MWB Business Exchange

BY EMAIL

Wednesday 8th December 2010

IFRS Foundation
c/o www.ifrs.org

Re: Exposure Draft ED/2010/9, Leases

Dear Sir or Madam

We write in response to the publication for comment of ED/2010/9 leases.

As one of the UK's major providers of serviced offices we operate primarily from properties where we ourselves are lessees. The proposals that are currently in the Exposure Draft would have a direct impact on our financial reporting and our commercial business and, therefore, we believe that it is important that we comment on them at this stage.

We have been following the debate around the Exposure Draft (ED) and attended the RSA on 5 November 2010. We note that there is much criticism concerning the complexity and cost of the proposals as they currently stand and their possible contradiction with the economics of lease-related transactions In particular, we have read and broadly concur with the views put forward by Leaseurope and the Finance and Leasing Association and do not repeat them unnecessarily.

However, we do have the following additional comments on the ED which we believe will highlight some of the broader implications in the commercial context of our specific business. References are to paragraphs of the ED.

Background to and commercial context of MWB Business Exchange Plc

MWB Business Exchange Plc represents a group of companies engaged in the serviced office sector. We have revenue of over £100m, derived from approximately 2,000 clients, spread across 60 centres. Our centres operate mostly from properties which are occupied by us as a leasehold tenant for leases on various terms up to a maximum of 25 years. Our average serviced office client stays about two years, although the shortest term can be measured in weeks. At 30 June 2010 we had equity of £26m and cash of £2.6m with no borrowings. The group is listed on AIM.

Impact on sector performance measurement

Para. 5 The ED requires that its proposals should be applied to all leases (with certain exceptions for those less than twelve months in length). In the serviced office sector the landlord/tenant relationship is well understood: rent charged by the landlord is booked as an operating cost in equal instalments over the lease's lifetime. We see no reason to change this. EBITDA is an important metric within the industry, where it is used as an indicator of cash generated. The measurement proposals in the ED move away from the underlying cash transaction and artificially frontload the EBITDA over the life of a lease. In addition, the notional split between an interest and a "right of use" charge would convert what in this sector is considered an operating cost into a financing cost. Whilst we agree that lease commitments should be disclosed in the notes to the accounts, we see no need to amend the current accounting requirements insofar as property income and expense are concerned.

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Economic contradiction of applying a finance charge to short term lease commitments

Para 12 There are two main reasons for taking a lease in a property: one is the lack of available funding for an outright purchase and the other is that purchase of, say, a 25 year interest in a few floors of an office block is virtually impossible - there is no market. This in turn makes the requirement to use the incremental borrowing rate which would be occasioned by such a purchase, as per para B11, extremely difficult. At the inception of the ED as a standard, we would be faced with taking on over 50 leases with a total rental value of about four times our annual revenue. There is unlikely to be any financial establishment which would be prepared to lend us the cash for the purchase of such assets on such a scale, so the incremental borrowing rate is quite literally anything between 0.5% base rate and infinity. Any rate in between is subjective. One suggested alternative, of treating each lease as the first increment would result in an artificially low interest rate. A second suggested alternative, of going back to the original start dates and ‘building up’ from there, would mean that the most recent leases would be assessed as having the highest rates and would therefore be punitive in the first years following adoption.

Para 25 Following from the above, we believe that capitalisation in the statement of financial position on the scale required by the ED would be highly damaging to us as it will not be understood.

Para 27 We also suggest that the classification of cash payments for leases as financing activities pre-judges the outcome of the debate about whether or not cash-flow should be reported gross

Para 33 Concerning our clients’ contracts, the amounts charged are not based on any form of discount rate but are based on what the market will stand. A longer contract may be at the same monthly amount as a shorter one for an identical room, it may be more expensive, it may be cheaper. There is no “rate the lessor charges the lessee”, so this becomes a subjective exercise.

Consistency of ED proposals with the accounting treatment of lease incentives

Paras 90 & 94 The ED’s requirement to calculate the present value of all future lease payments does not appear to take into account current lease incentive accounting. The ED does not appear to discuss the treatment of lease incentives already received or paid and included in the balance sheet. We currently have over £20m of such items as a deferred liability and are not clear what their treatment would be on adoption of the standard? Similarly, the ED does not discuss the treatment of previously capitalised initial direct costs incurred on leases (such as legal fees and stamp duty) which are now being amortised.

Volatility in reporting caused by the estimation of lease terms

Paras 13 et seq The ED requires that the lease term be determined by estimating the probability of occurrence for each possible lease term. This is very subjective and very minor changes in methodology can result in major differences in outcome, as witnessed by the attached example (where a choice between using fractions and the nearest rounded decimal results in a difference of nearly 20% in reported expense over the first 10 years of the contract). In addition, there is no requirement to match the expected outcome to the treatment of, for instance, fixed assets which may be installed in the leased properties (so the lease term could be deemed to be, say, 10 years but there may be assets installed in the premises being depreciated over 25 years). Links need to be established so that the period selected is consistent with other elements of the balance sheet – and a priority ranking given as to which shall prevail in the case of disparities.

Paras 34 & 39 As noted above, our average client contract is about two years. Clients are welcome to renew contracts as long as they continue paying our fees. Thus virtually every contract has the possibility of extending beyond 12 months but there is no way of knowing how long any particular contract will be. If we take the average term almost all contracts will end up being reassessed, either because they have already ended or they have been extended. Thus, as noted above concerning paras 13 et seq, the numbers produced will be based on a completely subjective view of what might happen, in this case modified retrospectively by what has already happened. The amounts would be meaningless, and the process to produce them extremely onerous and costly.

Subjectivity of on-going measurement provides opportunities for manipulation of financial statements

Paras 90 & 94 The inconsistency between the methods and the rates prescribed by the paragraphs concerning initial and on-going recognition of lessor and lessee contracts is very much open to question. The possibilities of balance sheet manipulation (and hence future income and expenditure manipulation) are enormous. Both should be based on the conditions prevailing at the adoption date (otherwise even deals done on the same day in the past, lease received and lease given, could be on vastly different rates).

Commercial impact of current classification proposals

Paras 64 & 65 The cut-off proposed in the ED (of being able to treat leases of less than 12 months as they are currently) is arbitrary and will drive contracts such as those mentioned above to be limited to 365 days, which is an undesirable example of an accountancy prescription taking precedence over commercial good sense. If the distinction remains, we will end up with two radically different income and expenditure treatments for the same services: All the lease income would be included within EBITDA for those contracts less than 12 months whilst they would be treated as finance revenue and front-loaded for all contracts over 12 months. We believe that this is not helpful to the readers and end users of the accounts. Our other comments discuss the issues concerning the alternative, of considering every single contract as a full lease..

Comments on additional accounting and administrative burden

Paras 73-86 The disclosure requirements are excessive and extremely onerous – given the proposed convergence with FASB we wonder whether this is in part influenced by the FASB rulebook approach. We believe that organisations need to be provided with enough flexibility to be able to provide meaningful information most relevant to their business, based solely on the requirements of para 70.

Para 89 Our understanding is that adoption of this standard will mean the presentation of three balance sheets in its first year, which is not reasonable in our view.

Conclusion

You will see from the above that our main concerns in relation to the ED relate to the subjectivity of measurement involved, the seemingly arbitrary cut-off points, the additional accounting and administrative burden and cost and most importantly for us, inconsistency with the economic realities of the serviced office sector.. In our opinion the proposals in the ED are particularly problematic in relation to property leases and property related contracts. We do not see how the introduction of the standard in its current form can have anything other than a negative impact on the reporting of our businesses performance, our ability to raise funds or negotiate lease terms, or the understanding of our business in the sector or by the public at large.

MWB Business Exchange

We hope that the IASB will seriously consider the implications of the issues that we have tried to highlight in this letter and would press the IASB to consult more fully with all those involved before introducing any change in the accounting treatment of leases. Given how significant the accounting treatment of leases is for our business, we would welcome the opportunity to be participate in any further consultation.

Yours faithfully

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Example of how a minute change in judgement can have a large impact on the accounts.

Basic data:
1. Lease taken by Company ABC for 20 years covering one floor of a large City building.
2. Break option exercisable by either party at 10 years.
3. Annual rent £2,000,000
4. Assumed incremental cost of borrowing 10%

Scenario 1: Management estimates
(a) There is a 1 in 3 probability that the landlord will exercise the break (33.3% probability)
(b) There is a 1 in 5 probability that Company ABC will exercise the break (20% probability)
(c) Thus overall probability of break being exercised is 53.3%, so the lease is calculated over 10 years.

Scenario 2: Management estimates:
(a) There is a 30% probability that the landlord will exercise the break
(b) There is a 20% probability that Company ABC will exercise the break
(c) Thus overall probability of break being exercised is 50.0%, so the lease is calculated over 20 years as this is the longer possibility of the two 50% alternatives.

		Scenario 1				Scenario 2				
Year	Rent	Amortisation of capitalised lease	Interest charge	Depreciation of fixed asset	Total P&L charge	Amortisation of capitalised lease	Interest charge	Depreciation of fixed asset	Total P&L charge	P&L difference
1	2,000,000	771,087	1,228,913	1,228,913	2,457,827	297,287	1,702,713	851,356	2,554,069	96,242
2	2,000,000	848,195	1,151,805	1,228,913	2,380,718	327,016	1,672,984	851,356	2,524,340	143,622
3	2,000,000	933,015	1,066,985	1,228,913	2,295,899	359,718	1,640,282	851,356	2,491,639	195,740
4	2,000,000	1,026,316	973,684	1,228,913	2,202,597	395,689	1,604,311	851,356	2,455,667	253,070
5	2,000,000	1,128,948	871,052	1,228,913	2,099,966	435,258	1,564,742	851,356	2,416,098	316,133
6	2,000,000	1,241,843	758,157	1,228,913	1,987,071	478,784	1,521,216	851,356	2,372,572	385,501
7	2,000,000	1,366,027	633,973	1,228,913	1,862,887	526,663	1,473,337	851,356	2,324,694	461,807
8	2,000,000	1,502,630	497,370	1,228,913	1,726,284	579,329	1,420,671	851,356	2,272,028	545,744
9	2,000,000	1,652,893	347,107	1,228,913	1,576,021	637,262	1,362,738	851,356	2,214,095	638,074
10	2,000,000	1,818,182	181,818	1,228,913	1,410,732	700,988	1,299,012	851,356	2,150,369	739,637
11	2,000,000					771,087	1,228,913	851,356	2,080,270	
12	2,000,000					848,195	1,151,805	851,356	2,003,161	
13	2,000,000					933,015	1,066,985	851,356	1,918,342	
14	2,000,000					1,026,316	973,684	851,356	1,825,040	
15	2,000,000					1,128,948	871,052	851,356	1,722,409	
16	2,000,000					1,241,843	758,157	851,356	1,609,514	
17	2,000,000					1,366,027	633,973	851,356	1,485,329	
18	2,000,000					1,502,630	497,370	851,356	1,348,727	
19	2,000,000					1,652,893	347,107	851,356	1,198,464	
20	2,000,000					1,818,182	181,818	851,356	1,033,175	
		12,289,134	7,710,866	12,289,134	20,000,000	17,027,127	22,972,873	17,027,127	40,000,000	3,775,570

Year 5 accounting:
(as an example)

	Scenario 1		Scenario 2	
Income and expenditure statement (extract):				
Depreciation charge	1,228,913		851,356	
Interest charge	871,052		1,564,742	
	2,099,966		2,416,098	
Statement of financial position (extract):				
Capitalised leased asset	12,289,134		17,027,127	
Less depreciation	-6,144,567		-4,256,782	
Net asset	6,144,567		12,770,346	
Lease liability	-12,289,134		-17,027,127	
Less amortisation	4,707,561		1,814,968	
	-7,581,574		-15,212,159	
Net liability	-1,437,006		-2,441,813	