Hermes Equity Ownership Services

2013-270 Comment Letter No. 196 Hermes Equity Ownership Services Limited 1 Portsoken Street London E1 8HZ United Kingdom

Tel: +44 (0)20 7702 0888 Fax: +44 (0)20 7702 9452

www.hermes.co.uk

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

Financial Accounting Standards 401 Merritt 7 Norwalk, Connecticut 06856 United States of America

Via IFRS Foundation website

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Dear Board Members,

Re: Exposure Draft - Leases

We welcome the opportunity to comment on the Exposure Draft on Leases. We firmly welcome the step to bring all leases onto the balance sheet, removing the arbitrary distinction between operating and finance leases. This step should help address many of the prior concerns of investors over the opacity and manipulability of lease accounting.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many long-term institutional investor clients from around the world. In all, EOS advises clients with regard to assets worth a total of \$177 billion (as at June 30th 2013).

We answer the boards' specific questions below.

Yours sincerely,

Paul Lee Director



Scope

Question 1: identifying a lease

This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:

- (a) fulfilment of the contract depends on the use of an identified asset; and
- (b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

Yes, we agree with the definition and proposed requirements.

The accounting model

Question 2: lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Yes we agree that there needs to be different treatment of measurement and presentation for different leases. However, we are not wholly comfortable with the distinctions currently proposed to be drawn, as the bright line distinctions may introduce scope for unhelpful structuring such as those which the project is intended to eliminate. We would argue that the approach would be clearer if it were stated that all leases (other than those which are short-term) should be treated as Type A, unless the consumption of economic benefits is clearly insignificant – and we would strongly favour the use of the term 'immaterial' rather than 'insignificant' as this is a term which is much better understood and so can be applied with more confidence and consistency both by preparers and auditors.

Question 3: lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume

more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

Yes we agree, though with the caveat mentioned above about the term 'insignificant'.

Question 4: classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

We believe that the approach is relatively transparent and can be applied with ease by preparers. The natural split between property and other assets makes sense, and the scope for flexibility around this split also seems appropriate so that unusual circumstances can be appropriately reflected in accounts.

Measurement

Question 5: lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

Yes we agree with the proposals on lease term, which seem to include appropriate certainty and general simplicity, while also allowing some scope for flexibility to deal with unusual circumstances. We strongly agree with proposals that the lease term should not be adjusted unless significant changes occur, and particularly agree that a mere change in prevailing market prices should not be sufficient to change the approach to the issue of significant economic incentives.

Question 6: variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

Yes we agree with the proposals as this seems the most appropriate way to deal with the complexities inherent in such structures.

Transition

Question 7: transition

Paragraphs C2-C22 state that a lessee and a lessor would recognise and

measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

We agree with the transition proposals. While we usually strongly favour full transition to a new standard and retrospective application for disclosed past years to provide helpful comparative information, we accept that this is not wholly practical in this case and understand the need for a modified retrospective approach.

Disclosure

Question 8: disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

Yes, we agree with the proposals. We strongly welcome the articulation of the disclosure requirements in terms of providing users with useful and relevant information that aggregates similar leases and disaggregates those with differing characteristics. We believe that expressing the disclosure requirements in this way is most likely to drive the right level of disclosures, avoiding boilerplate and excessive materials but allowing a full understanding of the preparer's position.

Non-public entities (FASB only)

Question 9 (FASB only): non-public entities

To strive for a reasonable balance between the costs and benefits of information, the FASB decided to provide the following specified reliefs for nonpublic entities:

- (a) To permit a nonpublic entity to make an accounting policy election to use a risk-free discount rate to measure the lease liability. If an entity elects to use a risk-free discount rate, that fact should be disclosed.
- (b) To exempt a nonpublic entity from the requirement to provide a reconciliation of the opening and closing balance of the lease liability.

Will these specified reliefs for nonpublic entities help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements? If not, what changes do you propose and why?

We are content to support the proposed reliefs for non-public entities.

Related party leases (FASB only)

Question 10 (FASB only): related party leases

Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases (for example, to require the lease to be accounted for based on the economic substance of the lease rather than the legally enforceable terms and conditions)? If not, what different recognition and measurement requirements do you propose and why?

Yes, we firmly agree that there should not be different recognition and measurement requirements for related party leases.

Question 11 (FASB only): related party leases

Do you agree that it is not necessary to provide additional disclosures (beyond those required by Topic 850) for related party leases? If not, what additional disclosure requirements would you propose and why?

Yes, we agree that there is no need for additional disclosures.

IAS 40 Investment Property

Question 12: consequential amendments to IAS 40

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?

Yes, we agree with the proposed amendments.