



Dear Sir/ Madam

Accounting for leases

I am writing on behalf of the Federation of Wholesale Distributors in response to the draft standard on accounting for leases published by the IASB in August 2010 as part of the consultation process with industry.

General comments regarding the proposed standard

In assessing businesses in the wholesale sector stakeholders, to our knowledge, understand whether companies own their properties or whether they rent. For public companies, analysts' forecast models reflect the owned or rented position and this is taken account of in company valuations.

Lenders, as one of their measures, use information contained in notes to accounts to make adjustments to balance sheets of companies that rent properties on a 'geared up' basis, ie to restate the balance sheet as if properties used in these businesses were owned.

We are concerned that the introduction of this standard may lead some readers of accounts to misinterpret some companies' trading positions. We note below a number of issues that are of particular concern regarding the effect on balance sheets and income statements;

Balance Sheet

Currently the future estimated contracted liability is stated in notes to accounts. Under this proposal there will be flexibility afforded to directors to 'set' the expected term of occupation in each property, the inflation rate attaching to the rental stream and the rate at which the future hypothetical cash flows are discounted. Consequently the liability taken to balance sheet and the impact on the profit and loss account of two identical companies could be materially different.

The purpose of this proposed standard is to record on the balance sheet the estimated discounted rental payments and describe such as if it were debt. Some readers of the accounts will regard it as such, but others won't.

The other side of the balance sheet entry is to be described as a 'right-of-use' asset. This suggests that the value to a company in having a lease of a particular premise is equivalent to the expected future rental payments. This may be the case at inception but not necessarily beyond that point and it is currently not clear how that assessment is to be made. For example is the carrying value impaired if the profitability of the activity operating from a premise is lower than expected? Or vice versa if profitability improves? And to make a similar point to that made above, some readers of the accounts will regard this as an asset but others won't.

And some will regard the discounted future rental payments as debt, but will disregard the 'right-of-use' asset.

Whilst a company may have a long term intention to maintain a balanced geographical footprint, it may have little attachment to any particular sites and might generally consider moving locally, during or at the end of lease periods, based on financial considerations. Estimating the likelihood of remaining on a particular site within or beyond a lease period is speculative for many businesses. Both foreseen and



unforeseeable changes to consumer behaviour (such as the implications of increased use of on-line purchasing) mean that past practice in this area cannot be considered to be a guide to likely future behaviour. This means that basing capitalisation periods on predicted occupancy periods rather than legal obligations would be highly speculative, further opening the balance sheet to arbitrary guesstimates.

Income Statement

Lease conditions generally allow for inflationary increases over the lease term and most are subject to periodic negotiation with landlords. Some may be subject to fixed annual uplifts and, in these cases, the total cost of these leases would be spread evenly over the lease period. Generally annual costs rise gradually, as indeed do other costs incurred by businesses, such as utilities and payroll. As a proxy rental payments charged to the profit and loss account are generally broadly similar to rent paid.

The effect of the proposed standard switches the phasing of a lessee's real costs over the lease term to a profile it would have incurred if it were a landlord who had borrowed funds to purchase the property. The current gradually increasing rent charged to operating costs in the income statement, which tends to increase with inflation, is replaced by two separate charges;

- depreciation calculated on the 'right-of-use' asset charged to operating costs evenly over the lease period and
- a discount unwind charge on the lease commitment liability charged to net financing costs on a decreasing basis over the lease term.

Thus at the commencement of a lease the proposed cost charged to income will be greatest, and cash paid the least whereas at the expiry of the lease payments will be at their largest but the cost charged to income will be smallest. In the first half of a lease overall costs charged will be higher than on the current basis, but lower in the second half. As with the balance sheet the charges are sensitive to the inflation and discount rates assumed.

If this standard is introduced at inception depreciation charges will be less than the current rent charged however together with the financing charge the aggregate charge will be greater. Operating profit will rise but profit before tax will fall. Over a lease period the charge to income will fall progressively whilst cash payments rise but on expiry, say on removal to new premises, the charge will sharply increase whereas cash rental payments may only increase marginally. Some companies may conclude that their balance sheets would need to be restated to reflect the time elapsed on each lease, in an attempt in the short term to even out the over and under charges compared to rent paid. It will still be the case, though, that any new leases or lease extensions will attract a material front loading of costs.

Summary

The FWD is concerned that its members and over half a million small businesses that we serve will be burdened with maintaining information on each lease which will far outweigh any perceived benefit of restating financial statements. Moreover the costs associated with the extra work in property asset and liability valuations for rented properties could put excessive burdens on small and medium sized enterprises.

In considering the effects of the proposed standard we have concerns regarding how stakeholders would interpret financial statements in the future. The inclusion of material subjective assets and liabilities on the balance sheet, the dislocation of cashflows from the income statement charge, the removal of rent from the income statement, the introduction of a lower flat annual non cash amortisation of a notional asset in place of real rent and the introduction of another discount unwind charge in the financing line are all potential issues.



We are also concerned that comparability of financial performance up to the point of adoption and thereafter won't be possible without some form of restatement of prior years. This might mean that income statements, balance sheets and cash flow statements might need to be restated for several years to re-establish comparative information on a consistent basis.

In summary, we are concerned that the material front loading of property costs in the income statement and inclusion of subjective balance sheet items will trigger a loss of understanding of companies and could be materially damaging to those businesses.

You should also be aware that the publication of these proposals has already affected many businesses because they are no longer contemplating lease renewals on the basis that the additional rent commitments may be classed as debt on their balance sheet.

Finally, if it is believed that there is insufficient information contained within the notes to statutory accounts regarding leases, it would be our preference that the solution lies in improving disclosure requirements there rather than adopting what is currently being proposed.

Yours faithfully

James Bielby
Chief Executive
Federation of Wholesale Distributors
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