

20 Gresham Street  
London  
EC2V 7JE

**Tel:** +44 (0)20 7920 2620  
**Fax:** +44 (0)20 7920 2628  
[info@classic-technology.co.uk](mailto:info@classic-technology.co.uk)  
[www.classic-technology.co.uk](http://www.classic-technology.co.uk)

Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

Your ref:  
Our ref:

10 December 2010

Dear Sir

**Comments on Exposure Draft ED/2010/9 Leases**

I am writing in my capacity as a member of the Joint IASB and FASB Working Group on Leasing and I appreciate the opportunity to comment on the exposure draft on leases.

In my view, changes to lease accounting are long overdue and I support the general principle that lessees should, for all leases, recognise an asset representing the right to use the underlying asset and a liability representing the obligation to make the lease payments. However, I do not support the proposed models for lessor accounting. Furthermore, many aspects of the proposals are complex, are inconsistent with other standards and are either too costly or impracticable to implement.

In my view a significant amount of work is required to refine these proposals before a final IFRS is issued. Furthermore, in the absence of a detailed discussion paper on lessor accounting, little time has been allowed for interested parties to consider the proposals properly and it may well be that further issues will arise that have not yet been identified. It is therefore important that sufficient time is allowed to consider and consult on the issues (including possible re-exposure) before a final IFRS is issued. Sufficient time should also be allowed for lessees and lessors to implement the significant changes required to processes and IT systems.

# classic technology

*Comments on Exposure Draft ED/2010/9 Leases  
10 December 2010*

## *Scope*

I have concerns regarding:

- The practical difficulties in distinguishing between leases and service contracts;
- The rationale for excluding leases deemed to be in-substance purchases/sales and the lack of clarity in their identification;
- The rationale for excluding intangible assets; and
- The lack of guidance as to how to account for leases that fell within the scope of IAS 17 but which will be excluded from the scope of the new IFRS.

## *Options*

Whilst, under existing accounting, the right to use the underlying asset and the obligation to make the lease payments are not recognised in the case of operating leases, the proposals on options (and those contingent rentals which are effectively options) are equally flawed in requiring the recognition of rights and obligations at amounts that are potentially far in excess of their fair values. This is particularly so in the case of fair market value options where the option to extend the lease may have little value. The treatment is also inconsistent with the exclusion of purchase options which may, in substance, be little different to an option to extend the lease for the remaining useful life of the underlying asset.

The estimation of lease terms many years into the future is highly subjective and uncertain and will lead to a lack of comparability and undue complexity. One of the reasons given for the treatment is to minimise structuring (paragraph BC 123). However, introducing arbitrary rules that are not based on sound principles is not an answer to this.

In my view, an option to renew should not be recognised unless the lessee is economically compelled and/or reasonably certain to exercise the option. Such a principle is well understood, would be simpler to apply, would lead to more comparability and would minimise structuring and the need for remeasurement.

# classic technology

*Comments on Exposure Draft ED/2010/9 Leases  
10 December 2010*

## *Reassessment*

The proposals for reassessing contingent rentals and lease terms inconsistently vary depending on whether one is a lessor or a lessee and between the performance obligation approach and the derecognition approach. These are somewhat arbitrary rules which are not only complex, costly and difficult to apply in practice but can also produce nonsensical, misleading and volatile results.

It would be preferable if there were a higher initial recognition threshold and more specific triggers, such as for impairment testing. It would also be preferable if there were clearer and more consistent principles for making adjustments with more flexibility in applying the principles to particular circumstances.

## *Lessor accounting*

I do not support the proposals for lessor accounting. The technical arguments for the performance obligation approach are unconvincing and the approach is inconstant with the lessee model and the principles set out in the exposure draft *Revenue from Contracts with Customers*. Furthermore, the performance obligation approach overstates the net assets over the course of the lease and has the bizarre effect of recognising income faster the higher the residual value risk assumed by the lessor. It is difficult to see how the proposed lessor accounting can be said to be an improvement on existing accounting and how it can be said to provide a faithful representation of the transactions undertaken.

Having two models also requires the retention of an unnecessary bright line and for which the guidance is unclear. In my view, a single lessor model should be used based on the derecognition approach but with various amendments such as the accretion of the residual asset.

The exposure draft consistently ignores the fact that the pricing of certain leases is affected by tax considerations and that many leases in countries such as the UK are subject to rentals that are variable if tax assumptions change. There is not a single mention of these aspects in either the exposure draft or the basis for conclusions document and this suggests that no consideration has been given by the Boards to the issues that arise with these types of lease. It may be that the same conclusions will be reached but the issues should, at least, be properly considered and discussed rather than ignored.

classic technology

*Comments on Exposure Draft ED/2010/9 Leases  
10 December 2010*

*Transitional rules*

The use of simplified transition rules is to be welcomed but the prescriptive nature of the proposals will significantly distort in a misleading and inappropriate way the profit trends of lessors and lessees until existing leases have expired. More flexibility is required and I have suggested an alternative approach in my response to question 16.

I would be pleased to provide further comments on any aspect in the attached.

Yours faithfully

A handwritten signature in black ink that reads "David Maxwell". The signature is written in a cursive style with a long, sweeping underline.

David Maxwell  
*Director*

## Question 1: Lessees

*(a) 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?*

*(b) 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?*

---

I agree that a lessee should recognise a right-of-use asset and a liability to make lease payments and I agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments. However, I have concerns regarding some other aspects of the accounting as noted in my responses to subsequent questions.

### *Amortisation of the right-of-use asset*

I also have the following comments on the basis under which the right-of-use asset is amortised:

Paragraphs BC8 to BC11 discuss the so called “linked approach” whereby the right-of-use asset is amortised in a pattern similar to that of an interest-bearing loan. I agree that certain aspects of the linked approach as proposed has flaws (eg the proposal that the leased asset should always have the same value as the lease obligation as such an approach does not recognise the fact that a lease payment may not be made at the same time as the right of use is consumed) but in my view further consideration ought to be given to the use of annuity or interest methods of depreciation – not just for certain leases – but for the depreciation of all property, plant and equipment.

When one acquires a property, plant or equipment (either through obtaining title to that asset or through a lease that is in substance a purchase), one obtains the right to use that asset for its entire life. When one pays upfront for that asset (eg when one pays for the asset on acquiring title to the asset) one is paying in advance for the future right of use and the price paid for that asset represents the present value of those future rights – i.e. it is the value of those rights discounted to reflect the time value of money. As with any payment in advance, the accounting ought to reflect the reversal of that discount. I accept that to apply such an approach to all property, plant and equipment would be a radical change to conventional accounting and, in many cases, the cost of compliance would outweigh the benefits. Nevertheless, conventional accounting is flawed in this respect in not recognising the time value of money.

In the case of leasing, instead of paying upfront for the right-of-use, one generally pays for that right-of-use at the same time as one consumes that right (as noted in paragraph BC9). Consequently, current operating lease accounting is not subject to the same flaw regarding not recognising the time value of money – at least as regards the income statement. That is not to say that current operating lease accounting produces the correct balance sheet values.

One of the reasons given for not adopting the annuity or interest methods of depreciation for leases is that the result would not be consistent with the accounting for purchased assets. Therefore one is effectively changing the lease accounting to make the accounting consistently flawed for all assets. A better approach would be to allow the use of annuity or interest methods of depreciation for all property, plant and equipment and right-of-use assets where the impact is material.

## 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?

---

I do not agree that lessors should apply the performance obligation approach; in my view a single accounting model should be applied to all leases and this should be based on the derecognition approach. Having to classify leases between those subject to the performance obligation and those subject to the derecognition approach means retaining all the problems associated with classifying leases under existing lease accounting standards without any clear benefits.

However, whilst I consider the derecognition approach to be the most appropriate model, I do not agree with the proposed treatment of the residual asset. In this respect, I agree with the "Alternative view" of Stephen Cooper that the residual asset should be accreted to reflect the time value of money. This is particularly so where the residual value is guaranteed and so is akin to a financial asset. However, if the derecognition approach is to be applied more widely, I would limit the initial gain by excluding optional/non contractual lease periods from the value of lease payments used in the calculation (unless the lessee is economically compelled / reasonably certain to exercise the option) but I would include guaranteed residual values.

There are also some flaws in the treatment of initial direct costs in the exposure draft as set out in Appendix 1.

If two models are to be retained, further guidance is required on how to determine which method to use as the requirements in paragraphs B22 to B27 are difficult to apply in practice. In particular the term 'significant' is somewhat vague in that it is unclear where the line should be drawn between *significant* and *insignificant*. Is the test intended to be similar to the existing lease classification rules whereby, under a finance lease, substantially all the risks and rewards are transferred such that the lessor is left with no significant risks and rewards? Whilst some indicators are given, the comment in paragraph B26 that one or more factors is not conclusive is unhelpful as one is then left with no other principle or guidance on which to reach a conclusion.

It is also far from clear how one applies impairment under the performance obligation approach. Paragraph 41 simply refers to an impairment of the right to receive lease payments in accordance with IAS 39 but presumably the underlying asset could also be impaired in which case one would need to apply IAS 36. In these circumstances, how does one allocate the cash flows between the two assets and what discount rate does one apply (as IAS 39 requires one to use the original effective interest rate whereas IAS 36 requires one to use the current market rate)? How does the lease liability fit into this calculation?

Under the performance obligation, it is unclear why the lessor's income should vary with the pattern of the lessee's use of the underlying asset under paragraph 37(b). The lessor's obligation is to grant to

the lessee a right to use the asset and this is satisfied by making the asset available to the lessee regardless of whether and the extent to which the lessee actually uses (or is expected to use) the asset. The only exception is if the rentals vary with the lessee's actual usage. Furthermore, since the lessor is not the user of the asset, it will not know any of the factors listed in paragraph 38 and, in practice, a lessee is unlikely to disclose such confidential information about its business to the lessor.

I also have concerns regarding some other aspects of the accounting as noted in my responses to subsequent questions. More detailed comments on the performance obligation approach are given below.

#### *Assets that arise under a lease*

In my view, on entering into any lease, the resources that are controlled by the lessor are:

1. A right to receive the lease payments; and
2. A right to the asset when it is returned by the lessee (the residual asset).

Therefore, these are the two assets that arise in accordance with the conceptual framework. I see little benefit or technical merit in splitting the residual asset into two further components – namely the original PP&E asset less a performance obligation as proposed in the exposure draft.

As well as lacking technical merit (see further comments below), the performance obligation approach also overstates the net assets over the course of the lease and has the bizarre effect of recognising income faster the higher the residual value risk assumed by the lessor (see examples in Appendix 2).

#### *Technical merit of performance obligation approach*

The arguments given for the performance obligation approach are far from convincing from a technical point of view. For example:

- The existing lease accounting is based on the assumption that the leased asset is a single indivisible physical item and this assumption leads to an 'all or nothing' approach when determining whether the leased asset has been transferred to the lessee. Where the leased item has not been transferred to the lessee (i.e. an operating lease) the lease is treated as an executory contract under existing lease accounting. However, the proposed new lessee accounting recognises the fact that, in reality, the leased asset represents a series of rights to use the underlying asset and, as such, is divisible. However, the proposed new lessor accounting has inconsistently reverted to an 'all or nothing' approach.
- An asset is defined under the conceptual framework as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity." When acquiring the underlying asset, the resource controlled by the entity is the right to use the asset for its entire useful life. 'Title' is merely one of the legal means through which those rights can be obtained. Paragraph BC16 states that in granting the lessee the right to use the underlying asset during the lease term it does not lose control of the underlying asset. It does – it loses control of part of the resource underpinning the asset,

namely its right to use that asset and so derive income or other benefits from that asset during the period of the lease.

- Paragraph BC17 states that the performance obligation would result in an outflow of future economic benefits from the lessor. It does not – it results in a reduction in the inflow of future economic benefits and so represents a reduction in the lessor’s asset. It is not as though the lessor receives the benefits and then passes them on to the lessee. The fact that a netting approach is proposed suggests that the Boards, in practice, accept that the performance obligation is not a separate liability but is in reality a reduction in the value of the underlying asset.
- The proposals are inconsistent with the lessee model in deeming the lessor to have a significant obligation. The accounting under existing lease standards is on the basis that an operating lease is an executory contract. However, the proposed new lessee accounting is on the basis that the lessor has no other significant obligation once the underlying asset is delivered and as a consequence the lease is not an executory contract.
- The proposals are also inconsistent with the derecognition approach. If the performance obligation is satisfied continuously during the lease term as the lessor permits the lessee to use the underlying asset, then there is no reason why that should not also be the case for leases where the lessor has retained no significant risks or benefits relating to the underlying asset. Why does the fact that the lessor is exposed to, say, the residual value risk mean that it has not satisfied its performance obligation to the lessee but, if it obtains a third party residual guarantee, say, (and retains no other significant risk or benefit), then it has satisfied its performance obligation? The residual value has nothing to do with the lessor’s obligation to make the underlying asset available.
- Paragraph BC18 suggests that the performance obligation is satisfied continuously during the lease term as the lessor permits the lessee to use the underlying asset. This is inconsistent with the proposals under the exposure draft *Revenue from Contracts with Customers*. For example, that exposure draft suggests that the performance obligation is satisfied when:
  - A customer has an unconditional obligation to pay - paragraph 30(a). The lessee has an unconditional obligation to make the lease payments at the lease commencement and the lessor has an unconditional right to receive the lease payments on that date. If that were not the case, the contracts would be executory contracts and a lessee should not be recognising the liability to make lease payments at that date and the lessor should not be recognising the right to receive lease payments at that date;
  - A customer has physical possession – paragraph 30(c). The lessee has physical possession on delivery of the underlying asset.

Indeed, having delivered the asset, it is difficult to identify any performance obligation that the lessor has to satisfy in future, other than the passage of time.

**Question 3: Short-term leases**

*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?*

---

I agree with these proposals.

However, it is unclear how to apply the simplified approach for lessees as set out in paragraph 64. It suggests that a lessee should recognise a right-of-use asset and a liability to make lease payments. However, it then suggests that the lease payments should be recognised in profit or loss with no guidance as to how the asset and liability are to be amortised.

**Question 4(a): Definition of a lease**

*Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?*

---

I broadly agree with the definition of a lease but see my comments on questions 4(b) and 4(c).

#### **Question 4(b): Definition of a lease**

*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?*

---

The exclusion of contracts that represent purchases or sales creates an unnecessary bright line and is based on criteria that are inconsistent with the exposure draft *Revenue from Contracts with Customers*. Furthermore, the classification guidance given is far from clear and one is also left with uncertainty as to how to account for such contracts.

The case is not made for excluding such leases from the scope of the new IFRS. The snapshot makes the comment that the lessor's right to receive lease payments and the lessee's liability to make lease payments are not accounted for as financial assets and liabilities because they have unique features such as options and contingent rentals and so it is considered necessary to set out specific accounting requirements for such assets and liabilities. However, the same is true for the leases treated as purchases or sales and, by excluding such leases from the scope, one is left with uncertainty as to how to account for those contracts.

As stated above, it introduces an additional and unnecessary bright line test. For the lessee, both leases and in substance purchases will be on balance sheet under the proposals but there could nevertheless be significant differences in the accounting depending on which side of the bright line the lease lies. For example, where the lease contains a purchase option, for in-substance purchases these amounts would presumably be included in full in any liability representing the lease payments (as the cost of acquiring the asset would presumably equal the fair value of the asset and the liability would need to be the same amount). However, for leases falling within the scope of the new IFRS, purchase options will be excluded from the liability. If the approach to purchase options suggested in my response to question 7 is adopted, this difference would be resolved.

The guidance in paragraphs B9 and B10 is also unclear. For example:

- The criteria in B9 for exclusion are where an entity transfers to another entity control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset. The term "trivial" is a new concept but no guidance or examples are given as to what trivial means in this context. Furthermore, the items listed in B10 are limited to cases where title passes although in practice the criteria in B9 can be met in cases where no title passes (such as the example of a contract that covers the whole of the expected useful life of the asset which was included in earlier papers considered by the Boards). Is it intended that leases treated as purchases or sales be limited to just cases where title passes? If so, this should be more clearly stated.
- If the criteria is to be based on legal form (namely the transfer of legal title), there could be differences in accounting as a consequence of the differences in legal requirements between jurisdictions. For example, in many countries (eg the UK), one cannot strictly speaking acquire title to land (as all land belongs to the Crown/state) but instead one acquires either a freehold interest in the land (which is an indefinite lease) or a leasehold interest. Presumably a freehold interest would be treated as acquiring title but, if so, why not also treat other leases

that cover the whole of the expected useful life of the asset as being equivalent to acquiring title?

- The wording in B9 also refers to “at the end of the contract”. Does that mean that the criteria in these paragraphs would be met if title passes to the lessee at the contract end with only trivial risks and benefits retained by the lessor at the contract end but with significant risks and benefits retained during the lease term (eg rentals varying with market value)?

#### **Question 4(c): Definition of a lease**

*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?*

---

The guidance given in paragraphs B1 to B4 is similar to but less detailed than that in IFRIC 4. Furthermore, IFRIC 4 has not been sufficiently tested in distinguishing between service contracts and what were operating leases as the accounting is similar. Consequently the guidance given is far from sufficient, as discussed in more detail below.

In addition:

- Guidance is required as to when a portion of a larger asset is itself the underlying asset – this is discussed further below.
- IFRIC 4 exempts arrangements that are within the scope of IFRIC 12 but the exposure draft does not. Is this intentional?
- The guidance on assessing and reassessing whether an arrangement is or contains a lease in IFRIC 4.10 and 11 is not carried forward to the exposure draft even though the issues addressed will remain relevant.
- Paragraph B1 (b) refers to an ‘*agreed* period of time’ but the definition of a lease simply refers to a ‘period of time’. Is the use of the word “agreed” in this context significant? In particular, the period of a lease may often not be agreed in advance as the parties may have options to terminate early or extend the lease or the lease term may vary with some other factor.

#### *General comments on the difficulty in determining whether there is a lease*

Under current lease accounting standards, a significant issue is distinguishing between finance leases (which are on balance sheet for lessees) and operating leases (which are off balance sheet). Once all leases are brought on balance sheet, the classification issues will simply shift to the distinction between leases and service contracts.

Under current accounting, for a lease to be an operating lease, the lessor has to be prepared to assume some risk relating to the asset being leased. Commercially, the lessor may not be prepared to accept such risk and so may instead opt for a finance lease. In a service contract which involves the use of an asset, the service provider generally assumes risks associated with that asset. Therefore, compared to the finance lease / operating lease distinction, the parties to a contract may be less concerned commercially whether an arrangement is a service contract or an operating lease as the risks assumed may be similar. Therefore, the distinction between a service contract and an operating lease depends more on how the arrangement is structured than under current lease classification and less on the commercial aspects, such as risks.

Similarly, lessees are generally more interested in the output from an asset rather than the underlying asset itself and so may not care which asset is actually used or whether they physically operate it or have physical access to it. Indeed, asset users often outsource such aspects.

Under the proposals, determining whether an arrangement is, or contains, a lease is based on an assessment of whether fulfilment of the contract is dependent on the use of a specified asset and whether the arrangement conveys a right to control the use the asset for an agreed period of time. These aspects are considered further below. However, the key issue is that the proposal is not principles-based but simply a set of rules to capture certain transactions whilst avoiding others. It therefore fails to set out clearly the substantive difference between a lease and a service contract.

*Fulfilment of the contract depends on providing a specified asset or assets*

Current operating leases tend to involve assets that are widely available in the market, in use by many other parties and (apart from property) fairly moveable (such as vehicles, trains, aircraft, ships, computers and photocopiers). Therefore, compared to finance lease assets, to avoid the contract depending on a specified asset, it is easier to substitute assets and/or use arrangements that pool assets. A user may want use of a particular type of asset for a period of time for a specified price but may not care whether the asset is specified.

For example, an owner may have a pool of vehicles (such as commercial delivery vans) all of a similar type, age and condition and provides certain services, such as maintaining the vehicles. A user contracts to use an unspecified van for a specified price and specified period. In an extreme case, the user may collect a van from the pool every morning and return it in the evening but not necessarily the same van each day. One therefore has a series of one day leases with the result that only minimal lease obligations would be recognised in the accounts. The above is an extreme example whereby the asset is changed daily but this could equally be weekly or monthly or whenever the asset needs to be serviced or repaired (as is common in pooling arrangements for aircraft engines). The choice of a service contract or a lease is then reduced to issues such as whether the user wants its logo painted on the side of the vehicle (which may necessitate the asset being specified).

Where an asset is not identified in the arrangement, under the proposals one has to consider whether the asset is implicitly specified. B2 suggests that this is the case where:

- (a) It is infeasible or impractical for a lessor to provide alternative assets; or
- (b) The lessor rarely substitutes assets in practice.

In practice, it will be difficult for the parties to assess whether a lessor will rarely substitute an asset until after the event. One can also envisage the situation where lessors substitute assets for no other reason than to demonstrate that (a) and (b) do not apply. Also, how rare is 'rare' for this purpose? As regards the aircraft example given, aircraft lease periods are often relatively short compared to the useful life of the aircraft even where the aircraft has been tailored to a particular operator and so this may not be a significant barrier to substitution.

As another example, IT outsourcing arrangements are generally considered to be outside the scope of IFRIC 4 due to the ability by the outsourcer to substitute assets within the arrangement. The "implicitly" specified requirement is likely to be circumvented (as is the case for the IFRIC 4 "economically feasible or practicable" constraint) by the outsourcer moving the stock around.

A lessee may have a right to a particular asset for a specified period of time (which would be a lease for that period). It may then have a right to a similar but unspecified asset for a subsequent period. It may be that the lessor will provide the same asset for that further period or a different asset. However, since at the outset the lessee has a right to the specified asset only for the first period and not beyond, it would presumably be incorrect for the lessee to assume a continued right to that asset beyond that first period whatever its expectations.

It would be helpful for more examples to be given to assist one in determining scenarios in which the Boards expect assets to be considered specified and those in which they do not.

*Contract conveys the right to control the use of a specified asset*

B4 sets out certain conditions for when an arrangement conveys a right to control the use of the asset. This comprises a set of detailed rules which appear to be somewhat arbitrary rather than being based on a clear underlying principle.

The following are some observations on these conditions.

- For many assets that are currently subject to operating leases, there are likely to be few issues in a potential lessee under an arrangement, that involves an asset, in allowing another party to operate the asset (B4(a)) or control physical access to the asset (B4(b)).

In many cases, it may well be concluded that the potential lessee is simply directing the other party to operate the asset in a particular manner. However, in any service contract that involves the temporary use of an asset, in acquiring that service one is arguably also taking temporary control over how that asset is used and controlling the output from that asset for the period that the service is being provided. The distinction between the two is a fine one.

For example, if one enters into a ‘wet’<sup>1</sup> lease of an aircraft, charters a ship or hires a taxi or chauffeur driven car, the crew or driver would generally be supplied by the lessor / owner and be under that party’s control.

- There are several references to “insignificant amount of the output or other utility of the asset”. As in assessing “substantially all” risks and rewards under current lease standards, assessing “insignificant” involves a judgemental bright line and similar issues to those under current lease classification are likely to arise once entities try to push arrangements to the limit.

The wording in B4(c) around whether one party will obtain all but an insignificant amount of the output of an asset is more deterministic than the equivalent under IFRIC 4.9(c). Why is this?

- Leases where rentals vary with volume or with market rates are not uncommon. However, B4(c) treats such features as indicators of there being no lease.

---

<sup>1</sup> A wet lease is a leasing arrangement whereby the lessor provides an aircraft, complete crew, maintenance, and insurance to the lessee, who pays by hours operated.

For example, under a ‘wet’ lease of an aircraft, the lessee may be taking substantially all of the output generated by that asset during the term of the arrangement but the lessor will operate the asset and control physical access to the asset. If the payments are for the hours flown and the hourly rate is fixed or at market rates, the lessee will be considered to be paying for a service rather than paying for the right to use the asset.

What does “fixed price” mean in the context of B4(c)? Does an agreement which features one fixed ‘peak’ price and one fixed ‘off-peak’ price escape lease accounting? Is a fixed price that is indexed considered to be fixed?

#### *Portions of an asset*

As IFRIC 4 states, in some arrangements the underlying asset that is the subject of the lease is a portion of a larger asset. IFRIC 4 currently does not address how to determine when a portion of a larger asset is itself the underlying asset for the purposes of applying lease accounting (although there are references to IAS 16 and IAS 38). The exposure draft provides even less guidance.

For example, in the case of a factory, a party may purchase the entire output from one machine in that factory but this may represent an insignificant portion of the factory’s output as a whole. Does this mean that, potentially, the machine is being leased? Would the answer change if the production is split between two machines rather than using one machine exclusively? In practice, the contract is unlikely to specify a particular machine to use and so the contract would not be dependent on a specified asset. However, this just illustrates another uncertainty.

An aircraft is made up of many parts, most of which will be replaced long before the aircraft reaches the end of its useful life. In particular, the airframe, landing gear and engines often have differing depreciation periods under IAS 16. Does one therefore have a series of short leases for each component of the aircraft or a long lease for the aircraft as a whole?

What if one leases several buildings on a single site and the buildings have differing lives? Does one assess the likely lease terms based on the site as a whole or treat each building separately?

One may pay a rental for a telephone line. Part of that line may not be exclusive to the lessee but may be used by numerous parties or the telephone calls may be routed through one of many lines such that the precise line is not specified. However, another part of that line (eg where the line enters the lessee’s premises) may be exclusive to the lessee and effectively be specified. Does one have a lease for part of the telephone network?

**Question 5: Scope exclusions**

*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?*

---

It is unclear why intangible assets should be excluded. Given the lack of any alternative guidance on such contracts, it raises the question as to whether such leases should be accounted for in the same way as that proposed for other leases or whether they should be accounted for as executory contracts, even where the substance of such arrangements is financing in nature.

For example, there are many finance leases involving films and, whilst IAS 17 excludes leases of mineral right and licensing arrangements, in the absence of any other accounting guidance IAS 17 is nevertheless frequently applied to such contracts. If the exemption regarding intangibles remains, would entities be allowed to apply the new IFRS to such leases where there is no conflict with other standards, notwithstanding the exemption?

I agree that there should be an option to allow fair value accounting and so, in this respect, I agree with the IAS 40 exclusion in paragraph 7 of the exposure draft. However, this should be a more general principle and the option should not be restricted to just properties.

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

*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?*

---

In my view, all service components should be accounted for separately and consistently in accordance with the proposals in the exposure draft *Revenue from Contracts with Customers*, whether or not distinct. The distinction between distinct and non distinct components is an unnecessary complication.

### **Question 7: Purchase options**

*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?*

---

It is argued that the purchase option is not a lease payment as it terminates the lease. However, it is as much part of the lease contract as any other option or contingent rental and is no different (other than legal form) to a termination rental which also terminates the lease, particularly (as is common) if the lessee also controls the disposal of the asset (acting as agent for the lessor) and receives a rental rebate equal to substantially all of the sale proceeds.

Excluding purchase options is also inconsistent with the treatment of extension options. One could, say, have an option to extend the lease for the remaining useful economic life of the underlying asset for a fixed rental or even a one-off rental. Such an option gives the lessee virtually the same rights as if it had a purchase option and is, in substance, the same as purchasing the asset. The extension rentals would be included in the lease payments if the extension option was expected to be exercised but not an equivalent purchase option even if that was expected to be exercised. The choice between such an extension option and a purchase option would generally be based on their differing tax treatments but that should not be a reason for different accounting.

In my view, both purchase options and extension options should be included but only if the lessee is economically compelled / reasonably certain to exercise the option.

### **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?*

---

I agree with the “Alternative view” of Stephen Cooper regarding optional lease periods.

Whilst, under existing accounting, the right to use the underlying asset and the obligation to make the lease payments are not recognised in the case of operating leases, the proposals on options (and, to a certain extent, contingent rentals) are equally flawed in requiring the recognition of rights and obligations at amounts that are potentially far in excess of their fair values. This is particularly so in the case of fair market value options where the option to extend the lease may have little value. The treatment is also inconsistent with the exclusion of purchase options which may, in substance, be little different to an option to extend the lease for the remaining useful life of the underlying asset.

The estimation of lease terms many years into the future is highly subjective and uncertain and will lead to a lack of comparability and undue complexity. One of the reasons given for the treatment is to minimise structuring (paragraph BC 123). However, introducing arbitrary rules that are not based on sound principles is not an answer to this.

In my view, an option to renew should not be recognised unless the lessee is economically compelled / reasonably certain to exercise the option. Such a principle is well understood, would be simpler to apply, would lead to more comparability and would minimise structuring and the need for remeasurement. At the very least, options which are at the fair market rent at the time of exercise should be excluded.

### **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?*

---

I agree with the “Alternative view” of Stephen Cooper regarding contingent rentals.

In my view, a distinction should be made between:

- those contingent lease payments that are based on an index or rate, such as payments that vary with interest rates, tax assumptions or market rates; and
- those contingent lease payments where the lessee has control over the level of the payments and so represent an option, such as payments varying with usage.

Only the first category should be included in the measurement of lease payments. Rentals that represent options should be excluded for the same reasons as extension options, unless the lessee is economically compelled / reasonably certain to exercise the option – see my response to question 8.

Nor do I agree with the probability weighted approach suggested in the exposure draft. It would be unduly burdensome to carry out such a calculation for several thousand leases. Furthermore, estimating probabilities of each outcome would also be highly subjective and the result is unlikely to be particularly accurate. A best estimate approach would be no less reliable and simpler to apply.

#### *Interest rate*

Under paragraphs 14(a), 35(a) & 52(a) it is suggested that, where the lease rentals vary with interest rates, one should use readily available forward rates if possible. However, this could give rise to some bizarre results. For example suppose, at the start of the lease, the prevailing interest rate is 2% per annum but that the forward rate curve is for interest rates to increase from 2% per annum to 10% per annum at the lease end. If the estimated lease payments are based on these forward rates, the interest rate implicit in lease and the effective interest rate might be, say, 5% per annum. The lessee or lessor would then have lease interest charges or interest income in the first year of 5% when prevailing interest rates are only 2%. This would be highly misleading particularly given that the commercial purpose for having rentals varying with market rates is to ensure that the lease charges or income are in line with prevailing market rates in each period.

## 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?*

---

The proposed accounting treatment inconsistently varies depending on whether one is a lessor or lessee and between the performance obligation approach and the derecognition approach. These are somewhat arbitrary and inconsistent rules and are not only difficult to apply in practice but may also produce nonsensical and misleading results as illustrated below. It would be preferable if there were clearer and more consistent principles with more flexibility as to how to apply the principles to particular circumstances. Consideration should also be given to the use of retrospective adjustments as opposed to prospective adjustments, as also discussed in more detail below.

Continuous reassessment is particularly burdensome. If a quantitative analysis is required to determine whether a significant change has occurred, there is little benefit in changing the accounting only when the quantitative change is significant since the same level of effort would be needed regardless of whether a change is made. It would be preferable if there were a higher initial recognition threshold and more specific triggers, such as for impairment testing.

Some of the issues are illustrated in the following examples.

### *Interest variations*

It is suggested under paragraph 18 that the right-of-use asset should be adjusted for changes in contingent rentals that relate to future periods. Paragraph 19 suggests that the rate used to discount the lease payments should reflect changes in reference interest rates when contingent rentals are based on reference interest rates. It also suggests that any change in the liability to make lease payments arising from changes in the discount rate should be recognised in profit and loss.

If there is an expected change in *future* interest rates, does this mean that:

- one first changes the lease payments based on the revised interest rates and adjusts the right-of-use asset (in accordance with paragraph 18) and then changes the liability to make lease payments for the revised discount rate and recognises that adjustment in profit and loss (in accordance with paragraph 19); or
- that both adjustments are recognised in profit or loss?

I presume that the latter is intended.

The assumption is presumably that the change in lease payments will be matched by the change in discount rate such that the net adjustment is minimal. However, this will not be the case as the changes to lease payments will be based on the lessor's cash investment in the lease (including, for

example, its financing of the residual value) whereas the change in discount rate is applied to just the lease payments. It is not like a loan where the lender's balance will always equal the borrower's balance. The result will be that significant adjustments would be recognised in the profit and loss relating to expected future interest rate variations. This is illustrated in the example in Appendix 3.

It would be helpful if an example (based on realistic assumptions) were included in the IFRS to illustrate exactly what is intended.

There are also practical difficulties as, to calculate the future adjustments to the lease payments, the lessee needs to have both its and the lessor's cash flows held on its systems.

Furthermore determining the revised discount rate will not always be straightforward. For example:

- If the lessee used forward rates to determine the lease payments on initial recognition, how would one determine the equivalent revised discount rate? For example, using the example under question 9 where the forward rate curve was for interest rates to increase from 2% per annum to 10% per annum and which gave a 5% discount rate, if the prevailing interest rate increases from 2% per annum to 3% per annum, what is the revised discount rate?
- Suppose that the lease is priced reflecting some significant tax benefits such that the interest rate implicit in the lease is, say, 4% per annum, compared to a market interest rate of 6% per annum for a lease with no tax benefits, and the lessee uses this rate as its discount rate. Suppose the lease is interest variable and market interest rates increase to 7% per annum. What is the revised discount rate to use? A method of calculating such a rate is given in IAS 36 paragraph BCZ85 but this is somewhat complex.

It would be far simpler and more sensible to recognise interest variations as they arise without any adjustment to the assets and liabilities (as is current practice).

#### *Performance obligation approach*

A lessor applying the performance obligation approach needs to determine whether a change in contingent rentals represents a satisfaction of the lease liability but it is far from clear how one applies this requirement when the variation is unrelated to the obligation to make the asset available to the lessee. For example, see the comments below regarding tax variations. It would be clearer to use similar criteria to that for the lessee - namely assessing whether the change relates to past, current or future periods.

#### *Derecognition approach*

A lessor applying the derecognition approach takes any changes to expected contingent rentals to profit or loss. If, for example, an increase in rentals is due to an expected increase in the usage of the asset in future (such as an excess mileage charge on a car), this might result in a corresponding reduction in the expected residual value of the underlying asset. There should therefore be an adjustment to the value of the residual asset rather than taking this amount to income.

The examples 4 and 5 in the exposure draft relating to a change in lease term result in a meaningless carrying amount for the residual asset which neither represents its original carrying amount or its

current value. Consideration should be given to applying a retrospective adjustment (similar to that in paragraph 19 of the exposure draft *Revenue from Contracts with Customers*). Under this, the cumulative accounting after the change would be the same as it would have been had one known the revised lease term at initial recognition.

#### *Tax variations*

The exposure draft makes no reference to rentals that vary with tax assumptions even though such leases are common in many countries, particularly the UK.

Determining whether a tax variation represents a satisfaction of the lease liability as required under the performance obligation approach is somewhat unclear. For example, the recent UK Budget proposed a reduction in future tax rates. These changes give rise to an immediate release of deferred tax in the current period and a reduction in the future tax charges. For a tax variable lease, to what extent does the corresponding reduction in the lease rentals represent a satisfaction of the lease liability?

In the case of the derecognition approach, the entire tax variation would be recognised immediately in the profit or loss even though part of the variation relates to expected reductions in future tax rates.

It is also suggested that the discount rate should not generally be changed. This may give rise to unintended results. For example, suppose that a lease is priced reflecting some significant tax benefits such that the interest rate implicit in the lease is, say, 4% per annum, compared to a rate of 6% per annum for a lease with no tax benefits, and the lessor uses this rate as its discount rate. Suppose that the lease rentals vary with changes in tax assumptions and suppose also that, after the lease has commenced, there is a change in the tax legislation or interpretation thereof that eliminates or significantly reduces the tax benefits available to the lessor. The lessor therefore increases the rentals to reflect this change such that the revised interest rate implicit in the lease becomes 6% per annum. In such circumstances, it would not be appropriate to continue to discount the rentals at a tax adjusted discount rate of 4% per annum.

Again consideration should be given to applying a retrospective adjustment (similar to that in paragraph 19 of the exposure draft *Revenue from Contracts with Customers*). Under this, one would recognise the cumulative effect of the tax variation in the period in which the change arises such that the cumulative accounting after the change is the same as it would have been if the tax variation had been included in the initial recognition.

### **Question 11: Sale and leaseback**

*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?*

---

I do not agree with the sale and leaseback proposals as they are based on inconsistent principles and the guidance given is unclear.

#### *Definition of a sale*

As noted in my response to question 4(b), the criteria for determining whether there has been a sale are inconsistent with the exposure draft *Revenue from Contracts with Customers*.

Furthermore, whilst the principle for determining whether there is a sale is said to be the same as for determining whether a 'normal' lease is a sale or purchase – namely as set out in paragraph B9 - there is additional guidance in paragraph B31 which may lead to a different result. This is somewhat confusing and it should be made clearer as to whether a difference is intended. If a difference is intended, it should be expressed as a different principle rather than as a series of rules.

The guidance is also unclear because it requires the effect of the transfer contract and the lease contract to be considered together to determine whether the requirements for a sale are met. Is it intended that a transaction involving even a fairly small leaseback would not qualify as a sale as the lessee would have retained more than trivial risks or benefits associated with the underlying asset?

Also is the reference to "transfers" in paragraph 66 intended to widen the requirements to arrangements other than legal sales – such as lease and leasebacks? In any event, 'lease and leasebacks' are common and, given the inconsistency between normal leases and leasebacks, some guidance on 'lease and leasebacks' is also required. For example, should such arrangements be treated in the same way as head lease / sublease arrangements?

#### *Definition of a sale and leaseback*

Given that only the performance obligation approach is allowed for the leaseback, it is important that one can identify when an arrangement represents a sale and leaseback as opposed to a 'normal' lease. This is not always as straight forward as may first appear. For example, a lease of some new large value equipment is often arranged as follows:

- the 'lessee' negotiates the specification of the equipment required with a supplier and enters into a purchase contract with that supplier;
- at a later date, prior to delivery of the equipment, the 'lessee' negotiates a lease with a bank;
- the purchase contract is assigned or novated to the bank, which then pays the supplier and reimburses the lessee for any payments already made to the supplier.

Does this represent a sale and leaseback?

*Application of the proposals*

Under paragraph 67(b), if the transfer does not meet the conditions for a sale, the transferor shall recognise any amounts received as a financial liability. This assumes that the present value of the lease payments equates to the whole of the amount received. However, how does one account for the financial liability if it is greater than the present value of the lease payments if, say, the transferee expects to recover the difference from the residual value?

## **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?*

---

In all cases, lessees and lessors should be permitted to present the assets and liabilities either separately in the statement of financial position or make the disclosure in the notes.

**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?*

---

In all cases, lessees and lessors should be permitted to present the lease income and expense either separately in the profit and loss or make the disclosure 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?*

---

In all cases, lessees and lessors should be permitted to present the lease cash flows either separately in the statement of cash flows or make the disclosure in the notes.

**Question 15: Disclosure**

*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?*

---

In my view the level of disclosure required is excessive given that the objective of the IFRS is to present leases more appropriately in the financial statements rather than having to rely upon the notes.

The key information that needs to be disclosed is:

- Accounting policies;
- Significant judgements and estimates applied and, in particular:
  - the extent to which obligations to make lease payments or rights to receive lease payments are contractual or estimated/contingent at the balance sheet date;
  - the extent to which residual values are guaranteed;
- Maturity analyses in accordance with IFRS 7;
- Reconciliation of movements in balances.

### **Question 16: Transition**

*(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?*

*(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?*

---

I agree with the “Alternative view” of Stephen Cooper regarding the transitional provisions. The transition proposals are far too simplistic and the proposed rules are too rigid to allow for the large range of possible variations found in leases. These proposals will significantly distort the profit trends of lessors and lessees for many years until existing leases have expired. In my view, a full retrospective application of the lease accounting requirements (together with reasonable approximations) should at least be permitted, such as the approach suggested at the end of this section.

As Mr Cooper states, the requirements will lead to a misleading and inappropriate reduction in profit of a lessee on transition and increase profit growth in subsequent periods. The opposite effect will arise for lessors. This is illustrated by the example set out in Appendix 4.

In addition, I have the following points:

- It is suggested that finance leases will be recognised at the existing carrying amounts only if the lease contains no options, contingent rentals, term option penalties or residual value guarantees. In practice, few finance leases would meet this condition. Even in the simplest of leases, penalties are likely in the case of an early termination.
- For an existing finance lease, under current accounting, there will be no significant “recognised” prepaid or accrued rentals and so does this mean that the adjustment in paragraph 91 does not apply? If not, the proposals will result in a lessee having to write off the leased asset recognised under existing standards if the lease has been prepaid, say.
- The requirement in paragraph 91 applies only if the lease payments are uneven. However, the rentals may be even but adjustments may be required for rentals payable in advance and which have been paid just before initial application and for rentals payable in arrears relating to periods prior to initial application.
- For a lessor, using the performance obligation approach, no adjustment is suggested for prepaid and accrued rentals and so, for a fully prepaid lease, the lessor would just reinstate the underlying asset and subsequently have depreciation charges with no income.

- For a lessor, under paragraphs 94(a) and 95(a) the lease payments are required to be discounted at the rate charged in the lease determined at the date of inception but a lessee would use the rate at the date of initial application. This gives rise to various problems as follows:
  - The proposal would produce meaningless results for a lessor if the lease is variable for interest rates. For example, if the lease was written when interest rates were 10% per annum but the prevailing interest rates are 2% per annum at the time of initial application, the lessor would show significantly higher profits than are, in reality, being earned if it shows income of 10% per annum.
  - The requirement that a lessee uses the rate at the date of initial application can also give rise to issues. For example, the charges on a lease that was at a fixed rate of 10% might fall to only 2% post initial application.
  - The difference in rates between a lessor and lessee would significantly distort the figures for an intermediate lessor in a head lease / sublease scenario. One could have a head lease at a fixed rate of 10% per annum and an identical sub lease at a fixed rate of 10% per annum. If the prevailing interest rates are 2% per annum on initial application, the intermediate lessor would have sublease income of 10% per annum and head lease charges of 2% per annum.
  - For existing operating leases, there could be significant difficulties in determining the interest rate at inception if the lessor did not originally calculate such a rate or has retained no records of the rate.
- There is no mention of initial direct costs. Therefore any initial direct costs incurred on a lease written just prior to implementation (and which would have been added to the lease balances under a fully retrospective approach) will presumably have to be immediately written off.
- No guidance is given on how the revised classifications (i.e. between performance obligation, derecognition and purchase/sale) should be carried out. This would be an issue if there are no detailed records as to what the view would have been at lease inception under the new rules. It is also difficult to carry out this exercise retrospectively without applying hindsight.

#### *Simplified fully retrospective approach*

An alternative simplified approach might be as follows:

A lessee will know the future rental payments under the proposals (or at least it will need to determine these in any event) and will, hopefully, know the actual rentals paid in the past including contingent rentals. The total rentals could therefore be present valued at an appropriate discount rate – such as the original fixed rate if known or the current incremental borrowing rate – to determine an estimate of the original value of the right-of-use asset. This could then be amortised to determine the current carrying amount.

This would not be a perfect solution but it would be more accurate than the proposals in the exposure draft in that it would eliminate the distortions whereby the right-of-use asset is assumed to equal the current liability for lease payments and it would properly take into account prepaid and deferred rentals.

A similar approach could be used by a lessor applying the performance obligation approach.

*Additional transitional issues the boards need to consider*

Guidance is also needed on the transition provisions (for both lessors and lessees) for lease contracts previously accounted for under IAS 17 but which are now outside the scope of the new IFRS such as intangibles and contracts no longer considered to be leases by virtue of paragraph 8(a). For example:

- Where entities have, in the past, applied lease accounting to intangibles, would those entities be allowed to continue to apply the new IFRS to such contracts in those cases where there is no conflict with other standards?
- Where entities have, in the past, applied lease accounting to finance leases of intangibles outside the scope of IAS 17 (such as film leases - see my response to question 5) but not to operating leases, would those entities be required to apply the new IFRS to all such leases or to none and would the prior accounting need to be restated to achieve consistency?

Guidance is also needed on the transition provisions (for both lessors and lessees) for sale and leasebacks under the new rules.

**Question 17: Benefits and costs**

*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?*

---

Whilst overall the lessee changes represent an improvement compared to existing accounting there are many areas of concern and many aspects of the proposals that are complex, are inconsistent with other standards and are either too costly or impracticable to implement. In particular, in my view, the Boards have not demonstrated that the benefits of reassessing lease payments during the lease term outweigh the costs.

As regards lessors, it is difficult to conclude that the proposed accounting - in its present form - represents an improvement on existing accounting or that the changes justify the considerable costs that will be involved.

The implementation costs from systems changes and the need to analysis and collect data on each lease transaction will be very significant, particularly where there are several thousand leases. The ongoing costs of regularly reassessing the leases will also be considerable.

In my view a significant amount of work is required to refine the proposals before a final IFRS is issued. Given the costs of implementation, it is important that time is taken to get the IFRS right to avoid the necessity of further changes to the accounting in the near future. It may well be that a re-exposure of the proposals is required before an IFRS is issued.

## Question 18: Other comments

*Do you have any other comments on the proposals?*

---

### *Subleases*

There is little guidance on how to apply the proposed IFRS to subleases. For example, if one leases an asset from a head lessor for, say, five years (and this represents a small proportion of the asset's useful life) and one then enters into a sublease of the asset also for five years, would the grant of the sublease be accounted for under the performance obligation approach (because the lease is for a small proportion of the life of the underlying asset) or under the derecognition approach (because one has not retained any significant risk or benefit relating to the right-of-use asset)?

### *Cash flows prior to commencement*

There could be a significant gap between inception and commencement, such as if an asset is being constructed, but no guidance is given on the accounting during this period.

**Date of calculations** It is unclear why paragraphs 12, 33 and 49 refer to the date of inception rather than the date of commencement (i.e. when the amounts are initially recognised). Presumably the amounts actually recognised in the accounts should be the present values as at the date of recognition. Furthermore paragraph 50 refers to the fair value of the underlying asset at the date of inception but the asset may not even exist at this date. These issues need to be clarified.

**Prepaid rentals** At the date of commencement, payments by the lessee prior to that date need to be included in the lessee's right-of-use asset but not in its liability to make lease payments. The calculation of the initial gain under the derecognition approach also needs to take account of payments already made and not just future lease payments.

**Underlying asset** Financial institutions generally acquire the underlying asset for a specific lease/lessee and then dispose of the asset at the lease end. Such entities would not acquire the asset until the lease agreement has been signed. Where the lessor assumes no significant risks or benefits relating to the underlying asset (i.e. it would have been a finance lease under existing accounting), any payments made for the asset prior to the lease commencement (eg to the supplier during construction of an asset) are in effect financial assets and so this is how the payments should be accounted for. Showing the assets as PP&E would be misleading.

However, where the lessor already had the underlying asset (eg the lessor is a manufacturer or dealer) or where the lessor assumes significant risks or benefits relating to the underlying asset, the assets prior to the commencement of the lease do represent PP&E or trading stock.

It would be helpful if this were clarified.

### *Residual value guarantees*

The current IAS 17 makes a distinction between third party guarantees and guarantees given by related parties. Should a guarantee given by a related party (eg a fellow subsidiary of the lessee) on an arm's length basis be treated as a third party guarantee for the individual financial statements of the lessee entity (but as a lessee guarantee in the lessee group accounts)? Given the previous requirements, it would be helpful if this was clarified.

It would also be helpful if it was explained why unrelated third party residual value guarantees should be excluded from lease payments under paragraph 35(c) and how such payments should be recognised.

### *Rental rebates*

It would also be helpful if it were clarified whether an expected rebate of sale proceeds should be treated as a deduction from the lease payments or a deduction from the expected residual value.

For example, under a typical UK finance lease, at the lease end the lessee may have an obligation to pay a balloon rental (of, say, CU 100) which may be close to the expected residual value at that date. The leased asset would then be sold and the lessee would receive virtually all of the sale proceeds as a rental rebate.

- Should the lessee include the expected rental rebate as a deduction in the measurement of the obligation to make lease payments such that the expected lease payment at the lease end would be nil (being the CU 100 balloon rental less the expected rental rebate of CU 100)?
- Would the lessor have:
  - an expected residual value of CU 100 and a nil balloon payment after deducting the rental rebate; or
  - an expected lease payment of CU 100 (being the balloon rental) and a nil residual value after deducting the rental rebate?

### *Term option penalties*

This term needs to be defined as its meaning is unclear.

### *Lease modifications*

Guidance is required on how one addresses changes to the lease agreements and, in particular, whether a modified lease is treated as a new lease.

### *Offset and derecognition rules*

The IFRS should confirm whether the lessee's liability to make lease payments and the lessor's right to receive lease payments are financial liabilities and assets, such as for the purpose of the IAS 32 offset rules and the IAS 39 derecognition rules.

## Appendix 1

## Initial direct costs

I suggest the following changes to the exposure draft to reflect initial direct costs more appropriately:

- Under paragraph 33(b), the initial direct costs should be *deducted from* the lease liability and not added to the right to receive lease payments; the lessor would generally reflect the cost of initial direct costs in the pricing of the rentals and so adding the initial direct costs to the right to receive lease payments would represent a double counting.
- The definition of the rate implicit in the lease in paragraph B12 should be as under IAS 17, namely:

The rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to equal the fair value of the underlying asset *plus the lessor's recoverable initial direct costs*.

- Under paragraph 49(a), consistent with the suggestion above regarding paragraph 33(a), no recoverable initial direct costs should be added to the present value of the lease payments.
- In paragraph 50, instead of the “fair value of the right to receive lease payments”, this should be the present value of the lease payments *less* the recoverable initial direct costs. Without this adjustment, the amount derecognised could exceed the original carrying amount of the underlying asset.

The following examples illustrate the need for the above changes:

*Performance obligation approach*

Assume that the lease term is 5 years, the fair value and cost of the underlying asset is CU 10,000 and its expected residual value after 5 years is CU 1,200. Assume that the lessor applies the performance obligation approach. For the purpose of this illustration, assume that the recoverable initial direct costs of CU 1,000 are also incurred. The lessor calculates the rentals to give a return of 6% per annum. Tax effects have been ignored in the pricing for simplicity. The rentals so calculated are CU 2,398 per annum, as shown by the following:

Year	Fair value of asset	Initial direct costs	Rentals	Residual value	Return 6.0%	Net cash investment
0	(10,000)	(1,000)				(11,000)
1			2,398		(660)	(9,262)
2			2,398		(556)	(7,419)
3			2,398		(445)	(5,465)
4			2,398		(328)	(3,395)
5			2,398	1,200	(204)	(0)
					<b>(2,192)</b>	

In this particular case, the lessee's incremental borrowing rate is likely to be 6% per annum and, under paragraph B12, the lessor could use this as the discount rate. This would give a present value of the rentals of CU 10,103 and so the initial value of the right to receive lease payments would be CU 11,103 after adding the initial direct costs. This exceeds the fair value of the asset plus initial direct costs (CU 11,000). Furthermore, the effective interest rate for the purpose of paragraph 37(a) would be only 2.6% per annum.

The interest rate implicit in the lease defined in paragraph B1 (i.e. *ignoring* the initial direct costs) is 9.4% per annum. If a rate of 9.4% per annum is used, the present value of the rentals is CU 9,234 and so the initial value of the right to receive lease payments would be CU 10,234 after adding the initial direct costs. The effective interest rate for the purpose of paragraph 37(a) would only be 5.5% per annum which is still below the 6% per annum return used in pricing the lease.

A more appropriate solution would be to discount the rentals at the interest rate implicit in the lease *including* the initial direct costs which would be 6% per annum and is more likely to be consistent with the lessee's incremental borrowing rate. This gives a value of CU 10,103 for the lease payments including recoverable initial direct costs. The recoverable initial direct costs are then deducted from this amount to determine the performance obligation liability. The effective interest rate would then equal the discount rate – namely 6% per annum.

In any event, more guidance is required in the IFRS and perhaps the lessor should be given less choice in the selection of the discount rate to use.

#### *Derecognition approach*

The following uses the same lease assumptions as above but applying the derecognition approach. As the asset cost equals the fair value, no initial income would be expected on derecognition.

The rate that the lessor charges the lessee and the rate implicit in the lease (using the amended definition above) would be 6% per annum. At this discount rate, the present value of the rentals is CU 10,103 (excluding the initial direct costs).

Under paragraph 50 (as amended), the carrying amount of the asset to be derecognised would be:

$$\begin{aligned}
 &\text{Carrying amount of the underlying asset} = \text{CU } 10,000 \\
 &\quad \textit{multiplied by} \\
 &\text{Present value of lease payments (CU } 10,103) \text{ less initial direct costs (CU } 1,000) = \text{CU } 9,103 \\
 &\quad \textit{divided by} \\
 &\text{Fair value of the underlying asset} = \text{CU } 10,000
 \end{aligned}$$

This gives an amount derecognised of CU 9,103 and a residual asset of CU 897.

This gives net assets equal to the right to receive lease payments of CU 10,103 plus the residual asset of CU 897 - i.e. CU 11,000. This equals the costs of the underlying asset of CU 10,000 plus initial direct costs of CU 1,000. The residual asset of CU 897 equals the present value of the residual asset (CU 1,200) discounted at 6% per annum which is what one would expect.

## Appendix 2

## Comparison of lessor accounting models

To illustrate the effects of the differing accounting, the following simple example has been used. It is assumed that the fair value and cost of the underlying asset is CU 10,000 and its useful life is ten years. At the end of five years its residual value is expected to be CU 5,000. The asset is leased for an initial term of five years with, in certain cases, the option to extend for a further five years. The rentals are payable annually in arrears and the lessor calculates the rentals to give a return of 6% per annum on its investment. When applying the performance obligation approach, it is assumed that the underlying asset and lease liability are both amortised on a straight line basis. No initial gain is recognised under the derecognition approach (as the cost of the asset to the lessor is assumed to equal the fair value of the asset).

Three scenarios are considered, giving the following net income figures for the first five years:

	<b>Scenario 1</b>	<b>Scenario 2</b>	<b>Scenario 3</b>
<b>Expected term:</b>	5 years	10 years	5 years
<b>Residual value:</b>	Unguaranteed	Unguaranteed	Guaranteed
<b>Approach:</b>	Performance obligation	Performance obligation	Derecognition
<b>Year</b>			
1	629	600	376
2	562	547	309
3	491	490	238
4	417	431	164
5	337	367	1,348
	<b>2,435</b>	<b>2,435</b>	<b>2,435</b>

As can be seen, the higher the risks assumed by the lessor, the higher the income recognised in the early years – for example, the income is recognised at a faster rate (and the net carrying amount is greater) if the residual value is unguaranteed (scenario 1) compared to the case where the income is guaranteed (scenario 3). Income is also recognised at a faster rate if the lessee is expected to return the asset (scenario 1), leaving the lessor with the risks associated with the asset, compared to the case where the lessee is expected to continue leasing it (scenario 2).

Furthermore, the net assets recognised in the accounts under the performance obligation approach (eg scenario 1) will generally exceed the recoverable amount of those assets – namely the present value of the future cash flows – as shown below. Arguably, an impairment adjustment is therefore required. The larger the lessor's residual value exposure, the greater the overstatement of net assets.

<b>Year</b>	<b>Right to receive lease payments</b>	<b>Lease liability</b>	<b>PPE</b>	<b>Net assets</b>	<b>PV of future cash flows</b>
0	6,264	(6,264)	10,000	10,000	10,000
1	5,153	(5,011)	9,000	9,142	9,113
2	3,975	(3,758)	8,000	8,216	8,173
3	2,726	(2,505)	7,000	7,221	7,176
4	1,403	(1,253)	6,000	6,150	6,120

Appendix 3

### Lessee interest variation

The following example is of a five year lease where there is a 70% residual value. It is assumed that the original interest rate was expected to be 4% per annum and this was the discount rate used in measuring the initial liability to make lease payments. One year after the lease commencement, it is assumed that the prevailing interest rates increase to 6% per annum.

As can be seen from the tables below, and assuming a prospective adjustment approach, this results in a CU 439 increase in the lease liability at the end of year one and hence the interest charge in year one increases from CU 170 to CU 609 (which is 14.3% of the liability) in respect of an expected *future* increase in interest rates from 4% to 6%. The result is a series of somewhat volatile and misleading adjustments every time interest rates vary.

Lessor cash flows

Year	Asset cost	Rentals <i>(before variation)</i>	Residual value	Interest cost <i>(incl profit margin)</i> 4%	Cash investment <i>(before variation)</i>	Increase in interest <i>(From end of year 1)</i> 2%	Additional rentals	Cash investment <i>(after variation)</i>
0	10,000				10,000			10,000
1		(954)		400	9,446			9,446
2		(954)		378	8,870	189	(189)	8,870
3		(954)		355	8,271	177	(177)	8,271
4		(954)		331	7,648	165	(165)	7,648
5		(954)	(7,000)	306	0	153	(153)	0

Lessee liability to make lease payments

Year	Rentals <i>(before variation)</i>	Interest cost <i>(at 4 %)</i>	Liability to make lease payments <i>(before variation)</i>	Rentals <i>(after variation)</i>	Interest cost <i>(4 % yr 1 then 6%)</i>	Adjustment to liability	Liability to make lease payments <i>(after variation)</i>	Interest rate as % of liability
0			(4,247)				(4,247)	
1	954	(170)	(3,462)	954	(170)	(439)	(3,901)	14.3%
2	954	(138)	(2,647)	1,143	(234)		(2,993)	6.0%
3	954	(106)	(1,799)	1,131	(180)		(2,041)	6.0%
4	954	(72)	(917)	1,119	(122)		(1,044)	6.0%
5	954	(37)	0	1,107	(63)		0	6.0%

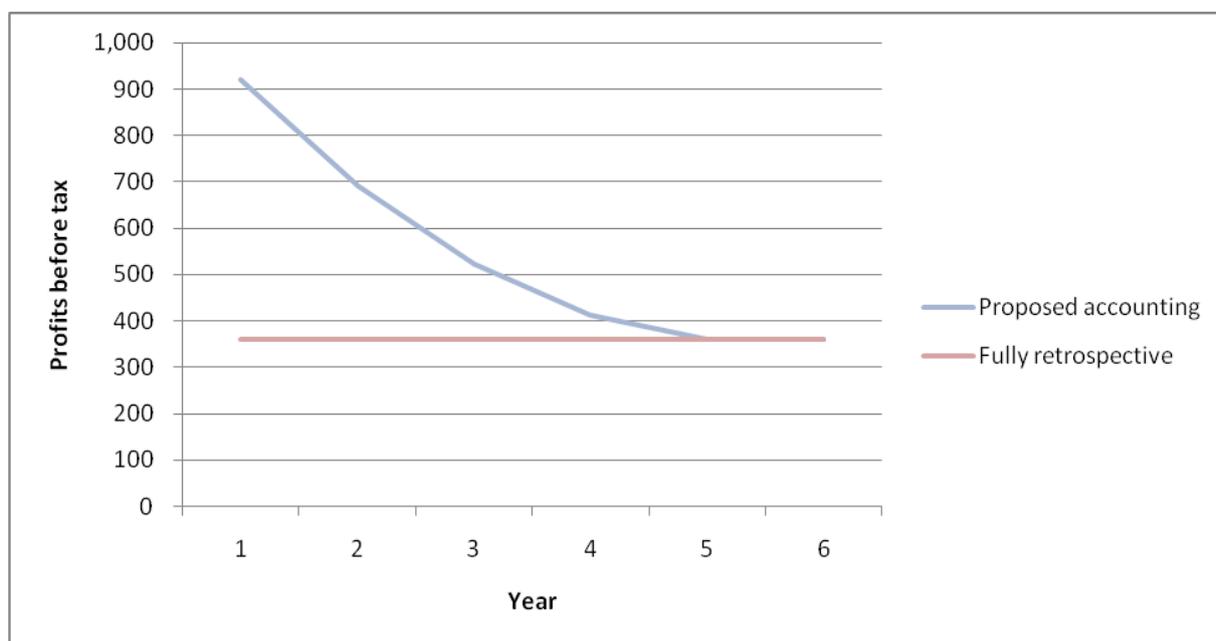
Appendix 4

## Lessors transition example

Suppose a company has been writing CU 10,000 of business each year and expects to continue to do so in future. Suppose also that the leases are all for five years with a 25% residual value at a 7% per annum interest rate. This gives a rental of CU 2,000 per annum. Suppose the lessor funds these leases at an interest rate of 6% per annum giving a 1% per annum pre tax profit margin.

If these were previously operating leases, the lease income (rentals less depreciation) would have been CU 2,500 in every year and the profit before tax would have been CU 360 each year after interest costs.

If a fully retrospective approach is adopted and assuming that the performance obligation approach applies, one would also expect the net income to remain at this level (the higher income on new leases being offset by lower income on older leases). However, under the proposals, the profits before tax would be as follows, the initial application being at the start of year 1:



This would imply that the profitability of the business is declining when in reality it is stable. As such the accounts would be highly misleading and fail to provide a reader with useful information as to the entity's profit trends. The excess profits in years 1 to 5 above are in fact profits that would have been earned in earlier years had the new lease accounting been applicable then.