconsider whether this is needed.

PRESENTATION

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

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 statement of financial position. We would prefer disclosures to be in the notes instead unless separate presentation is relevant to an understanding of an entity's financial position.

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 considered 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 and would prefer disclosures to be in the notes instead.

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 would prefer disclosures generally to be in the notes instead.

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 do not believe that the information should necessarily be disclosed on the face of the primary 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 dichotomy in their deliberations concerning financial statement presentation. In the meantime we are willing to accept presentation as financing cash flow as an interim measure. However, we believe 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.

However, we are concerned that practical application risks resulting in voluminous disclosures, exacerbating the already extensive requirements in financial statements. Therefore, we welcome the requirement in paragraph 71 that states 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' as this allows some flexibility and will ease the reporting burden in many cases. We would recommend that the Board clearly states that all of the disclosures listed should not be regarded as mandatory in all situations. If the intention is that they must be disclosed in all instances we would not support the inclusion of such voluminous requirements.

We also note that paragraph 71 allows entities to 'aggregate or disaggregate disclosures'. We welcome this too, as presumably this allows entities to apply a portfolio approach where appropriate. Perhaps this option should be explicitly stated to remove any doubt or confusion as to whether it is acceptable.

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 are particularly welcome and will be of great interest to users of the financial statements and analysts alike. Similar disclosures for other types of long-term debt, other than just lease liabilities, would also be welcomed.

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 would be too onerous in many cases and we therefore agree that some simplified transitional arrangements are necessary.

However, what the Board is proposing is not a suitable solution.

We share the concerns raised in the alternative view; 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.

BENEFITS 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 the costs for preparers on implementation and ongoing application are likely to exceed the benefits for users.

We are also concerned that there has been no proper impact assessment of the wider affect of these proposals on businesses, such as the potentially significant impact on metrics, key performance indicators, employee remuneration, bank covenants, regulatory capital, taxation, audit costs etc. In addition, consideration should be given to the possibly high cost of changing systems and processes to accomodate the proposed requirements, especially as the proposals will introduce a need in many cases to look beyond management's regular business planning cycle when make judgements. We encourage the Board to undertake more work in this area.

Some of the costs arising from the proposals would be reduced if our suggestions relating trenewal options, contingent rentals and short-term leases were incorporated into any new standard.

We are concerned that the proposed changes will have a disproportionate impact on SMEs if these proposals affect the updating of the IFRS for SMEs. We urge the IASB to develop a simplified model for SMEs that recognises their limited resources and the realistic needs of users. Some of the suggestions we make regarding lease term, contingent rentals and remeasurement of lease obligations would go a long way towards achieving this.

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 addresses these matters in order to reduce the risk of a proliferation of application issues in the years following adoption.

- 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 relating to lease contracts, such as non-monetary lease incentives, key money, 'make good' provisions 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 literature 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 literature as a basis for developing 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?
 - We believe the Board could address these issues by means of application guidance.
- 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.

Paragraphs 7, 7(b) and Appendix C imply that investment property held for lease (as opposed to investment property that is leased-in) is scoped out of the proposed standard but this is not clear.