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December 15, 2010

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

Dear Sirs,

This letter is the response of the Canadian Accounting Standards Board (AcSB) to the Exposure Draft, *Leases* issued jointly by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (together “the Boards”), in August 2010.

The staff of the AcSB discussed aspects of the proposals with the AcSB’s User Advisory Council, Academic Advisory Council, and Private Enterprise Advisory Committee and also the Leases Advisory Working Group. The staff of the AcSB has consulted with a broad spectrum of Canadian preparers, practitioners and users. The views expressed in this letter take into account comments and perspectives raised by these stakeholders. However, they do not necessarily represent a common view of the Board, its Committees or staff. Views of the Board are developed only through due process.

We commend the Boards in their efforts to develop a comprehensive standard on the accounting for leases and think it is imperative that they reach a consensus on those issues on which their views still diverge.

The AcSB supports the objective of recognizing all assets and liabilities arising from leases in the statement of financial position. We think that the right-of-use/lease obligation model is the correct general approach, as we think that lease contracts give rise to assets and liabilities that

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should be recognized in the financial statements of lessees. However, we disagree with how the Boards propose to apply the right-of-use/lease obligation model, as discussed below. We also think that the Boards should explore more fully the use of the derecognition approach as the sole method of lessor accounting, as this approach is more consistent with the right-of-use/lease obligation model and the Boards' proposals for revenue recognition.

Scope

From the inception of this project it has been clear that some of the most difficult practice issues in accounting for leases relate to the scope of the standard. The scope issues are critical because of the significant differences between accounting for leases and otherwise similar executory contracts for both lessees and lessors. The exposure draft proposals perpetuate, and in many respects, increase the differences between lease accounting and the requirements of other standards. We believe that the Boards have not devoted nearly enough attention to clarifying and resolving fundamental questions about scope that are clearly evident in the application of current standards and that will continue under the proposals. We have identified three major sources of problems. They are probably not exhaustive.

i) Differentiating service elements of a contract from right-to-use elements.

We are struggling to understand the conceptual basis used by the Boards to differentiate elements of a single contract into "service element(s)" and "right-of-use" elements. We are concerned that there will be inconsistent application of the proposed standard in practice, due to the lack of clarity of the definitions and the lack of implementation guidance in the standard on differentiating these two notions. Accordingly, we suggest that the definition of a lease be modified to distinguish more clearly between a pure services contract and a contract that contains a lease, and the conceptual basis for that distinction. For example, there are service contracts that refer to a type of tangible capital asset that will be used in providing the service but the lessee is indifferent as to which specific asset is provided (e.g. short-term car rentals and many

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information technology outsourcing arrangements). We think it would be inappropriate, in many cases, to account for these contracts as leases.

ii) IFRIC 4, Determining whether an Arrangement contains a Lease

Paragraphs B1 – B4 in the exposure draft carry forward existing guidance from IFRIC 4. However, the guidance is not identical to that in IFRIC 4, nor does it include all the guidance in the IFRIC. Further, applying IFRIC 4 has raised many difficult issues in practice, resulting in diversity in application of the IFRIC. Applying IFRIC 4 to leases that would be operating leases under existing IAS 17 may raise further issues. Determining whether an arrangement contains a lease is a critical scope issue and more complete guidance on this is required if the standard is to be operational.

iii) Leases of intangible assets

We are concerned with the Boards' decision to defer consideration of the accounting for leases of intangible assets until the accounting for intangible assets is considered more broadly. This decision is in spite of the fact that the exposure draft *Revenue from Contracts with Customers* (Revenue ED) includes the accounting for licensing arrangements that, as the Basis notes, often have characteristics similar to those of a lease. There is no current intangible assets project and given the IASB's current work plan and the nature of the issues in accounting for intangible assets, it is unlikely there will be a new intangible assets standard for several years. Since the accounting for leases of intangible assets is not currently addressed in IFRSs, we think guidance is needed earlier than the completion of the reconsideration of IAS 38.

Measurement

i) Lease term

We agree in principle with including renewal options in the determination of the lease term. However, based on feedback from lessees, there is usually insufficient information for the lessee

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to estimate reasonably the likelihood of renewing a lease until late in the life of the lease. This is an even larger problem for a lessor who would have to assess what a lessee will do with substantially less information on which to base this assessment. A “more likely than not” criterion is therefore, in our view, not operational. We suggest a criterion of “reasonable assurance”, which would provide a safeguard against companies structuring leases with a single year term plus multiple renewals and is consistent with judgments currently being made by lessees and lessors. A hurdle of reasonable assurance would also be consistent with our understanding of the definition of a liability.

ii) Contingent payments

We do not think that all contingent payments should be included in the measurement of lease assets and lease obligations. We agree that contingencies based on an external index, such as an inflation index or a foreign currency, should be included in the measurement of lease assets and lease liabilities as these amounts can be reasonably estimated. We also concur with the guidance provided in the Exposure Draft for estimating such indexed contingent rents. Contingent payments based on usage should only be included when they can be determined with reasonable assurance. This is consistent with our proposal regarding lease renewal options. Both are means by which a lessee can obtain more usage of the leased asset. However, contingencies based on the lessee’s performance derived from the underlying asset (e.g. based on sales or profits) should be excluded from the measurement of lease assets and lease liabilities. These contingent payments should be treated consistently with royalty or risk sharing arrangements which, in effect, they are.

It is often impractical to apply an expected value approach to contingent payments based on factors such as sales or profits due to the amount of uncertainty associated with these payments particularly in long-term leases. Forecasting these payments is particularly difficult for lessors since they are essentially forecasting the performance of lessees. Some users advise us that they are concerned with the level of subjectivity and measurement uncertainty inherent in estimating

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this type of contingent rentals and the possibility (or probability) of significant management bias. These users advise us that they would prefer to have sufficient disclosure of the terms of such contingent rents and historical information to enable them to make their own estimates.

Some constituents think the proposals for renewals and contingent rents are an overreaction by the Boards in their desire to reduce or eliminate structuring opportunities. We think that concern would be addressed by the appropriate application of the proposed disclosure requirements.

Lessor accounting

Two different models

We disagree with the exposure draft proposal for two fundamentally different lessor accounting models that result in different patterns of profit recognition. We struggle to understand the conceptual basis for two different models and are concerned that this will result in different lessors accounting for similar lease contracts quite differently, due to minor differences in the lease contracts or differences in judgments about the retention of risks and benefits.

Under a single model for lease accounting we would expect that there would be a single approach to accounting by the lessor and that this would be consistent with lessee accounting. The performance obligation model is not consistent with the proposed lessee accounting. We also note that a lessor would use the performance obligation approach when it retains exposure to significant risks or benefits associated with the underlying asset. However, the lessor is not required to disclose the nature and carrying amount of the asset at the end of the lease term. This would result in the lessor providing less information about the residual asset risks than under the derecognition approach, even though the risks associated with the underlying asset are judged to be higher. We find this to be paradoxical. We think the derecognition model is preferable because it is consistent with the lessee right-of-use/lease obligation accounting model. Lessor accounting should therefore follow this approach. Therefore, we think that the Boards should

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focus on further developing the derecognition model to address the outstanding issues and concerns with it.

Inconsistencies with the exposure draft, Revenue from Contracts with Customers

We think it is important that the accounting for lease revenue by lessors should be consistent with the accounting for other revenues. Inconsistencies between lessor accounting and other revenue accounting will result in practical scope and interpretation issues.

One significant inconsistency is that the lease proposals use the transfer of risks and benefits as the basis for determining the timing of the recognition of profit by a lessor while the Revenue ED recognizes revenue based on when the customer obtains control of the good or service.

The proposals in the Revenue ED require only that control be transferred for a sale to be recognized, but the lease proposals also require the transfer of “all but a trivial amount of the risks and benefits associated with the underlying assets” for a lease transaction to be considered a sale. Consequently a lease transaction might not be viewed as a sale (and be scoped out of the lease proposals) even though it would be treated as a sale using the Revenue ED criteria (because “control” of the right to use asset has been transferred to the other party). A third inconsistency is the accounting by a lessor when the contract contains a service component that is not distinct and the lessor applies the derecognition approach. We fail to understand why lease revenue recognition would differ from that for a non-distinct performance obligation embedded in a contract that is not a lease.

Summary

While the AcSB supports the right-of-use/lease obligation model for lessees, we believe that the benefits of the exposure draft proposals do not exceed the costs. We also support further exploration of one model for lessor accounting. We think it is necessary for the Boards to undertake a thorough reconsideration of the exposure draft proposals in the areas identified in this letter (as well as other issues identified in the Appendix), which may lead to a need to re-

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expose. New leasing standards will provide significantly improved information to users of financial statements but are likely to require significant changes to preparers' systems and accounting processes. We think that this necessitates field testing of the final proposals, with both preparers and users, to ensure that the benefits of the final standard exceed the costs.

We urge the Boards not to rush to finalize the proposals by June 30, 2011. Because of the issues identified above we do not think that the Boards will be able to develop a high quality, operational standard by that date. Proceeding on that timeline is likely to produce an inadequate solution with the consequence that the Boards will be bombarded with requests to improve, clarify or interpret the standard shortly after it becomes effective. In particular, we think it would be inappropriate for the Boards to finalize a standard without clarifying the known problems with its scope.

If the Boards are, nevertheless, determined to adopt a standard with the objective of providing a significant improvement in lease accounting by June 30, 2011, we strongly recommend that the Boards adopt an interim standard that accomplishes the primary object of this project – namely, recognition by lessees of a right-to-use asset and a lease obligation. Such an interim standard could be based on a requirement that lessees capitalize the minimum rental payments determined in accordance with IAS 17/SFAS 13 etc.

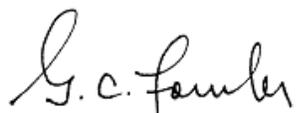
We think that this (i) would provide users with a “baseline” of information about the lessee's minimum contractual obligations; (ii) would reduce substantially the measurement uncertainty and management bias that users are concerned about; and (iii) would be significantly less costly for preparers to apply because they would be using information that is already being disclosed.

We have included in the Appendix to this letter our responses to the questions set out in the Exposure Draft.

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We would be pleased to elaborate on our comments in more detail if you require. If so, please contact me, Peter Martin, Director, Accounting Standards at +1 416 204-3276 (email peter.martin@cica.ca) or Grace Lang, Principal, Accounting Standards at +1 416 204-3478 (email grace.lang@cica.ca).

Yours truly,

A handwritten signature in cursive script that reads "G. C. Fowler".

Gordon Fowler, FCA
Chair,
Canadian Accounting Standards Board

Appendix

AcSB Comments on the Exposure Draft, Leases, Dated August 2010

Question 1

(a) We agree that the right-of-use model is the correct general approach to accounting for leases by a lessee as it results in all assets and liabilities arising from lease contracts being reflected in the statement of financial position. We think this is consistent with the Boards' conceptual frameworks. However we have a number of concerns about the proposed method of application of the right to use model, which are discussed below in responses to other questions.

(b) We agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments for the reasons cited in the Basis for Conclusions.

Question 2

The key concerns with the current lease accounting model relate to lessees. Paragraph BC 13 indicates that lessor accounting has been included out of a desire to achieve consistent accounting for lessees and lessors and to be consistent with the Boards' proposed approach to revenue recognition, described in the Exposure Draft, *Revenue from Contracts with Customers* (Revenue ED). We agree with that objective but do not agree that the lessor accounting proposals meet the objective.

Under a single model for lease accounting we would expect that there would be a single approach to accounting by the lessor and that this would be consistent with lessee accounting. We are concerned that the exposure draft proposes two fundamentally different methods that result in different patterns of profit recognition, depending on whether or not a lessor thinks it has retained significant risks and benefits. Therefore, similar lease contracts could be treated quite differently due to relatively minor differences in the lease contracts or solely based on a

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different judgment of who has exposure to significant risks and benefits. This is likely to result in inconsistent application and a lack of comparability between entities.

To illustrate, in example 5 in paragraph B30, the derecognition approach is used when an asset with a 10 year life is leased for an expected 8 years. Presumably the 20% of the asset life not covered by the expected term of the lease is not considered to leave the lessor retaining exposure to significant risks or benefits. However, some might argue that exposure to the cash flows from the asset for 20% of its useful life does constitute exposure to significant risks or benefits and the performance obligation approach should have been used instead. In practice, the example would likely result in debates about whether it makes sense or is applicable to individual circumstances and may have the effect of creating a “bright line”.

Using the retention of risks and benefits as the basis for determining the timing of profit recognition is inconsistent with the Revenue ED. In fact, the term ‘performance obligation approach’ is potentially misleading or confusing because it applies to an approach that is based on assessing the retention of risks and benefits, which is inconsistent with the Revenue ED’s focus on satisfying performance obligations.

We also note that lessors are required to include contingent rentals, term option penalties and residual value guarantees only if they can be reliably measured but lessees must always include them. For some leases this could be a significant difference.

There is also an inconsistency between the derecognition approach and the performance obligation approach related to the carrying amount of the asset at the end of the lease. Under the performance obligation approach the carrying amount will be the cost less accumulated depreciation, consistent with the carrying amount of an asset that had not been leased. However, under the derecognition approach the residual asset will be measured at an allocated portion of the carrying amount of the underlying asset at the commencement of the lease. This allocation

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may be materially affected by contingent rentals, for which estimates may vary significantly. Applying the methodology in paragraph 50 will result in a lower carrying amount for the residual asset than the carrying amount at the end of the lease (using straight line depreciation) under the performance obligation method. We think that the historical cost carrying amount of an asset at the end of the lease should not be affected by the accounting for the lease (or by whether it has been leased). Consequently the residual asset should be measured at cost less depreciation for the lease period (subject to impairment). Please note that the aforementioned issue is raised in the context of accounting for the asset on a historical cost basis.

As noted in the covering letter, we think that the performance obligation approach is inconsistent with the lessee accounting model and the proposals in the Revenue ED while the derecognition approach is consistent with both. Therefore, we recommend that the Boards should focus on further developing the derecognition model to address the outstanding issues and concerns with it (see the responses to other questions).

Question 3

We support simplification of the accounting for short-term leases. However, we do not agree with the proposed simplified requirements for lessees' short-term leases. The main burden in applying the proposed right-of-use model to short-term leases is the cost and effort of identifying and tracking the expected lease payments (including contingent rentals) for a large number of leases, rather than the cost of discounting those lease payments. Consequently the simplification proposed for lessees for short-term leases does not offer significant relief. We think lessees should be permitted to apply the existing operating lease accounting requirements in IAS 17 to short-term leases. This would be consistent with the proposed accounting by lessors for short-term leases. We recognize that this will result in lessees not recognizing short-term leases in the statement of financial position. This concern is mitigated by the fact that these leases have a maximum term of 1 year and most will have an unexpired term of much less than that at the balance sheet date. In practice many short-term leases are likely to be accounted for on a cash

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basis due to materiality considerations. Permitting lessees to apply the existing operating lease accounting requirements to short-term leases will eliminate the need for management to assess short-term leases to determine the accounting to be followed and result in consistency between accounting by lessees and lessors. Overall, on the basis of a cost/benefit analysis we recommend that short-term leases be excluded from the scope of the proposed IFRS.

We agree with the proposed simplification for short-term leases of lessors.

Question 4

We agree that a lease is defined appropriately but we think that more extensive guidance is needed to distinguish clearly between a “pure” service contract and a lease contract that must be accounted for under the proposed IFRS. The guidance in paragraphs B1-B4 is not sufficient to make this distinction in many cases. We recognize that paragraphs B1-B4 in the ED carry forward existing guidance from IFRIC 4. However the guidance in the ED is not identical to that in IFRIC 4, it does not include all of the additional guidance from the Interpretation and it does not address the many issues that have arisen in practice, resulting in significant diversity in application of the Interpretation. Applying IFRIC 4 to leases that would be operating leases under existing IAS 17 may raise further issues.

For example, certain service contracts refer to a specific type of tangible capital asset that will be used in providing the service but the lessee is indifferent as to which specific asset is provided. A party renting a car for a few days normally views this as obtaining a transportation service and is indifferent as to precisely which car is provided. Since the rental contract will identify a specific vehicle, one can argue that the conditions in paragraph B4 are met. However, others may interpret that guidance differently. It is unclear whether or not such contracts would be included in the scope of the proposals. We think that this type of contract should not fall within the scope of an IFRS on leases as it is in the nature of a service contract rather than a lease and, therefore, it would be inappropriate to account for the contract as a lease.

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We disagree with the proposal that certain leases be scoped out of the proposed IFRS as purchases or sales. This introduces additional complexity as entities will have to determine first if a contract in the form of a lease should be accounted for as a lease. Provided the proposed IFRSs for revenue and leases are consistent, there should be no significant difference in accounting for the contract. We also note that there would be no need to distinguish in-substance purchases and sales if the derecognition approach was adopted for all lessor accounting.

The definition of a sale in the leases proposals is different from that in the revenue proposals. The leases exposure draft proposes that purchases/sales arise in those arrangements that transfer control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset. However, the Revenue ED requires only the transfer of control as a condition for recognition as a sale.

As a result, situations may occur when a transaction would not qualify as a sale under the leases proposals (because it does not meet both criteria), but would qualify as a sale in the Revenue ED proposals. For example, a lease under which the lessee "controls" the asset would be considered a sale under the Revenue ED, whether or not the lessor is exposed to significant risks or benefits associated with the underlying asset. However, it is treated as a "partial sale" under the leases exposure draft if the lessor uses the derecognition method (i.e. the portion of the "sale" related to the residual value is not recognized in profit and loss). Additionally, a lease where a lessee "controls" the asset but that exposes the lessor to significant risks or benefits associated with the underlying asset would also be accounted for as a "sale" under the Revenue ED, but would be accounted for using the performance obligation approach under the leases exposure draft. We think the criteria in the leases standard for distinguishing a lease from a purchase or sale should be consistent with the criteria for recognizing revenue.

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Question 5

We are concerned with the Boards' decision to defer consideration of the accounting for leases of intangible assets until the accounting for intangible assets is considered more broadly. There is no current project on intangible assets and, given the IASB's current work plan and the nature of the issues in accounting for intangible assets, it is unlikely there will be a new intangible assets standard for several years.

Since the accounting for leases of intangible assets is not currently addressed in IFRSs, we think guidance is needed earlier than the completion of a reconsideration of IAS 38. Paragraph BC36 in the Basis for Conclusions of the Exposure Draft only states that "the boards decided that they would not include leases of intangible assets within the scope of the proposed IFRS until they had considered the accounting for intangible assets more broadly". However, it provides no explanation for why the accounting for leases of intangible assets needs to be considered together with the accounting for the recognition and measurement of intangible assets, rather than together with the accounting for leases of tangible assets. The decision not to address leases of intangible assets seems inconsistent with the inclusion of licensing and rights to use in the Revenue ED. Paragraph BC 223 of that exposure draft says "the boards observed that licensing arrangements that are not sales of intellectual property often have characteristics similar to those of a lease. In both cases, a customer purchases the right to use an asset of the entity". The same paragraph goes on to say "the boards decided that it would be difficult to justify why the accounting for a promised asset should differ depending on whether the asset is tangible or intangible". We agree with that conclusion.

We agree that leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources should not be included in the scope of the proposed IFRS for the reasons set out in paragraph BC 34.

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Question 6

We think that service components should be accounted for separately from lease components. Not doing so will result in accounting for service contracts differently depending on whether they are part of a lease contract. In addition to a lack of consistency, this would potentially provide opportunities to structure arrangements to achieve specific accounting results. We recognize that in some contracts distinguishing the cash flows from the service and lease components may be challenging. This is the reason that the Revenue ED accounts for performance obligations separately only if they are “distinct”. However, we think that the implications of accounting for service and lease components as a lease are such that they should be separated. This may require some degree of estimation by management, but a reasonable estimation will provide better information than accounting for the entire arrangement as a lease. The Boards should develop guidance to assist preparers in separating lease and service components.

More importantly, we think it is imperative that the Boards come to a consensus on issues where their views diverge, so that lease accounting is the same under IFRSs and US GAAP.

Question 7

We agree that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. However, we do not agree that a purchase option should be accounted for only when exercised because we think purchase options are a form of a lease term extension. For example, a lease may permit the lessee to extend the lease term to the end of the useful life of the leased asset. This has the same effect as a purchase option. A purchase option may also permit the lessee to cancel the contract before the end of the lease term, somewhat similar to a term option penalty. Therefore, we think purchase options should be accounted for in the same way as options to extend or terminate the lease (see our responses to other questions on that issue).

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If the Boards decide that a purchase option should not be accounted for as part of the lease, then the option is a separate asset (lessee) or liability (lessor) and there is the question of how it should be accounted for. IFRS 2 and IAS 39/IFRS 9 require options to be accounted for prior to exercise and the accounting for a purchase option in a lease contract could be analogized to these IFRSs. We think the standard should address how the option would be accounted for.

Question 8

We agree with including renewal options in the determination of the lease term but do not agree that the lease term should be based on the longest possible term that is “more likely than not to occur”. Based on feedback from lessees, there is often insufficient information for a lessee to estimate reasonably the likelihood of renewing a lease until just before the end of the current lease period, unless there is some form of economic compulsion at commencement of the lease. Lessees also informed us that they do not usually think about whether they will renew a lease until close to the time to make a decision because the key decision factors for renewals, which may be many years in the future, are too uncertain. If they had to apply the proposed criteria, this would constitute little more than a guess. This is an even larger problem for lessors who would have to assess what a lessee would do with substantially less information on which to base this assessment. Therefore, in our view, a “more likely than not” criterion is not operational.

Instead, we propose a criterion of “reasonable assurance”. This criterion exists in other IFRSs and is being applied in practice under IAS 17. However, due to the significance of renewal options, we recommend that more guidance be provided as to when renewal is “reasonably assured”. Requiring assets and liabilities arising from a lease to be measured on a basis that assumes the longest possible lease term that has reasonable assurance of occurring would ensure, for example, that lessees include renewal options when they have renovated a leased property based on renewing the lease, the terms of the lease make renewal very likely or the lessee has

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determined, as part of its business planning, that it is likely to renew the lease. The criterion of “reasonable assurance” would also provide some safeguard against companies structuring leases with a single year term plus multiple renewals.

Question 9

We recognize that one of the Boards’ objectives in the leases project is to make the accounting for the liability for lease payments consistent with the treatment of other financial liabilities (paragraph BC10). We agree that a lease obligation is a financial liability. A contingent lease payment is an embedded derivative.

IAS 39 paragraph AG 33(f) (incorporated into IFRS 9) discusses embedded derivatives in a host lease contract and states that many contingent lease payments are embedded derivatives that are closely related to the economic characteristics and risks of the lease contract. Lease contingencies are therefore scoped out of IFRS 9 and not accounted for separately from the lease contract. In effect, this means that the derivative is not accounted for until it results in a cash flow. The exposure draft proposal for accounting for contingent lease payments is inconsistent with IAS 39/IFRS 9. No explanation is given for this.

The Basis for Conclusions identifies three types of contingencies – those that are based on usage of the asset, those based on an external index (e.g. those based on the consumer price index or a foreign currency) and those that are based on the lessee’s performance of the asset (e.g. those based on sales). We think these have sufficiently different characteristics that they should be considered separately. We agree that contingencies based on an external index should be included in the measurement of lease assets and lease liabilities as these amounts can be reasonably estimated. We agree with the guidance on this in paragraph 14 of the Exposure Draft. Also, contingencies based on usage of the asset should be included in the measurement of lease assets and lease liabilities, but only when they can be determined with reasonable assurance. We

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note that this treatment is consistent with our proposed treatment of a lease extension option. Both are means by which a lessee can obtain more usage of the leased asset.

However, many constituents have informed us that it is generally impractical to apply an expected value approach to contingent payments based on the lessee's performance derived from the asset, such as sales, due to the extreme uncertainties associated with these payments that may stretch many years into the future. For example, we are aware of leases in Canada with terms of up to 60 years in which the rental payments are entirely contingent on the lessee's revenue. Forecasting contingencies is particularly difficult for lessors since they are essentially forecasting performance by the lessee and often will not have knowledge of the lessee's industry, the lessee's strategy and other key relevant factors.

Therefore, for both conceptual and practical reasons, we do not think that contingent payments based on the lessee's performance derived from the asset should be included in the measurement of lease assets and lease obligations. In fact, users have advised us that they would prefer to have sufficient disclosure of the terms of these contingent payments in order for them to make their own estimates. We think that these payments should be treated like royalty or risk sharing arrangements which, in effect, they are. We also want to emphasize that the accounting for similar types of arrangements should be consistent to avoid interpretation and application difficulties (and structuring opportunities).

The exposure draft proposals imply that a lessee must account for contingent rentals even when the amount cannot be measured reliably, while a lessor only accounts for contingent rentals when they can be measured reliably. Paragraph BC 126 justifies this on the basis of concerns about reliability of lessors' estimates of contingent rentals. We think that the same criteria should apply to lessees and lessors. The fact that lessees may be able to measure contingent rentals

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reliably more often than lessors, is not a good enough reason to have different criteria. Having different criteria for lessees and lessors is inconsistent with the Boards' desired outcome of consistent accounting between lessees and lessors.

We agree that contingent rentals should only be included if they can be measured reliably – unreliable measurements are inconsistent with the qualitative characteristic of faithful representation. This would also be consistent with the Revenue ED which states that an entity shall recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraphs 38-40 of that exposure draft provide guidance on when a transaction price can be reasonably estimated. We think that the proposals should include similar guidance to determine what is considered “measured reliably”.

Question 10

We agree with the principle that leases should be reassessed when there is a significant change. However, the cost of reassessing contingent rentals and options to extend or terminate a lease on a lease-by-lease basis can be very high, especially for entities that have a large volume of leases. Although the issues with reassessments are mitigated by the fact that they are only required when there is an indication of a significant change, there is no guidance on what are considered indicators and no guidance on what represents a significant change. This additional guidance is needed to make the proposals operational and to ensure comparability. Similar guidance exists in other IFRSs. For example, IAS 36 requires that an entity assess whether there is an “indication” that an asset may be impaired and provides guidance on what to consider as an “indication”.

We also think that the methodology for determining the adjustments needed when a lease term is reassessed is inappropriate and produces illogical results. To illustrate, in example 4 in paragraph B30 a 20% decrease in the lease term, from 10 years to 8 years, resulted in a 53% decrease in profit (e.g. a CU1,007 reduction to the profit recorded at the commencement of the

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lease of CU1,917). The carrying amount of the residual asset only increases by CU34, which does not seem a reasonable measurement for the residual asset that represents the final two years of an asset that has an original carrying amount of CU 5000 and a total life of 10 years. We think that this methodology requires reconsideration.

Question 11

As discussed in our response to Question 4 above, we are concerned that the definition of a sale in the leases proposals is different from that in the Revenue ED. Therefore, we think the criteria used to determine a sale in the leases proposals, including for classification as a sale and leaseback, should be consistent with those in the Revenue proposals.

Questions 12

We agree that a lessee should present lease liabilities with financial liabilities and right-to-use assets within property, plant and equipment or investment properties as appropriate. We also agree that the amount of these assets and liabilities should be provided separately from other assets and liabilities due to their unique characteristics. Users have informed us that information on leases is important to them. However, we think this information could be disclosed in the notes and should not be required to be presented separately on the face of the statement of financial position. We are concerned that too much detail on the face of the financial statements can make the statements appear overly complex and difficult to understand. Lease amounts should not be considered on their own but in the context of the total information included on the face of the financial statements. We think companies should be permitted to decide whether to provide this detail on the face of the statements or in the notes.

We also agree with the proposed presentation by lessors (subject to our comments above on disclosure in the notes). In particular we agree that under the performance obligation approach the net lease asset or liability should be shown. Presenting the gross amounts on the asset and

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liability sides of the statement of financial position would overstate a company's assets and liabilities and exacerbate the difference between the performance obligation approach and the derecognition approach (see our comments disagreeing with the performance obligation approach in responses to other questions).

Question 13

We agree that lease income and expense information should be separately disclosed for reasons discussed in our response to Question 12. For the same reasons we think that this information should be permitted to be provided in the notes.

The FASB proposes to require a net lease income/expense presentation while the IASB does not propose to require it (although we assume this would be permitted). As we have noted elsewhere, it is important that the FASB and the IASB issue a single standard, without differences such as this. We prefer the IASB approach, which is consistent with its recent decision in the employee benefits project.

Question 14

We agree that lessees and lessors using the direct cash flow method should disclose cash flows arising from leases separately, although we think disclosure in the notes to the financial statements should be permitted. For lessors using the indirect cash flow method we do not see the benefit in presenting changes in the right to receive lease payments separately from changes in other operating receivables.

Question 15

We agree that lessees and lessors should disclose quantitative and qualitative information that identifies and explains the amounts recognized in the financial statements arising from leases and

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describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows because this provides users with relevant information for their analysis of the financial statements.

Since there is significant diversity in the needs of different types of users, we recognize the difficulty with providing all user groups with the information they want and need. For example, for many debt analysts/investors the most important information to them is the non-cancellable minimum rental payments, which are based on the contractual terms of the lease. Therefore, in many cases, users will make substantial adjustments to the amounts reported in the financial statements in order to obtain information that is useful to them. For this reason, note disclosure is critical to provide different users with the information that meets their needs.

It is unclear how companies with large numbers of leases should present a number of the disclosures so that they provide useful information to financial statement users. We think that examples of disclosure based on field tests involving both preparers and users would be helpful in this respect. Such field tests could also ensure that the required disclosures do meet a cost/benefit test, given ongoing concerns about disclosure overload.

Question 16

- (a) We agree that lessees and lessors should be able to recognize and measure all outstanding leases as of the date of initial application using a simplified approach since the costs of full retrospective application will outweigh the benefits for many entities. However, the simplified retrospective approach that the ED proposes will result in distorting lessee expenses and lessor income (by overstating them) in the initial years after adoption. For some companies this may be material, possibly for several years. Therefore, we suggest that more research is needed on the proposed simplified approach so that the income statement for lessors and lessees is not distorted by the transition requirements.

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- (b) We also think that, although full retrospective application of lease accounting requirements will be impractical for many entities, it should be permitted since some entities may think that the benefits of full retrospective application will outweigh the costs.

- (c) We do not think the transitional guidance in paragraph 93 provides much relief for lessees for short-term leases since, as we noted in Question 3 above, the main burden for lessees in applying the proposed model to short-term leases is the cost and effort of identifying and tracking the expected lease payments, rather than the cost of discounting those lease payments.

Question 17

The proposals in the Exposure Draft are complex and many preparers will incur significant one-time and ongoing costs if required to adopt them. We also think that the benefits to users are limited by some of the complexities, as discussed in the cover letter. Consequently we do not think the proposals as issued meet a cost/benefit test. However, we continue to support the right-of-use/lease liability model and urge the Boards to modify the proposals and provide additional application guidance. We think that this can result in the benefits outweighing the costs.