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# International Association of Consultants, Valuators and Analysts

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International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom Submitted to: ifrs.org

Ladies and Gentlemen,

This letter of comment is submitted on behalf of the IFRS Committee of the International Association of Consultants, Valuators and Analysts (IACVA), a member of the International Valuation Standards Council (IVSC) and the World Association of Valuation Organizations (WAVO). We are a knowledge transfer and credentialing organization with Charters and Chapters, existing or pending, in Australia, Canada, China, Germany, Ghana, India, Indonesia, Kuwait, Lebanon, Mexico, New Zealand, Nigeria, Philippines, Russia, Saudi Arabia, South Korea, Taiwan, Thailand, the United States (National Association of Certified Valuation Analysts – NACVA and the Institute of Business Appraisers – IBA) and Vietnam. The organization has nearly 10,000 members, who are mainly involved in business valuation and fraud deterrence.

As a worldwide organization, our members are extremely concerned with the effect on valuation practices of many provisions in International Financial Reporting Standards (IFRS), as well as Generally Accepted Accounting Principles in the United States (GAAP). They are especially worried by the recent trend in the convergence activities that seems to result in IFRS moving towards GAAP rather than the process correcting the many practical deficiencies and complexities of the recent Accounting Standards Codification, especially its excessive rules.

We appreciate the opportunity to comment on the Exposure Draft "Leases" (the "ED").

# Introduction

In general, we support the Boards' efforts to improve lease accounting; the proposals in the ED address some criticisms of the current model by requiring that assets and liabilities arising from leases be included in Balance Sheets. As English is not the native language for many of our members, they sometimes confuse the terms, lessor and lessee. We believe for clarity, the Boards should use the term "User" rather than Lessee. We support the Boards' decision to pursue an approach in which the rights and obligations that arise from a lease are recognized in a single unit of account but are and remain opposed to any approach that would attempt to have the individual elements accounted for at Fair Value.

Until now an entity has not been required to recognize all lease liabilities on its Balance Sheet based on what many consider to arbitrary distinctions between operating and capital (finance) leases. We are not convinced that the Boards' goal has entirely been achieved in the ED, which will have a significant impact on both the Balance Sheets and Income Statements of nearly every entity throughout the world.

That there is a problem is well known. In August 2010, Credit Suisse based on 2009 date, estimated that \$549 billion of off-balance sheet (operating lease) liabilities will be recognized on the Financial Statements of the S&P 500 companies. This is only 4.65 times the \$118 billion of 2009 lease payments much less than the eight times rule-of-thumb, suggesting the problem is significantly smaller than many have thought. The liabilities amount will be offset by a greater amount of right-of-use assets. They will create interest expense, while the related assets will be amortized. In early years, under the ED's concept, the total of these changes will exceed the lease payments; the situation will reverse later in the term.

With a change of this magnitude in the United States, roughly over a trillion dollars for all enterprises, and similar or greater implications being felt elsewhere, it is essential that the Boards get it right; we do not believe they have yet done so.

For Managers, as a result of the ED, there will be a great deal of difficulties in:

- 1. Assessing the impact of the proposed changes on the Financial Statements, calculated lease by lease.
- Evaluating the existing lease management system and determining whether the existing installation can be upgraded to supply the necessary information or must be replaced.
- 3. Determining the impact of the proposals on loan covenants, corporate funding, compensation plans or other initiatives.
- 4. Considering the impact on future "lease versus buy" decisions.
- 5. Training staff and communicating with stakeholders.

The new Standard will replace four existing pronouncements: IAS 17 Leases; SIC 15 Operating Leases – Incentives; SIC 27 Evaluating the substance of transactions involving the legal form of a lease; and IFRIC 4 Determining where an arrangement contains a lease; as well as affecting IFRIC 12 Service concession; among others.

# **Conceptual Problems**

There are serious conceptual and application issues related to the proposals that must be addressed for them to be operational. The Boards should state a clear conceptual basis for their differentiation between leases and other contracts. Such a statement of the rationale for drastically different accounting treatments, is essential as we are not able to understand the principles that led to the Boards' decisions. In the absence of a well defined concept, preparers, auditors and valuators will have difficulty in making appropriate and consistent judgement.

Without a consistent vision for User and Lessor accounting and an understanding of the underlying premise to account for leases differently from other contracts, we are unable to fully understand the proposed models for Users and Lessors. One possible premise for recognizing assets and liabilities from leases differently may be that they are a means for a User to obtain many of the rights and benefits of ownership. We do not support this premise although it may be considered a reasonable basis for recognizing a lease obligation on the Balance Sheet at commencement.

Our objection is that it is inconsistent with the application of the lease model to arrangements that convey a right-to-use asset for which direct ownership is not feasible (e.g., a lease of a physically distinguishable portion of a larger asset that cannot be sold or sub-divided). Leases of such items are within the scope of current lease standards and appear to be within that of the ED. We believe such leases are merely an allocation of Cash Flows between operators and asset suppliers.

# Right-of-use Model for Users

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We support recording all leases on the Balance Sheet, even those that lead to ownership, recognizing a right-of-use asset and the corresponding liability to make lease payments. We are uneasy with how the ED proposes to determine and measure them. We believe that a lease obligates the User to make payments as a result of providing it with future economic benefits. The asset and liability of a User from a simple lease are fairly straightforward but the rights and obligations in a complex lease in the context of the conceptual framework require additional practical accommodations. Without them, to the accounting model will not be operational and offer benefits that exceed the substantial related costs.

While we would prefer to retain the current lease model, we recognize that the Boards have, unfortunately, decided in principle that leases give rise to rights and obligations

that should be reflected "on-balance sheet." Therefore, in our view, the right-of-use asset and the liability to make lease payments, recorded by the User, should be based only on its unconditional legal obligations. Only non-cancellable and unavoidable payments should be included. There are concerns that the contractual obligation does not measure the total liability of the User and including only such amounts, would allow for structuring opportunities. This appears to be throwing the baby out with the bath water as the proposals involve recording contingent and avoidable liabilities such as contingent rents based on the performance or usage of the underlying asset. However, residual value guarantees and index-based contingent rents would be covered (although we differ on the measurement method).

# Right-of-use model for Lessors

We to believe that the Boards should develop an accounting model for Users separately from that for Lessors. We understand that the analyses used to develop the proposed Lessor model, led the Boards to revise previous tentative conclusions relating to the model for Users. We hope that further development of the proposed Lessor model will not affect the views of the Boards regarding that proposed for Users, as much of the criticisms of current lease accounting have been directed at their practices.

The Boards should finalize the accounting model and issue a Standard for Users before completing the Lessor model. We believe that the later should be conceptually consistent with the proposed models for both Users and revenue recognition that applies to any contracts. We are not convinced the proposals for Lessor accounting offer a more realistic representation of their financial positions and results of operations than the current standards.

Certain aspects are inconsistent; the Boards propose that, in general, entities recognize revenue on the transfer of control of a good or service to the customer. However the ED uses exposure to risks or benefits to determine the timing of revenue recognition for Lessors. We believe that leases are just one of many transactions for which the proposed transfer of control model requires refinement. We do not agree that a risks and benefits based approach is preferable for Lessors.

The receivable recognized by the Lessor should be measured on a basis consistent with the liability recognized by the User, only reflecting the payments that the Lessor has an unconditional right to receive; all non-cancellable and unavoidable amounts should be included but nothing else.

#### Measurement

In our view, the proposed method of measuring the assets and liabilities recorded for lease contracts is not operational. Changes are necessary to remove s significant amount of estimation uncertainty (i.e. exercise of renewal options and contingent rents) that many entities may not be able to make reliably. We question the value to

anybody of recognizing unreliable estimates; we are also concerned that the proposed measurement methods will result in significant costs for which the benefits are marginal.

# Scope

A new and very different accounting model for all leases warrants a complete reappraisal of the existing requirements to determining whether a contract is, or contains, a lease. We believe that the Boards should clarify the guidance for distinguishing leases, including those implicit in service contracts, from other agreements. While the ED is consistent with existing standards, we are concerned its scope is too narrow to provide for consistent application to the many varieties of contracts that might be deemed to contain a lease. The main function of the current requirements seems to be identification of capital leases. The process does not typically have a significant effect on the accounting, as the treatment of operating leases and other executory arrangements are currently similar. We believe that the Boards should require only the recognition of the lease element if it forms a major part of the transaction.

We disagree with the Boards' decision to distinguish and exclude leases representing a purchase or sale of the underlying asset. Determining which contracts are, insubstance, purchases is the underlying premise of current lease accounting. The necessary classification has lead to many of the concerns and criticisms of the existing model. We believe that the proposal to exclude leases that contain a bargain purchase option or provide an automatic transfer of title to the User creates, an arbitrary and unnecessary distinction. In our view, lease accounting should be sufficiently robust to reflect all such contracts in a factual manner.

# Application guidance

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Additional application guidance and examples are needed to ensure, especially for Users, consistent application of the proposed Standard. The right-of-use model is a substantial change from current practice and further guidance is needed to fully explain its application. In particular, more guidance is needed to clarify the definition and identification of leases. While we understand the basic definition in the ED (a lease is a contract in which the right to use a specified, underlying asset is conveyed, for a period of time, in exchange for consideration), we have a number of concerns with the different treatment proposed for leases in comparison to other contracts.

An entity has the alternative of either, purchasing an asset and obtaining separate financing or of leasing it (both cases result in an asset and a liability), Executory contracts are not recorded on the Balance Sheet. While they convey certain rights and obligations, they do not meet the definition of an asset since the benefits are not received until completion of an act (e.g., the delivery of the goods or the

performance of the service). The definition of liability is also not met as the counterparty has not yet performed the obligating event. Purchase agreements are similar to leases that have been executed but not yet started. No asset is conveyed until the purchased material is delivered and the vendor no longer has control. As noted above, we are uncertain if the Boards conceptually consider leases as an alternative to asset ownership or not.

# Specified asset

We believe that the definition of a lease should be modified to clarify that only leases of depreciable tangible assets and land (i.e., property, plant & equipment) are within the scope of the Standard. We believe that the Boards should define a lease by what it is, instead of what it is not, which will enable users and preparers to clearly understand the scope of the Standard and properly apply it. As the Boards have explicitly excluded intangible assets, we would expect that only property, plant & equipment would be subject to leases within the stated scope of the ED. However, given the definition chosen by the Boards, other assets, including inventory, could potentially be covered. We are unclear as to the Boards' intention for using such a broad definition as we do not believe other underlying assets would meet the "right to use" criteria; they need to be productive or have output in order to do so.

# Unit of account

It is important for the Boards to clarify what constitutes the underlying asset (the appropriate unit of account) as the ED does not explicitly address this. In a lease of a ship, is the unit of account the entire vessel or the storage location of a specific container? If a plant has several production lines, can an individual line be considered the underlying asset of a lease for accounting purposes, as it can be legally? Current accounting allows for physically distinguishable portions of property, plant & equipment (e.g., a floor of a building) to be the unit of account. Paragraphs 3 and BC 12 of IFRIC 4 state that the guidance as to whether an arrangement is or contains a lease should be applied to those in which the underlying asset would represent the unit of account under either IAS 16 or IAS 38. Neither explicitly specifies what the required unit of account is. We suggest that the Boards provide the conceptual basis and additional guidance as to the underlying asset. This will ensure consistency in assessing whether a contract contains a lease and in the amortization period for the right-of-use asset and lease obligation.

# Right-to-use of a specified asset

We believe that clarification of paragraph B4(e) is necessary to ensure consistent application. Diversity in practice exists, primarily based on the interpretation and meaning of the phrases "fixed per unit of output" and "market price per unit of output." This paragraph should be enhanced by:

- 1. Explaining the rationale for the criteria. We believe they are based on the concept that the pricing terms indicate which entity has control. Currently, when the arrangement involves a single purchaser taking substantially all of the output from a specific asset other than at market price and the price varies other than in response to changes in the market, the variability ("off-market") nature is regarded as indicating that payment is being made to use the asset rather than for its output. We do not believe this is a reasonable assumption.
- 2. Clarifying the meaning of "fixed per unit of output" and "market price per unit of output" and how broadly those exceptions can be applied.
- 3. Confirming that the slight wording changes to the criterion are not intended to affect the fundamental assessment. Paragraph BC30 states that the ED carries forward the existing criteria with some clarification, however, the ED eliminates the assessment of the probability that the purchaser will take all but an insignificant amount of the output replacing it with the term "will obtain." Is this criterion based on absolute certainty at inception? Does it allow for the assessment of possible events over the term? Since the accounting treatment differs drastically depending on whether the criterion is met, we consider a possible future re-assessment to be essential.

The basis for conclusions and illustrations in the current standards are not carried forward. Additional application guidance and examples similar to those IFRIC 4 and ASC 840 are needed; they should include:

- 1. Clarification of the meaning of "right to operate the asset or direct others" (paragraph B4(a)).
- The basis for why "ability or right to control physical access" in paragraph B4(b) indicates control. IFRIC 4 states "that in such arrangements the purchaser would have the ability to restrict the access of others to economic benefits of the underlying asset."
- Various scenarios that do not meet the criterion of paragraph B4(c) due to the "fixed per unit of output" or "current market price per unit of output" exceptions.
- 4. Assessment examples, such as those in ASC 840-10-55-30 to 55-34 and IFRIC 4.1E1-1E4.

Our detailed observations to the questions in the ED are as follows:

#### **Question 1: Lessees**

(a) Do you agree that a lessee should recognize 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 recognize amortization 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?

(a) From a valuation point of view, we believe that the current differentiation between Capital (purchase) and Operating (service) Leases is satisfactory. An analysis of the cash flow coverage of fixed charges (rent, lease, interest and mandatory principal payments) is normally undertaken in any valuation to determine the level of financial risk. The Fair Value of an entity, together with those of its recorded and unrecorded assets, as well as the related recorded or unrecorded liabilities, changes over time, depending on its outlook and the level of interest rates. Capitalization of lease payments at the current low interest rate is likely to overstate liabilities in subsequent years when interest rates inevitably rise. Our preference is to leave well enough alone.

However, the Boards appear to have decided that capitalization of all leases is essential. We therefore recommend a model for recording operating leases that reflects their economic reality, rather than the "asset" or "liability" situation. It is similar to Mr. Stephen Cooper's Alternative View and is based on:

- A. The legal lease term ignoring all, except for "bargain", options.
- B. Including only contingent rents that are unavoidable and can be readily measured, but not those established on some subjective basis such as management's expectations.
- C. Excluding all service contracts, even those which, under IFRIC 4, might contain a lease, unless the payments, reasonably attributable to such activity, are considered to be significant to the operations of the entity as a whole.
- D. Restating the lease liabilities and the related right-of-use asset at each reporting date using a discount rate that reflects
  - (i) the relevant currency
  - (ii) the remaining term
  - (iii) the Weighted Cost of Capital attributable to that class of assets, reflecting the amount that might be borrowed to purchase it and the implicit equity required
- E. Amortizing the right-of-use asset (which should not exceed the Fair Value of the underlying asset) on a sinking fund basis (similar to that used for some real

estate in the 1950s and 1960s). In this method, amortization increases over time as the asset apparently deteriorates. The effect is that the sum of the interest charge and the amortization is approximately the same as the cash lease payments.

(b) We accept that, if the present value of lease payments are recorded on A Balance Sheet, then an interest charge is necessary. However, as stated in answer 1. (a), we recommend that an amortization basis should be allowed for a right-of-use asset that will result in the total of the interest and amortization charges of the user to be approximately equal to the cash payments, which represent the economic effect of the lease. The current proposal considerably understates the entity's profit, compared with the economic effect, in the early years and overstates it in later periods. On the initial introduction of the Standard an immediate material adverse effect on profits is likely without any change in Cash Flows.

# **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?

- (a) We believe that while legal title to the asset remains with the Lessor, the performances obligation model should be applied. De-recognition should not occur until ownership has changed hands. It is important to realize that this IFRS will apply in over 100 countries with many very different legal frameworks for leases.
- (b) We accept the Board's proposals of the recognition of assets, liabilities, incomes and expenses in the performance obligation model. In our view, de-recognition is not appropriate accounting model for leases. In particular, we object to the recognition of revenue on inception, other than recovery of Lessor initial direct costs, as the principle of lease accounting should be the same as those for revenue recognition.

#### **Ouestion 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 recognize 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 recognize assets and liabilities arising from a short-term lease in profit or loss, nor derecognise any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other IFRSs and would recognize 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 question whether the short-term leases referred to in paragraph 64 are completely the same as the normal type of lease which is defined in Appendix A, paragraphs B1- B4 and BC29 – BL32. We consider them to be more like day to day or monthly rentals, which may be cancelled at any time. Therefore, we do not believe that they should be capitalized at all. In particular we consider that a user should have the same rights of election as a Lessor (paragraphs BC41 – BC 46).

#### 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? (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?
- (a) We believe the proposed definition is unduly broad. We are concerned that supply or services contracts that involve a take-or-pay clause such as for gas pipeline capacity or utility agreements with a capacity charge may be covered, as well as long term magazine printing contracts or "power by the hour" aircraft engines.. In particular, we are worried that the application of IFRIC 4 Determining Whether an Agreement Contains a Lease and IFRIC 12 Service Concession Agreements will result in an expansion of the payments required to be capitalized as lease liabilities. In our view, any agreement that principally relates to the supply of output, irrespective of how the payment is specified, should be excluded from the IFRS and declared not to be a lease. We believe that operating leases, while they meet the definition of liabilities are not financial liabilities but merely the allocation of an entity's cash flows.

We are concerned that the Boards are adopting a "Back to the Future" policy returning to the nineteen century when the Balance Sheet was predominant. In that era assets and liabilities were separately developed and "profit" arose as the result of the differences in their changes. As valuators, we are principally concerned with the Income and Cash Flows Statements. For our purposes it is essential to separate the results of operations from those of other (mainly investment) activities, which are reflected in Other Comprehensive Income (OCI).

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For valuation purposes, the Statement of Financial Position consists of Tangible Working Capital. Capital Assets (Property, Plant & Equipment) Intangible Assets (both purchased and internally generated) and Term Liabilities together with the deferred costs and accruals involved in matching the revenues and expenses of each past and future period. Each item except for the accounting deferrals and accruals are restated to fair value.

- (b) As stated previously, we prefer that no attempt be made to separate leases deemed to be purchases or sales. However, if the Boards persist in insisting on segregation, we find the criteria in paragraph B9 and B10 unduly restrictive. In our view, a sale transaction is one that involves a transfer of legal title. If title cannot be transferred, it is not a sale even if control changes hands at a price other than fair, or fair market, value. This has been common for many types of leases for over 150 years. Where there is no right to legal title, it cannot be a sale.
- (c) In our view, the guidance in B1 to B4, is inappropriate. Many service contracts involve the use of customer dedicated equipment, as in nearly all IT outsourcing. This is usually incidental to the provision of the relevant goods or services. Most such agreements are caught by clause (a) or especially (b) of paragraph B2. We find the reasoning of B3 more persuasive and recommend the rejection of the concept of IFRIC 4 that underlies paragraphs B1 to B4 based on the economic and legal structure. If one goes looking for a problem one usually can be found.

# Scope

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# **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 do not agree with the existing scope, believing that only property, plant & equipment should be covered. In addition, we would an exception. The first would be for service contracts as discussed under Question 4(c). The second is for incidental (non-core) equipment following the reasoning (unfortunately rejected by the Boards) in BC39. Peripheral equipment, such as printers, copiers, PC's, etc., should be treated as "small tools" and excluded. Such leases are generally of the nature of rentals unless a purchase option is included. The time and effort needed to estimate the "longest possible term" that is more likely than not to occur (paragraph B16) for such items would be substantial. With much electronic equipment, the time of replacement is based on future technological developments of which management cannot have any idea.

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

The exposure draft proposes that lessees and lessor 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?

As set out previously, we believe that when a service contract involves a imputed lease component that is incidental to the total payments involve, such lease element should be excluded. When the lease component is substantial, we believe the contract should be split into two from an accounting viewpoint – an inputted lease and an agreement for the sale of goods or services. Under no circumstances should the User or the Lessor, be required to apply the lease accounting requirements to the combined contract.

#### **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 concur that any purchase option should not be reflecting in the accounting records until exercised.

#### 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).

# With respect to Measurement:

- (a) We believe that the liability should only reflect the present value of payments to be made under the User's legal obligation for the stated term of the lease. We recommend ignoring any options to renew as it is a subjective decision as to which, if any, options will be exercised in 15 to 20 years' time. The corollary is an extendable bond that, depending on interest rates at the initial (say 10 years) maturity, may have a total term of either 10 or 15 years. The requirement to consider the "probability of occurrence of each possible term" requires management to make judgements based on instinct, not facts.
- (b) In our view, a lease obligation is not a financial liability, not even a secured one, because of the different treatments on liquidation. With a secured financial liability, the collateral is sold and any (unlikely) surplus returned to the borrowers; any deficit is a continuing unsecured obligation. With a lease liability, the appropriate asset is repossessed and additional payments are undoubtedly required.
  - The Board seems rather ambivalent on this subject. BC10 suggests, by analogy, that leases are financial liabilities, BC75 says, although they meet the definition, they are not they are not, because the liability is linked to a right-of-use asset. BC123 specifically states they are, while BC145 refers to the view that they are a unique class of liability. The latter is an obvious fudge. Either they are or are not. In our view, leases are non-financial liabilities, therefore avoidable items such as indeterminate contingent rents (related to expectations as to future sales) should be excluded. Reasonably determinable contingent rents, such as increases tied to an index for which there are available forecasts, should be included. We believe that all such figures should be based on the most likely situation rather than the more complex, subjective and considerably more expensive "expected outcome" techniques.
- (c) The wording of the Standard should reflect the view that mandatory updates are expected to be reasonably rare and only reflect changes in the underlying economics of the leased asset or, the obligation to make lease payments.

# **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?

As set out previously we believe that an operating lease is in most cases, an allocation of cash flows rather than a term liability. However, as the Boards have decided that a liability must be recorded, we believe that, in line with other non-financial liabilities, it should not include avoidable costs. For that reason, and the subjective nature of the

decision whether or not to exercise any renewal options, we recommend that the accounting lease term be the same as that of the legal obligation.

# **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 accept the concept that the carrying amount of the right of use asset be based on the related lease payment liability. However, as mentioned previously, we prefer the most likely situation rather than an expected outcome technique. This is normally how management operates a business. We believe that only costs that can be reasonably measured and are not avoidable should be included in determining the payments to be present valued. Therefore, many contingent rentals would be excluded.

#### **Question 10: Reassessment**

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?

We believe that changes in a lease obligation should, as described in Answer 1 (a) D, be made every reporting period reflecting all changes in the underlying economics of the leased assets and restating the present values of the obligations to make lease payments to current interest rates; these changes would be made through OCI.

# 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).

#### **Ouestion 11**

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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?

In the case of a sale leaseback transaction, we prefer the method of deferring any gain on sale of the asset over the lease term as a reduction of the amortization expense relating to the right of use asset. This deferred gain would be grouped with the present value of the lease payments over the legal term to establish the lease liability.

# 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: 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?

- (a) As stated previously, we do not believe lease obligations are financial liabilities and therefore, consider they should be shown separately. With respect to the right of use assets, we believe they can be grouped with the owned assets of the same class (property, plant & equipment etc.) with the separation of the balances related to the owned and leased items being shown in the Notes.
- (b) We concur with the Boards' position for Lessors that use the performance obligation model.
- (c) We do not agree with adopting the de-recognition model unless legal title to the assets is transferred.
- (d) We believe that on entry into a sub lease, the right of use asset should be replaced by a receivable for the present value of future lease payments. Any implicit losses should be charged immediately to OCI, with any gains being taken in as received.

# 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?

15 December 2010 Leases

Under the proposed model, lease expense for a User, consists of interest on the liability and amortization of the related right-to-use asset. To reflect the economics of the lease, the amortization method chosen should result in the total recorded expenses being approximately the same as the lease payments. This may be done by allowing a sinking fund method of depreciation. This was often adopted by real estate companies in the 1950's and 1960's. The interest should be grouped with other interest expenses while the amortization should be separately identified in the Notes.

# **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?

There is no difference in nature between the cash flows from lease and those from other sources. Therefore there is no need to separately disclose them..

# Disclosure

# **Question 15**

Do you agree that lessees and lessors should disclose quantitative and qualitative information that: (a) identifies and explains the amounts recognized 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?

- (a) The degree of disclosure required reported by the Boards smacks of overkill. For an organization with several hundred real estate leases spread over a number of I legal jurisdictions and even more for store equipment, the indicated disclosure would be voluminous. A simple statement in the Notes showing the average discount rate used and breakdowns of the right-to -use assets by category, (property or plant & equipment) together with analyses of the related liabilities on the same basis should be sufficient.
- (b) An indication of how the lease may affect the amount, timing and uncertainty of the entity future cash flows is essential for valuators, especially one showing the impact of anticipated changes.

#### **Transition**

# **Question 16**

(a) The exposure draft proposes that lessees and lessors should recognize 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?

- (a) We are very concerned with the negative impact on the reported profit of Users as a result of the transition provisions even though there would be no effect on actual y Cash Flows. Our suggestion to use sinking fund amortization for the right-to-use assets would reduce the distortion.
- (b) As a result we believe that any entity should have the right, on a lease by lease basis, to implement full retrospective application as suggested in Paragraph AV10.
- (c) Another transitional issue is how to deal with leases that are in the process of renegotiation. We believe the anticipated characteristics should be used?

# Benefits and costs

#### **Ouestion 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 Boards have yet provided sufficient evidence to support their conclusion that benefits of capitalizing lease obligations outweigh the costs. As valuators, we see few benefits comparable with substantial costs. For the illustrative example shown in our answer to Question 18, it took an experienced professional accountant over a working day to analyze a single, relatively simple lease.

# Other comments

#### **Question 18**

Do you have any other comments on the proposals?

We regret the relatively small number of illustrative numerical examples in the ED, most of which relate to Lessors not Users. In a matter as complex as this, it is desirable that the Standard not only include significant application guidance but also a framework for the analysis of a lease together with a worked out example. We have done so in the following slides which are some of those presented, by the writer, at an IASB round table in Toronto, Canada, on 22 November 2010. More comments follow the slides.

#### Framework for Analysis of Leases by Users

- 1. Does the agreement contain a lease?
- Is he transaction to be accounted for as a sale or a lease?
- 3. Which elements are to be accounted for as services?
- 4. What is the Lease Term?
- 5. What is the appropriate discount rate?
- 6. What is present value of rental payments during the Lease Term?

#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

- 7. Are there any contingent amounts?
- 8. What is the present value of estimated future contingent amounts?
- 9. What is the present value of any extra payments such as termination costs or restoration expenses?
- 10. Which initial direct costs are to be capitalized in the right of use asset?
- 11. What information has to be disclosed in the Financial Statements and accompanying notes?
- 12. What is the tax treatment of the various payments?

#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

- Rental area 2,050 square feet (useable 1,907)
- Term 20 years from 1 October 2001
- Starting gross rent \$19.00 per sq ft
- After 2003, rent rises every February 1 by CPI of year ended previous December
- Option to renew for further 5 years at fair market on renewal date plus same annual increases
- Cancellation right on six months notice and payment of six month's rent
- 2010 rate of \$21.15/sq ft covers all occupancy costs
- Occupancy costs: taxes, utilities, maintenance, etc. estimated at \$8.90 per sq ft

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#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

# **Application of Framwork**

- 1. Does the agreement contain a lease?
- The agreement is a lease supplying the right office space for a significant period.
- 2. Is the transaction to be accounted for as a sale or a lease?
- The transaction does not transfer control or give a purchase option at the end of the period, therefore it is not a sale.

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# SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

# 3. Which elements are to be accounted for as services?

- The service element of the lease is debatable. All costs relate directly to the occupancy of the real estate although in some leases they are treated as operating costs separately disclosed (pro-rata) and charged as additional rent.
- However as the lessor could sell the services separately (they have a distinct function and different profit margin

   cost plus admin fee) their supply has been considered a

  service contract.
- Table 1 shows the actual (2001-2010) and projected (2011-2015) figures for Contractual al Payments, Service Components, Effective Rents and Contingent Portions.

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**18** *Leases* 15 *December* 2010

				Lea	ase Analys	es					TAB	LE 1
_					ntractual		Services	Services		fective		ntingent
December	Source	CPI	Change	Payment		Component		Increase	Rent		Portion	
				I	er sq. ft	1	er sq. ft		pe	er sq. ft	pe	r sq. ft
2017	Projection		2.00%	\$	24.65	\$	11.32	3.5%	\$	13.33	\$	0.71
2016	Projection		2.00%	-	24.17	\$	10.94	3.5%	\$	13.23	\$	0.71
2015	Projection		2.00%	\$	23.70	\$	10.54	3.5%	\$	13.12	\$	0.51
2013	Projection		2.00%	-	23.23	\$	10.21	3.5%	\$	13.02	\$	0.40
2013	Projection		2.00%	-	22.78	\$	9.87	3.5%	\$	12.91	\$	0.29
2012	BNS	121.2	1.93%	-	22.33	\$	9.53	3.5%	\$	12.79	\$	0.18
2011	BNS	118.9	1.80%	\$	21.91	\$	9.21	3.5%	\$	12.69	\$	0.08
2010	BNS	116.8	1.74%	\$	21.52	\$	8.90	3.5%	\$	12.62	Ψ	0.00
2009	Actual	114.8	1.32%	\$	21.15	\$	8.60	3.5%	\$	12.55		
2008	Actual	113.3	1.16%	\$	20.87	\$	8.31	0.0%	\$	12.56		
2007	Actual	112.0	2.38%	\$	20.63	\$	8.31	0.0%	\$	12.32		
2006	Actual	109.4	1.67%	\$	20.16	\$	8.31	0.0%	\$	11.85		
2005	Actual	107.6	2.09%	\$	19.82	\$	8.31	2.3%	\$	11.51		
2004	Actual	105.4	2.13%	\$	19.42	\$	8.12	5.4%	\$	11.30		
2003	Actual	103.2	2.08%	\$	19.00	\$	7.71	2.2%	\$	11.30		
2002	Actual	101.1	3.80%	\$	19.00	\$	7.54	3.1%	\$	11.46		
2001	Actual	97.4		\$	19.00	\$	7.31		\$	11.69		
	BNS	Bank of	Nova Sco	tia l	Economics							

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# **SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE**

# 4. What is the Lease Term?

- The lease term is defined as the longest possible term that is more likely than not to occur. An entity determines the lease term considering all explicit and implicit options included in the contract and given effect by law.
- The ED (paragraph B22) sets out the following factors in assessing the probability of each possible term:

# SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

# A. Contractual

- Explicit terms that could affect whether the entity extends or terminates the lease.
- · Those include:
  - the rent in any secondary period(bargain, discounted, market or fixed)
  - the existence and amount of any contingent payments, term option penalties or residual value guarantees
  - the terms of any renewal options
  - costs associated with restoring or returning the underlying asset

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**19** *Leases* 15 *December* 2010

# B. Legal & Financial

- · Consequences of a decision to extend or terminate the lease not explicitly stated in the contract, including:
  - local regulations affecting the lease term
  - significant leasehold improvements that would be forgone if the lease were terminated or not extended
  - non-contractual costs, such as those relating to relocating
  - lost production, tax consequences and sourcing on alternatives

#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

# C. Operational

- The suitability of the asset for continued use after the expiry of the initial term, including the cost and benefits of cancellation.
- Alternatives to the use of the asset such as subcontracting

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#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

- The lease term is the longest possible period including all likely options more likely than not to occur. It is to be determined by estimating the probability of occurrence for each possible term, taking into account any options to extend or terminate.
- As the initial term has 11 years remaining and it is difficult to estimate the fair market rent at that time, it is impossible for management to say if the options at fair market with a CPI escalator is more likely than not to be exercised.
- However, there is a cancellation right. Based on available information management establishes that the premises will be required for at least four years.

Situation

· The characteristics of the lease are:

- Balance of term 11 years

Option period 5 years

four alternatives:

Probability Cancellation - 4 years 20% Cancellation - 9 years 55% Maturity - 11 years 20%

SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

- Cancellation right 6 month notice plus 6 month rent penalty

After reviewing all available information, management considered

Exercising option - 16 years 5% 100%

# SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

- The cancellation right can be exercised at any time but the current facility is expected to be satisfactory for at least four years. There is a 75% probability (20% plus 55%) that it will no longer be suitable in 9 years (2019) due to expanded operation in that community.
- From a 4-year term to a 9-year term (5 years) the change in probability of cancellation is 55 percentage points (pp). This is equivalent to 11pp per year. Therefore the longest possible term more likely than not to occur is 6.75 years (20pp + 30.25pp = 50.25pp) to 30 June 2017 with notice given after 6.25 years on 31 December 2016.

# SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

# 5. What is the appropriate discount rate?

 The ED states (paragraph 12) that the liability to make lease payments is to be determined using (a) the lessee's (user's) incremental borrowing rate or (b) if it can be readily determine, the rate the lessor charges the user. Those terms are defined in Appendix A of the ED.

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15 December 2010 20 Leases

· lessee's incremental borrowing rate

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.

rate the lessor charges the lessee

A discount rate that takes into account the nature of the transaction as well as the specific terms of the lease such as lease payments, lease term and contingent rentals.

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#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

 Those rates were very different. The interest rate environment has changed significantly since 2001.

Incremental Borrowing Rate

- The user's records indicate it borrowed at prime +0.5%. On 1 October 2001, the prime rate was 5.25% while the commercial mortgage rate was 7.5%.
- Discussions with the firm's bankers indicate that for condominium office space (which is rarely available in the particular city) the maximum loan to value at that time, was 66.7% and a premium of 0.35% would have been charged on the mortgage loan due to the lesser security compared with freehold lending.

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#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

 Therefore the lessee's incremental borrowing rate would be 9.1% made up as follows considering the business's 2000 Return On Equity of 12.12%

	Portion %	Rate %	Product %
Mortgage	66.7	7.60	5.07
Equity	33.3	12.12	4.03
			<u>9.10</u>

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# SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

Lessor's Charge Rate

- Around the time of commencement of the lease (July 2001 to Jan 2002), several office buildings were sold in that city.
- According to available records the Overhead Capitalization Rates varied from 7.95% to 8.25%.
- The mean (5 examples) was 8.98% while the most comparable deal was at 8.01%.

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# SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

# Selected Discount Rate

 As the lessor's charge rate can be reasonably estimated from market data, while projecting the user's incremental borrowing rate 9 years in the past involves significant assumptions, the estimated lessee's charge rate rounded to 8.0% has been selected as the appropriate Discount Rate. SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

- 6. What is present value of rental payments during the Lease Term?
- For the purposes of the ED, the rental payments appear to mean the portion of the current monthly payment not devoted to services.
- As shown in the TABLE 2, their present values, at an 8.0% Discount Rate total \$223,844.

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	Present V	alue	Rental Pa		TABLE 2		
						Present	
Year	Months	Rent per sq. ft		Rent	PV Factor	Value	
				\$	8.0%	\$	
2010	3	\$	21.52	11,028	0.9804	10,812	
2011	12	\$	21.52	44,113	0.9078	40,044	
2012	12	\$	21.52	44,113	0.8405	37,078	
2013	12	\$	21.52	44,113	0.7783	34,332	
2014	12	\$	21.52	44,113	0.7206	31,788	
2015	12	\$	21.52	44,113	0.6672	29,434	
2016	12	\$	21.52	44,113	0.6178	27,254	
2017	6	\$	21.52	22,056	0.5941	13,103	
						223,844	

#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

# 7. Are there any contingent amounts?

• A contingent amount arise annually as payment are increased each 1 February by the previous year's change in the CPI. Therefore this not only covers the increase in service costs but generates an element of contingent rent.

#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

# 8. What is the present value of future contingent amounts?

 The present value of the estimated contingent rent is \$3,396 as shown in table 3.

SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

Present	Value of	Cont	ingent R	Rents		TABLE 3	
			ntingent	Contingent		Present	
Year	Months	Rent		Rent	PV Factor	Value	
		pe	r sq. ft	\$	8.0%	\$	
2010	3	\$	-	-	0.9804	-	
2011	12	\$	0.08	154	0.9078	140	
2012	12	\$	0.18	362	0.8405	304	
2013	12	\$	0.29	593	0.7783	462	
2014	12	\$	0.40	819	0.7206	590	
2015	12	\$	0.51	1,039	0.6672	693	
2016	12	\$	0.61	1,252	0.6178	773	
2017	6	\$	0.71	729	0.5941	433	
						3,396	

# SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

# 9. What is the present value of any extra payments such as termination costs or restoration expenses?

- The Cancellation Right requires six months notice and the payment of six month's rent (including the services component) at that time. Therefore, the estimated exercise payment \$24,774 on 31 December 2016.
- The exercise payment of \$24.17 per square foot (table 1) applied to 2.050 square feet for 6 months is \$24,774.. Applying the 8.0% present value factor of 0.6178 gives a present value of \$15,306.

SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

- The liability to make lease payments should include the present values of:
  - estimated contingent rents;
  - if those it depend on a rate or index, the expected payments should use readily available forward rates or indices. When they are not available, the prevailing rates or indices should be applied
  - estimated payments under a residual value guarantees
  - estimated term option penalties

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- A purchase option is not included in the present value of lease payments.
- For Sample Lease A the liability consists of the following:

<b>Present Value of</b>	\$
Rental Payment during the lease term	223,844
Contingent rents	3,396
Extra payments	15,306
	242,546

#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

# 10. Which initial direct costs are to be capitalized in the right of use asset?

- The ED (paragraph 12(b)) allows the addition of initial direct costs to the liability in calculating the amount capitalized as the Right Of Use asset.
- Paragraph B14 states:
  - Initial direct costs result directly from, and are essential to, acquiring or originating a lease and would not have been incurred had the lease transaction not been made.

#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

- Those may include:
  - Commissions
  - Legal fees
  - Evaluation of the prospective lessee's financial condition
  - Assessing and recording guarantees, collateral and other security arrangements
  - Negotiating lease terms
  - Preparing and processing lease documents
  - Closing the transaction
  - Other incremental costs directly attributable to arranging the lease

#### SAMPLE LEASE - FIFTH FLOOR CITY OFFICE SPACE

- Most such costs relate to lessors. For the Sample Lease, the user had hired a realtor to negotiate the lease. His fee was 10% of the first 24 month's rent.
- Commission in 2001, was \$7,790 calculated as follows: "rent" \$19.00 per square foot; rentable area 2,050 square feet; monthly payment \$3,2463. Total for 24 months \$77,900.
- In addition, there were legal fees of \$1,572.
- Both amounts, totalling \$9,362, were expressed as occupancy costs when paid.
- In this case, such sums would not be capitalized as had previously been written off.

# Additional clarifying guidance

Additional clarifying guidance related to the following would be beneficial:

# Discount rate

Paragraph 12 states that a lessee can use the rate the lessor charges the User if it can be "readily" determined, but paragraph B11, adds that the rate the lessor charges the User can be applied if it can be "reliably" determined. Is the level of certainty required by readily the same as that for reliably? The Standard should use consistent terminology. With the exception of a lease with a fixed price purchase option and a first dollar loss residual guarantee, the rate the Lessor charges is generally not easily determinable. We believe the Boards should clarify that the rate stated in the contract meets the determinable criterion.

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# Incremental borrowing rate

Additional guidance is needed relative to the determination of a lessee's incremental borrowing rate under apply in various circumstances. Problems may arise when leases are entered into by subsidiaries, are denominated in foreign currencies and for which it is the only way to obtain 100% third party financing. An entity can rarely purchase an asset with 100% vendor or bank financing.

# Residual value guarantees

The ED is unclear with regard to whether changes to the expected amount payable to the Lessor for residual value guarantees would be reflected in the current or future periods. One view would be that the change was realized in the current period (i.e., that in which the expected value of the underlying asset declines), whereas the contrary position is that the amount payable is not determined until the end of the term and therefore pertains to a future period. The Boards should provide an example to ensure consistent application.

#### Lessor initial direct costs

The treatment of initial direct costs incurred by Lessors, needs clarification. Paragraphs 33(a) and 49(a) indicate they should be included in the initial measurement of the right to receive lease payments. Subsequently they are carried at amortized cost using the effective interest method (paragraphs 37(a) and 54). It would appear that this capitalization would affect the interest income over the term, as a Lessor would need to impute an effective interest rate (other than that it charges the User) to allocate payments received between interest income and a reduction in the right to receive lease payments. Alternatively it may be reasonable to amortize initial direct costs over the term on a straight-line basis. To the extent that the Boards do not agree with either approach, the Standard should indicate an appropriate method. The capitalization proposals in the ED appear to be inconsistent with the capitalization of contract costs provisions in the exposure draft *Revenue from Contracts with Customers*. We believe that consistent principles for capitalizing and expensing the costs of obtaining a contract should be applied.

# Lease payments

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Appendix A defines lease payments as "payments arising under a lease including fixed rentals and rentals subject to uncertainty, including, but not limited to, contingent rentals and amounts payable by the lessee under residual value guarantees and term option penalties." Economically, leases can include not only those cash payments, but also other types of consideration. Examples include non-monetary items (perform services, assume a liability), guarantees of debt, indemnifications and payments by unrelated third parties. We believe the definition should be clarified and additional application guidance provided to address the following:

- Indemnification clauses including but not limited to environmental contamination incurred during the lease term, pre-existing environmental contamination, tax payments, changes in tax law
- Non-performance-related default covenants
- Loan guarantees
- Asset retirement obligations and return provisions

Paragraphs 14, 35 and 52 specify that residual value guarantees provided by an unrelated third party are not lease payments. The Boards should provide the conceptual basis for this conclusion and clarify if all payments related to a residual value guarantee involving a third party are also excluded (e.g., a User pays an unrelated third party to guarantee the residual asset with all payments under the guarantee paid directly to the Lessor). Additionally, the Boards should clarify when residual value guarantees can be excluded (e.g., a lessee pays an unrelated third party and is removed as the primary obligor under the residual value guarantee). We suggest that the Standard clarify how such excluded residual value guarantees are to be accounted for.

# Investment property

We believe the IASB's intention was to provide a scope exclusion from the leases ED for Lessors measuring investment properties at fair value. However, paragraph 7 could be read to include Lessor owned investment properties within the scope of the ED as paragraph 7(b) is a continuation of the initial sentence, which only references investment property that an entity holds under a lease (i.e., leased-in investment properties or properties that the entity does not own, but leases to Users). Conversely, the discussion of amendments to IAS 40 in Appendix C appears to indicate that leases of both owned and leased-in investment properties measured at fair value would be excluded. Paragraph 7 should be clarified.

Additionally, the ED's description of the accounting for leased-in investment properties, is inconsistent with IAS 40, and there is no indication of how IAS 40 will be amended. We believe that the Boards should develop and expose an amendment covering complete and comprehensive accounting for investment properties held through a leasehold interest.

Should you wish to discuss this matter further, a member of your staff may contact the writer in Toronto, Canada at 416-865-9766.

Respectfully submitted on behalf of the IFRS Committee of IACVA

Per

James P. Catty, MA, CA•CBV, CPA/ABV, CVA, CFA, CFE

fun P. C. S

Chair