

International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

13 December 2010

Dear Sirs,

### **Comments on Exposure Draft on Leases (ED/2010/9)**

Thank you for the opportunity to comment on the Exposure Draft on Leases.

Howden Joinery Group both manufactures and externally sources kitchen and joinery products and appliances, which we sell to the building trade through a network of almost 500 depots around the UK. We have a small selling operation in France, and a sourcing office in Asia. We employ over 5,000 people.

In terms of our involvement with leases, we are mainly lessees, except in the case of a small number of property leases where we have some sub-tenants. Under current International Financial Reporting Standards, we have an immaterial amount of finance leases, but we have significant operating leases. At our December 2009 year end, 85% of our £49.1m operating lease commitments for the next year were property leases, with the remainder being represented by assets such as vans, cars and trucks, copiers and phones. We have restricted our comments to those questions in the ED which apply most directly to our situation.

#### **Question 1(a): Lessees**

Do you agree that a lessee should recognise 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?

#### **Answer to Q1(a)**

Whilst we can see that the right-of-use model is one way of accounting for leases, we are not convinced that it is a better model than that currently set out in IAS17, and we are concerned that it will bring added cost and complexity to preparers, without adding any net benefits to users of accounts. We would ask you to consider the following points in support of our views:

- The introduction to the ED says that the current leasing models lead "*many users of financial statements [to] adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.*" Although we operate through a network of approximately 500 depots, and the total property operating lease commitments in our December 2009 Group accounts were £340m, we did not have any significant level of investor or analyst queries about these leases until the announcement of the proposals which form this ED. Analysts tell us that they do not restate our balance sheet in order to reflect operating lease assets and liabilities.

- We are pleased to note the continuing emphasis on listed companies to provide a clear description of their business model in their Annual Reports, as this has always been a major theme in our communications with investors, analysts, customers and the general public. In common with many companies in the retail sector, investors and analysts understand that we operate from leased premises and, as such, expect to see rent payments in our income statement rather than interest and depreciation. This has been a clear understanding and expectation since the Howden Joinery business began.
- We would note that the Board has accepted the arguments of analysts in the investment property sector that they receive sufficient information under the current accounting treatment, and that the Board has therefore granted property investment companies exemption from the leasing ED. For most companies like us, property leases are by far the largest class of leases. It does not appear consistent or logical to us to require lessees to recognise assets and liabilities in respect of those leases, and at the same time to exempt the owners of those assets from the other side of the same accounting requirements.
- We are currently financed by an asset-backed lending facility. As is typical with such facilities, the lender imposes restrictions on us taking out additional borrowings. These restrictions put caps on us taking out further secured borrowings, and on us taking out further finance leases. They have a £20m restriction on us taking out non-property operating leases (equal to 65% of our total non-property leases at Dec 2009 – i.e. it is a restriction set at a level that it's highly unlikely we would ever want to exceed), but they have no restrictions at all on us taking out further property operating leases. Given that property operating leases represent 85% of our total leases at December 2009, we take this as a clear signal that lenders do not consider operating leases to be the same as finance leases, and that they do not wish to see operating leases treated in the same way as finance leases in the accounts of companies to which they lend.
- The proposed method of calculating the liability involves discounting at the lessor's incremental borrowing rate. This will have the result that a company with a better credit rating (and therefore access to cheaper funds) will recognise a larger liability for the same lease than a company with a worse credit rating. Not only will this create another barrier to comparing different companies' accounts, it is also illogical.

In our view, the current IAS17 model is well-understood by decision-makers within the business, as well as by our investors, sector analysts, and our lenders. None of these groups currently ask for information to allow them to restate operating leases on the same basis as finance leases. We would anticipate that if the ED is implemented as currently drafted, this would lead to pressure for companies to strip out the effect of the changes to operating leases and to present alternative measures of financial performance and position on the IAS17 basis. We are not in favour of an increased use of non-GAAP performance measures, but if investors and analysts require this information then companies will find that pressure hard to resist.

### **Question 1(b): Lessees**

Do you agree that a lessee should recognise amortisation 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?

### **Answer to Q1(b)**

We do not agree that the proposed method of amortising the asset and charging interest on the liability will produce useful information for users of accounts. We would ask you to consider the following points in support of our views:

- By using an effective interest method on the liability, and a straight line depreciation rate on the asset, the ED will create significant fluctuations in the income statement from year to year. This means that the pattern of the charge for using the asset will neither match the pattern of income from the asset nor will it match the cash flows under the lease contract, which are two main measures which users refer to when considering the costs and benefits of leasing an asset. Our analysts have told us that they would want us to provide additional information which would strip out the effects of the ED, and to present them with a measure of underlying earnings (which will, in effect, involve restating the income statement back to an IAS 17 basis).
- Unless the effects of the ED are stripped out of the income statement, there will be no meaningful comparison between companies who are at different stages in the cycle of renewing their leased assets. Companies whose leases are mainly in their early years will report a worse result than those whose leases are mainly coming to an end, even though their underlying trading may not differ. Investors wishing to make a comparison between two such companies will find that the ED's proposed method makes this more difficult than under IAS17.
- The financial performance and position of a single profit centre within the Group, as measured according to the Group's (i.e. IFRS) accounting policies, will fluctuate over time as a direct result of applying the effective interest method. Our depot managers run their depots as individual profit centres, and they are rewarded on the basis of their depot's performance. The ED will require us to adjust the management information which we provide to our depots to remove this fluctuation, and will mean that we are forced to adopt a non-IFRS accounting policy at depot level, which we then adjust back to comply with the ED for external reporting purposes.

We would propose that it would be more appropriate, and would provide better information to users, to recognise the total cost of the lease in a way which matches the benefits derived from the underlying asset, and/or matches the cashflows under the leases.

### **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?

### **Answer to Q2**

We do not agree that two approaches should be open to the lessor, whilst only one approach is open to the lessee of the same asset. BC26 to the ED, says: "*The boards propose that lessors should determine the appropriate approach to apply on the basis of whether the lessor retains exposure to significant risks or benefits associated with the underlying asset.*" We would support such an approach being applied to both lessees and lessors, and we think that the framework proposed for lessors above, based on the transfer

of significant risk or benefit, is well understood and leads to acceptable reporting outcomes, especially in terms of the P&L account, but we cannot agree that it is appropriate for one party to have a choice in accounting treatment where another party is denied that choice.

We would suggest that the Board should amend the ED so that treatment of the same asset in the hands of lessee and lessor retains the link which it does under the current leasing standard, if applied correctly.

### **Question 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 recognise 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 recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise 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?

### **Answer to Q3**

For lessees, this proposal is not likely to make implementing the ED any simpler. This is because:

- The number of leases with maximum lease terms under 12 months is likely to be small.
- It is considered unlikely that any leases with maximum lease terms under 12 months would be discounted in any case, on grounds of materiality.

We believe that it would be a weakness of any proposed new leasing regime if it were not to apply equally to all leases within the scope of that regime. However, it is typical for companies to have a high number of low-value lease contracts for items such as telephones, copiers, and minor IT equipment. These are typically of short duration, although their maximum term on inception, including renewal options, may well be over one year. We believe that accounting for each of these contracts under the terms of the proposed ED will not give any material benefit for users, whilst requiring significant work for preparers both on adoption and at each reporting period end.

We would welcome further work from the Board to reconsider whether small leases of non-core assets should fall within the scope of the ED, or whether they could be excluded. We would propose that the distinction between core and non-core assets is best made by each individual company, in the context of the industry sector in which it operates, and we would propose that any subjectivity involved in this decision could be made transparent by requiring extensive disclosure of any asset types which a company decides to treat as non-core. To some extent, this would be covered by the existing legislation on disclosure of areas of significant judgement, but we would support a requirement for additional specific information on accounting policy choices being given in the relevant note to the accounts.

By way of an example, using the figures from our December 2009 consolidated Group accounts, we had total operating lease commitments falling within one year of £49.1m.

£41.6m of these commitments (85%) relate to the leases on our depots, our manufacturing sites, and our corporate offices. In aggregate, we lease just over 500 properties, with the average term for a lease on a new depot being between 10 and 15 years. These leases are central to our business, as well as being relatively low in number (in relation to the total number of our leases), and high in value. The terms of the leases do not change frequently, and we already collect a high degree of information about the leased assets as part of our normal operating procedures. Whilst we do not support the ED's proposals to recognise assets and liabilities in respect of these leases, it would be easier for us to report on these leases than on any others.

A further £7.0m (14%) of commitments relate to items such as company vans and cars, mechanical handling equipment, and trailers. We believe that it would be common for companies operating in manufacture, sourcing and retailing, as we do, to regard these assets as core assets. The number of leases involved is higher than the number of property leases, the lease terms are shorter, and the leases are likely to change with a greater frequency than the property leases, but at least we can accept that these assets are used to manufacture, transport, and market our products. Although we do not currently get investor or analyst requests that state or imply that they wish to restate our balance sheet in order that it shows our leased assets, we can see that, if this were to ever happen, it would be the properties and the other core assets which those hypothetical investors and analysts would be interested in.

The third group of assets under operating leases, as shown in our December 2009 group accounts, accounts for £0.5m of the next year's operating lease commitments (1% of total operating leases by value), and represents copiers, printers, and telephones across the whole business, as well as a small amount of minor IT equipment in our two overseas operations. The nature of these assets is such that they are non-core to the business, as well as being high in number, low in cost, and likely to be replaced by fairly frequent upgrades. It is these very qualities which explain why we lease them, and which we feel are dealt with very well in the current IAS17 decision as to when to recognise a leased item as an asset. We do not think that it would possibly aid users to see us represent assets and liabilities for these leases, even if it were the case that users wanted to see core leased assets represented on our balance sheet, which, as we have said above, is not currently the case. Indeed, some of the leased assets in this category are of such low value that they are below our capitalisation threshold for purchased assets. In those cases, it would be inconsistent to find that the ED required a right-of-use asset to be recognised in respect of a portion of the life of an actual asset whose value is so low that it would not be recognised as an asset if it were purchased. In our case, there are easily twice as many leased assets represented in this non-core group of assets as there are leased properties, and the ED would require that we carry out calculations for each of them on inception, as well as that we review them at each year end and adjust the calculations and carrying values as necessary. We do not feel that this level of work for these minor assets will give any benefit to any of our users, and we would ask the Board to exclude non-core assets.

### **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?

### **Answer to Q8**

We do not agree with this proposal. We would prefer that a lessee uses the minimum committed lease term as the default lease length and includes renewals only if they are virtually certain. We would ask you to consider the following points in support of our argument:

- Once we begin to take the possibility of renewals into account (rather than the minimum contracted term of a lease, or a renewal which is virtually certain), we're ceasing to recognise actual commitments and are recognising possible commitments, contingent upon a future event which may or may not be within the control of the entity. We do not believe that this is in line with IAS37, in that it requires a company to recognise liabilities where there is no legal or constructive obligation.
- In situations where the cumulative probability method has led to a very long expected lease term for a property, this can lead to lease assets which are significantly in excess of the market value of the building. We do not support a method of calculation which can lead to these types of outcomes.
- The terms involved in a typical property lease are longer than the typical business planning horizon, which makes it highly unlikely that forecasting renewals will lead to accurate estimates. In addition, especially in terms of retail property leases, the effect of external factors can easily override even the most accurate planning process. Changes in the landlord's situation can mean that they want to develop the whole park on which you're a tenant, and that you end up with little practical alternative than to move out of a lease early. It is also becoming more common for landlords to go into administration, with the effect that tenants find themselves dealing with the new plans and priorities of the new landlords. Changes can also be driven by local or national government: for example new roads or housing developments can alter the desirability of a location over time in a way which cannot be foreseen in long term forecasting.
- In England, the most common type of property lease will be one controlled by the 1954 Landlord and Tenant Act. Amongst other things, this means that the lease contract will, by default, include a provision which grants the lessee some rights to renew the contract when it comes to an end. The ED works on the principle that these provisions have an intrinsic value, which makes it more likely that the lease itself will be calculated at a greater asset and liability. However, the commercial facts are that such provisions are the default position under English law, and that the reality of whether a tenant renews a property lease or not can be affected by a number of factors beyond their control, whether or not their lease is covered by the Landlord and Tenant Act.
- Furthermore, we think that the ED's proposed cumulative probability method, for measuring when a lease renewal is more likely than not, will lead some companies into arriving at longer lease terms than others, even where all facts and circumstances are identical. In the example given above of a lease under the Landlord and Tenant Act, the initial lease will contain a right to renew. If the lease were to be renewed, it would be replaced by another similar lease with a further

right to renew. We would ask you to imagine the case of a high street retailer considering the likelihood of renewing the lease on its flagship store where it may have traded for 125 years and which is a key part of its brand identity. Under the cumulative probability method, it would not be unreasonable for management to feel compelled to look at the possibility of several renewal cycles, leading far into the future. Depending on management's interpretation of the ED, it is possible that the management of one such retailer might think that it was unreasonable to consider terms in excess of, say 15 years because this is far in excess of any timescale that the business uses for planning, whereas a different management group might think it at least possible that they may still be trading from that same flagship store in another 125 years' time. Looking at the management team who have chosen the longer timescale, it is reasonable to assume that they will feel compelled to assign some probability to a 125 year term. This probability may be small, but in choosing that term as the end of their scale, they are saying that it is the point beyond which the probability is zero. It is reasonable to also assume that if we work back from the least likely term of 125 years, then every successively shorter term becomes relatively more likely and thus attracts a greater probability. The cumulative probability method involves working back from the longest possible lease term to the shortest term: once we come to a lease term where the cumulative probability of renewal is in excess of 50%, this is the lease term we are required to use to calculate the lease asset and liability. A result of using such a method is that the act of considering the possibility of a longer lease term is likely to force you to recognise a greater lease asset and liability than a different management team who may be making a similar decision but who refuse to consider a lease term longer than their planning horizon. Note that the most likely lease term (and indeed the actual lease term) in both cases could be the same. However, by using the cumulative probability method, the team who are willing to consider the possibility of a longer lease term will almost inevitably end up recognising a greater asset and liability.

- Depending on the size and composition of a company's leasing portfolio, it is possible that landlords and competitors will be able to use the assumptions made around renewals to the detriment of the lessee company by gaining access to insight into their current assessment of the likelihood of renewing certain leases. From year to year, as the company is required to review and update its lease assumptions, information may also be available which allows third parties to gauge how it feels about future trading confidence in the shape of the likelihood of renewal of leased trading sites or leased production machinery.

#### **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?

#### **Answer to Q9**

We do not agree with this. We think that it goes against IAS37 in its approach to what we would consider to be contingent liabilities, which in the case of turnover-based rentals are dependent upon landlords delivering footfall or other services for these rentals to become payable. Contingent rents and residual value guarantees are not generally material in our sector, but we would recommend that only the lease payments, where there is a present

obligation, are used to calculate the lease asset and liability, and that the requirements for lessee and lessor are linked.

**Question 15**

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

**Answer to Q15**

We support effective disclosure and open communication with the users of our accounts. However, there is no history of our investors, analysts, or lenders, asking us for any significant information on our leases in addition to that which we currently make public. We have no history of users asking us to restate our balance sheet to show the effect of recognising operating leases. We would ask the Board to consider whether there is actually a significant demand for this information at all. If the Board concludes that there is a significant demand from a subsection of users, we would ask them to consider whether the needs of all users could not best be served by providing the additional information needed to model a balance sheet containing operating lease assets and liabilities in the notes to the accounts rather than recognising them on the balance sheet.

**Question 16**

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

**Answer to Q16**

We can see the simplicity of treating all leases as if they were entered into at the date of adoption of the ED, and we are generally in support of measures to aid the simplicity of adopting new and amended IFRSs. However, given that the effective interest method has such a distorting effect on the P&L account in the earlier years of a lease, we would support an approach which allowed companies free choice as to whether to adopt retrospectively or not, in combination with comprehensive disclosure of the effect of adoption. This would allow companies to adopt the ED at a point in their leasing cycles which gave the least distortion in the income statement, which would aid comparability and minimise the concentration on alternative performance measures in the early years of the new standard.

**Question 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?

**Answer to Q17**

We do not agree, because we are not convinced that any of our users will realise a significant benefit from the proposed ED, whereas we can see that the implementation of the ED, together with the regular ongoing review of lease terms in the future, will involve significant additional work for people within companies. In contrast to most accounting standards, the demands of the proposed ED require continuing additional work from people in many different departments of most companies, not just a few people in the finance department, as traditionally happens. Furthermore, we believe that there will be additional costs for preparers as they are asked by users to restate the accounts (particularly the P&L account) back onto an IAS17 basis, so that users can see actual rents paid.

We appreciate the opportunity to comment, and hope that you find our comments useful.

Yours faithfully,

Mark Robson – CFO  
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