1850-100 Comment Letter No. 404

BRITISH RETAIL CONSORTIUM

for successful and responsible retailing



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15th December 2010

Dear Sir David

British Retail Consortium Response to ED/2010/9 Leases

The British Retail Consortium (BRC) welcomes the opportunity to comment on the ED/2010/9 Leases exposure draft.

The BRC is the lead trade association for the UK retail sector. We represent retailing in all its forms across the UK and work on the full range of issues affecting the sector. The BRC collectively represents one of the largest groups of commercial property lessees in the UK. Our aim is to ensure the UK's political and regulatory framework supports retailers in maintaining their outstanding record on job creation, consumer choice and product innovation.

Retailers recognise and accept the need for reduced complexity, improved comparability and full disclosure of their lease commitments in their financial statements, but this must be in a form that users of financial statements can understand and in a way that meets their needs. Most retailers disagree with the Boards' current proposals to capitalise all lease contracts on balance sheet. We do not believe that the proposed changes meet the Boards' objectives. The attached paper sets out the key concerns and priorities for the retail sector on the proposals set out in the Leases exposure draft.

We trust that you will give careful consideration to the issues raised in the paper. Please don't hesitate to contact me or my colleague Maria Hadisutanto (maria.hadisutanto@brc.org.uk; +44 207 854 8946) should you require any further assistance.

Yours sincerely,

Tom Ironside

Director of Business and Regulation

British Retail Consortium





British Retail Consortium Response to ED/2010/9 Leases

1. The British Retail Consortium (BRC) welcomes the opportunity to comment on the Leases Exposure Draft published jointly by the International Accounting Standards Board and the Financial Accounting Standards Board ("the Boards").

ABOUT THE BRC

2. The BRC is the lead trade association for the UK retail sector. We represent the whole range of retailers, from the large multiples and department stores through to independents, selling a wide selection of products through centre of town, out of town, rural and virtual stores. The BRC collectively represents one of the largest groups of commercial property lessees in the UK. Our aim is to bring about policy and regulatory changes that will ensure retailers thrive and maintain their outstanding record on job creation, product innovation and consumer choice.

RETAILING IN THE UK

- 3. Retail is at the heart of local communities, employing close to 3 million employees across the UK and providing important local goods and services to consumers. The sector is an essential contributor to economic growth and regeneration, and will play a vital role in the recovery of the UK economy. Approximately one third of consumer spending takes place with retailers, totalling £285 billion in 2009 and contributing about 8 per cent of GDP.
- 4. However, the retail sector is facing unprecedented challenges. The effects of tough public spending cuts and fiscal tightening measures will take some time to feed through yet consumer and investor confidence are already in decline. Latest figures from the BRC-KPMG British Retail Sales Monitor clearly show that growth in like-for-like sales in November was just 0.7% compared to the same time last year, which is disappointing growth given the increase in nominal spending last year. We expect consumer confidence will continue to be fragile, especially with the increases in VAT and National Insurance contributions next year.

EXECUTIVE SUMMARY

- Retailers recognise and accept the need for reduced complexity, improved comparability and full disclosure of all assets and liabilities in their financial statements, but this must be in a form that users of financial statements can understand and in a way that meets their needs.
- Most retailers disagree with the Boards' current proposals to capitalise all lease contracts on balance sheet. We do not believe that the proposals meet the Boards' objectives.
- Retailers enter into operating leases, primarily for property, so that they can conduct
 their primary trade. Lease transactions are often entered into not for financing reasons,
 but simply because the underlying property or asset is only available on leased terms.
 In particular we are concerned by the assumption implicit in the Boards' proposals that

operating leases are always entered into as a financing transaction. This assumption is fundamentally flawed and overlooks commercial reality.

- The proposed accounting treatment will introduce significant volatility into both the balance sheet and income statement for many companies, failing to reflect the true commercial nature of the transaction undertaken, reducing the comparability of accounts and as such impacting the usefulness of accounts to the end user.
- The standard would require companies to recognise lease assets and liabilities which
 do not meet the definitions under the conceptual framework, thereby creating
 inconsistency with other accounting standards.
- The cost of transition to, and ongoing compliance with, the proposed changes is
 expected to be high and disproportionate to any perceived benefit to users. In our
 view, the changes would actually reduce the relevance and comparability of accounts
 to users. The compliance and cost burden is therefore difficult to justify in an economic
 environment that is already extremely challenging for retailers and produces significant
 constraints on business resources.
- There is a strong consensus among BRC members that the objectives set by the Boards could be better served at a lower cost by improvements to the level of disclosure of the company/group's rights and obligations arising under lease contracts, rather than by capitalisation of the underlying assets and liabilities.
- If, despite these arguments, the Boards decide to proceed with the full lease
 capitalisation proposals, retailers strongly believe that they need to be improved
 significantly to remove unnecessary complexity and to reduce the onerous compliance
 and cost burden associated with the proposals.
- The Boards should also postpone their current intention to introduce a new standard by June 2011, to allow more time for meaningful deliberation and consultation with relevant stakeholders.

OVERVIEW OF RETAIL CONCERNS:

- 5. The BRC acknowledges the Boards' concerns that the existing rules do not fully meet the needs of users, and welcomes the Boards' overall objectives set out in the Exposure Draft (ED) to reduce complexity and improve the comparability of financial statements.
- 6. At the same time, retailers feel that the Boards' proposal to capitalise all leases as assets and liabilities does not meet the objectives that they have set out. Instead, the proposals introduce greater complexity, produce less comparability and a less meaningful picture of the underlying businesses that most retailers operate, which will in turn have a detrimental impact on the understanding of financial statements by users.

A) Does not reduce complexity or improve comparability

7. The application of a 'one size fits all' approach to lease accounting does not achieve comparability. The extent of judgment and subjectivity that senior personnel will be expected to apply in order to implement the proposed requirements is so high that the

proposal will, in effect, reduce the comparability between financial statements. In particular the requirement to include contingent rents and options to extend leases in the measurement of assets and liabilities, on initial recognition and subsequently, is very complex and involves a significant level of judgment and subjectivity.

- 8. The Boards' proposals will have significant implications for the accounting systems and controls that retailers already have in place. Retailers will also be required to dedicate additional resources to ensure that they comply with the new standard. For many retailers, this would involve collating information for thousands of lease contracts, each requiring separate review and assessment. This burden could have an impact on retailers' commercial practices, with many potentially opting to purchase short-term and non-core assets simply to avoid the disproportionate cost of compliance with the new proposals.
- 9. The Boards' proposals will also have implications for the UK tax system. In the UK, HM Treasury has recently announced that legislation will be introduced in Finance Bill 2011 "to ensure that any business that accounts for lease transactions using a lease accounting standard that is newly issued or changed on or after 1 January 2011 continues to apply all tax rules as if the changes to lease accounting standards had not taken place". If the proposed changes are accepted, companies will be required to maintain two sets of accounts, one for statutory reporting and the other for tax compliance purposes.

B) Does not meet needs of users

- 10. The proposed changes to lease accounting are not straightforward for users of financial statements to understand. We believe that users, both analysts and private shareholders, will get a less clear understanding of the underlying business if the Boards' proposals go ahead.
- 11. With companies having to significantly gross up their assets and liabilities, retailers are concerned that the proposed changes to lease accounting will produce distorted balance sheets. Reported performance in income statements will also be distorted, particularly at, and following, transition. Many users, including private shareholders, will have difficulty in understanding the changes and the resulting impacts they will have on company income statements. In addition, we do not consider that these changes will benefit external analysts, many of whom already have existing mechanisms to assess future lease commitments which we believe they are likely to continue to use.
- 12. Finally, we are concerned by the assumption implicit in the Boards' proposals that leases are always entered into as a financing transaction. This assumption is fundamentally flawed. The commercial reality for retailers is that properties will, in most cases, represent the only mechanism from which they can carry out their primary trade. Often a property is not available for purchase; therefore leasing may be the only way for retailers to secure suitable commercial space in a town or city centre location. Leasing is a fundamental reality of the way in which UK retailers do business and we are concerned that the Boards' proposed changes do not take account of the fact that not all leases are of a common type and that flexibility in accounting is required.

C) Increased compliance and cost burden for retailers

- 13. The requirement to capitalise all lease contracts on balance sheet would substantially increase the compliance and cost burden for the retail sector. The Boards' proposals would have significant implications for the accounting systems and controls that retailers already have in place, with retailers having to revise existing reporting and budgeting processes. None of the existing property or financial systems currently used in the sector capture the data required to implement the proposals.
- 14. There will also be higher resource costs associated with the ongoing management of the changes, as well as during the period of transition. Most retailers would need to dedicate additional resources to ensure that their business is able to collect, analyse and process the additional information required to apply the proposals to all their leases. For many retailers, this involves collating information for thousands of lease contracts, each with different terms and requiring separate review and assessment. The information would then need to be tracked/reviewed and reassessed on an ongoing basis. This additional burden will only be made worse by the requirement for companies to perform a reassessment at each balance sheet date.
- 15. There is also a potentially very significant compliance burden attached to applying the proposals in individual entity accounts, particularly for intercompany leasing arrangements between separate property and retail legal entities within the same group.
- 16. In order to assess the cost implications for the retail sector, some retailers have provided estimates of the costs which would result if the Boards go ahead with their proposals:
 - Company A, with around 600 property interests and in excess of 800 commercial vehicles, has estimated that the costs of adoption would be around £500,000 and with high ongoing costs to comply with the new standard. These costs would involve having to examine the large number of contracts and to dedicate additional resources to model and calculate the required accounting entries.
 - Company B, with over 3000 property lease contracts (as well as many thousands
 of other leases for commercial vehicles, equipment etc), has estimated the costs
 of adoption would be around £500,000 and then around £50,000 each year to
 comply with the new standard. These costs would include systems and process
 enhancements; training costs; discussions with banks regarding covenants; and
 possible renegotiation of leases as well as the more obvious increased
 accounting and audit cost burden.

KEY RETAIL PRIORITIES:

A) Improved disclosure, not capitalisation

17. There is a strong consensus across BRC members that the Boards' objectives could best be achieved through more robust disclosure requirements to be included in financial statements which are in addition to the disclosures already required by IAS 17. Improved disclosure requirements would provide a fuller picture of the rights, obligations and expected cash flows associated with the contractual obligations arising under the

lease. For example, these additional disclosures could set out the minimum contractual commitments for future payments and significant terms and conditions.

Recommendation: A more detailed disclosure note could include the following additional disclosures, analysed where appropriate between property and non-property lease contracts and by geographic segment:

- annual rental expense;
- lease terms (including break points and options to extend);
- the history of minimum, contingent and total lease payments along with a detailed and long-term future ageing of undisclosed minimum lease payments; and
- the reconciliation of the movement in the period of total undiscounted future minimum lease commitments, with detail provided on significant lease commitments entered into and exited.
- 18. The existing requirements of IAS 17, particularly their basis on risks and rewards, generally work and are well understood. However, it is recommended that a future review to address some of the Boards' concerns should be undertaken.

B) Improvements to capitalisation proposals

- 19. If all leases are to be capitalised on balance sheets, members strongly consider that the current proposals for the new accounting model need to be improved significantly. This is required to avoid unnecessary complexity and to reduce the disproportionately onerous burden for retail companies. The key priorities for the retail sector relate to the following:
 - Options to extend and contingent rentals
 - Transitional arrangements
 - Short-term/non-core leases
 - Applicable discount rates
 - Sale and leaseback transactions

i) Options to extend and contingent rentals

20. The ED requires the lease term to be recognised on the basis of "the longest possible term that is more likely than not to occur" that takes account of the effect of any options to extend or terminate the lease. The BRC is concerned that this requirement will create significant challenges with retailers having to identify the appropriate lease term to be used, forcing management personnel to make broad base assumptions about future events, which are largely uncertain in nature and beyond their control. Almost all leases contain renewal options (as defined by law) and decisions on whether to extend are not usually taken by retailers until one to two years before the end of the lease, as they will be dependent on a number of factors relevant at that time. Including the "longest"

possible lease term" in each assessment would be incompatible with retailers using planning processes.

- 21. In our view, a future option to extend a lease does not represent a present obligation unless the company is compelled to exercise the option either for economic or business reasons, and therefore does not meet the current definition of a liability. In the UK, retailers must also take account of Security of Tenure legislation providing for a statutory right to extend their leases. This could mean that retailers would have to account for a lease that is potentially never-ending (although, in practice, this would presumably be limited by the useful life of the asset).
- 22. In addition, as expectations over renewal periods will change over time, the Boards' proposals would lead to increased volatility, both on the balance sheet and the income statement.

Recommendation: Options to extend or terminate a lease should be excluded from the determination of a 'lease term', especially those rights which are derived from statute. We recommend that the lease term should reflect the contractual minimum period to which the company is committed.

However, should the Boards decide to retain a requirement to recognise lease terms over and above the minimum contract term, we recommend that, at the very least, a higher probability threshold should be applied – a company should only be required to take account of any options to extend where it is 'virtually certain' that the option will be exercised. A number of factors, both business and economic, could be taken into account, such as the retailer's dependence on the leased asset, or the fact that extremely onerous exit costs mean that it is in the retailer's financial interests to extend the lease.

- 23. The BRC does not support the inclusion of contingent rentals linked to usage or performance of the underlying asset in the measurement of lease assets and liabilities. We are concerned that the requirement for companies to recognise a liability for these types of contingent rentals is not consistent with the definition of a current obligation. It is important to note that, with contingent rentals, there is additional flexibility for the lessee company to either avoid making any additional payments or to stop using the asset altogether. We therefore support the alternative view put forward by Stephen Cooper, a member of the IASB Board, that recognising contingent rental agreements as a liability does not necessarily provide an accurate reflection of the "underlying economics of the lease agreement".
- 24. Retailers have also expressed concern about the probability-weighted approach for measuring contingent rentals under the proposed changes. We consider that the requirement to assign probabilities to a number of different possible outcomes would make it extremely difficult for companies to reliably predict their expected cash flows. This also gives rise to practical issues around considering every possible scenario (which are predominantly dependent on external factors). In addition, the resulting probability weighted average will not be equivalent to the amounts actually paid.

25. The proposals also require a significant level of judgment to produce long-term and reliable estimates. The ongoing requirement to reassess these judgments would lead to a high level of volatility, reducing (as opposed to increasing) levels of comparability for users.

Recommendation: The BRC is strongly of the view that contingent rentals should be excluded from the scope of the Boards' proposals.

ii) Re-examination of transitional arrangements

26. The BRC agrees with the Boards that the mandatory, full retrospective application of the new standard would be too onerous for companies. At the same time, retailers do not believe that retrospective application should be prohibited. To put this into context, retailers are concerned about the potential distortions that the transitional arrangements could have on their income statements in the years after transition as the balances recognised at transition are amortised. These arrangements could result in a significant reduction in profits in the early years, but could also result in a potentially misleading increase in profits in the years thereafter.

Recommendation: The Boards should consider giving entities an option to adopt either a full retrospective or simplified retrospective approach consistently for all leases in transition. This would help to avoid any distortions in income statement reporting.

iii) Exemption for short term and non-core leases

- 27. The BRC welcomes, in principle, the proposal to apply simplified accounting requirements to short-term leases. In practice, however, we are concerned that this measure would provide little, if any, real benefit to retailers and that a more meaningful exemption for short and non-core leases is required.
- 28. The retail sector does not believe that the capitalisation of short-term and non-core leases can be justified, especially since they only make up a small percentage of the overall liability for retailers and other businesses. Retailers are particularly concerned about the time and costs associated with having to put the required accounting systems and processes in place for short-term and non-core leases. Their application would also have a significant impact on the amount of time that retailers will have to spend accounting for such leases. The BRC is concerned that due to the significant administrative and cost burdens involved, the new standard might have the unintended adverse consequence of retailers choosing to lease fewer low-value, short-term assets.

Recommendation: Short-term and other non-core leases should be excluded entirely from the capitalisation requirements proposed in the ED. Instead we propose that the existing requirements relating to operating leases under IAS 17 should continue to apply to short-term/non-core leases.

Companies should be allowed to develop their own definition of 'non-core' assets, based around the significance for their business and their internal capital expenditure and other review processes/measures (such as return on capital). Companies would

then need to disclose the definition, justify the basis and disclose in detail the types of assets excluded.

However, should the Boards decide to proceed with the application of the standard to short-term leases, we recommend that the definition set out in Appendix A of the ED should be amended so that it applies to all leases with a maximum term of three years or less.

iv) Simplification of discount rates

29. The ED requires the discount rate used to determine the present value of lease payments for lessees to be the lessee's incremental borrowing rate or the rate the lessor charges the lessee if that rate can be reliably determined. For property leases it will usually not be practical to determine the rate being charged by the lessor and so the incremental borrowing rate of the lessee will need to be determined. The ED defines this as being "the rate of interest that, at the date of inception of the lease, the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar underlying asset". The BRC is concerned that calculating discount rates in this way will be onerous and could lead to inconsistencies between entities. For instance, it is possible that different discount rates will need to be applied for leases in different geographies, different entities within a Group and of different periods.

Recommendation: The Boards should provide further guidance on how to calculate discount rates and allow a standard discount rate such as Group WACC or the risk free rate to be used when discounting the present value of lease payments. This would reduce the administrative burden of the standard and improve consistency in reporting.

v) Sale and leaseback transactions

30. The ED provides 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". The guidance in the ED is not clear about when a sale and leaseback transaction will be recognised. Retailers are concerned it could result in the double recognition of some assets and transactions.

Recommendation: The Boards' should provide greater clarity in the guidance about when sale and leaseback transactions should be recognised.