International Accounting Standards Board
30 Cannon Street
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United Kingdom

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Germany

18 November 2010

Your Ref: Comment letter on Exposure Draft ED/2010/9 Leases

Dear Sir.

Thank you for giving us the opportunity to comment on your exposure draft Leases.

Your proposals abolish the current distinction between operating and financial leases, and clearly address long-standing concerns that current lease accounting permits entities to manage performance and gearing through off-balance sheet lease financing. I would be happy to accept your current proposals as an improvement over current lease accounting, however, I think that we can do a lot to improve the proposals, provide more meaningful information to users of financial statements (users), and provide some additional relief to preparers of financial statements (preparers). I will first address some general comments on the ED here, and then provide more detailed comments to the specific questions raised by the IASB.
Proposals for lessors

You propose two accounting models for lessors: the performance obligation approach and the derecognition approach. Lessors would determine the model to apply depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. A lessor which retains exposure to significant risks or benefits associated with the underlying asset would apply the performance obligation approach, otherwise the lessor would apply the derecognition approach. The determination of which model to apply would be made at inception, and could not be subsequently be changed.

Some guidance on which model to apply is given in paragraphs B22-B27, but this is not complete, and is open to interpretation. Furthermore, you state in BC27 that “In most cases an entity’s business model will indicate when a derecognition or a performance obligation approach would be appropriate…” This is not robust. Business models change over time, and can be presented differently depending on how an entity structures its business. The determination of which accounting model to apply for lessor accounting will involve considerable judgement, is not objective, and permits entities to game the accounting by structuring their business in such a way that maximises accounting over economic performance. I would recommend that you reconsider your proposals on lessor accounting and propose a single, unified approach to lessor accounting, which would aid comparability and provide more meaningful information to users.

Which model should lessors apply?

The problem with the performance obligation approach is that it is conceptually suspect, and introduces asymmetry with accounting for lessees. The ED defines a lease in Appendix A as a contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration. It is difficult to see what performance obligation is created for a lessor by this definition. A lessor signs a contract to lease a specified asset to a lessee. It delivers the asset, and the lessee pays for the right to use the asset. Apart from signing the contract and delivering the asset, what is the ongoing performance obligation of the lessor? I would strongly argue that the derecognition approach is much closer to the legal and economic impact of a lease transaction from the lessor point of view. The lessor cannot use the leased asset, and hence it should
Please note that the comments expressed herein are solely my personal views.

derecognise it, or at least it should derecognise the appropriate portion of the leased asset and maintain any residual portion in its statement of financial position. The lessee, likewise, recognises a right-to-use asset and a liability, implying a recognition of the specified asset. This is entirely consistent with your “right-of-use” model for leases.

The performance obligation approach is more akin to a service model, where the lessor provides a service to the lessee (the use of a specified asset) in return for payment from the lessee. However, this would not be consistent with your right-to-use model for leases.

Another problem with the performance obligation approach is that the lessor recognises an asset for its right to receive lease payments, whilst still fully recognising the entire asset. This double counts the same asset, and is conceptually unsound.

Given my comments above, I would strongly recommend that you adopt the derecognition approach for lessor accounting. This will provide a single, unified approach to lessor accounting, which is consistent with lessee accounting, and your right-to-use model generally for leases. I do not buy your objection to a single approach to lessor accounting in BC25 “...because of differences in the economics of the business models for different lessors”, as this argument could also be employed against a single approach to lessee accounting, and it is spurious.

Distortion of lease expensing and amortisation patterns

The ED proposes that, after the date of commencement, lessees measure the right-of-use asset at amortised cost, and the liability for lease payments at amortised cost (and recognise interest) using the effective interest method. This will front-end load the lease expenses compared with current lease accounting due to the recognition of interest expenses under the effective interest method. In my opinion, this does not reflect the economics of such lease transactions, and introduces an arbitrary distortion of profits, causing over-reporting of profits early on, and under-reporting of profits later on in the term of a lease. This can be very significant as the term of a lease increases, and the interest rate increases.
The table below shows an example lease expensing pattern for a 20 year lease with payments of 1000 annually in arrears, and interest of 8%. This shows the effect on total expensing of the different amortisation schedules for the lease asset and liability:

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The pattern of lease expensing shown above is inconsistent with the actual cash lease payments made. I would strongly recommend that you propose a consistent amortisation approach to assets and liabilities, in order to better reflect the true economic impact of lease transactions.
Please note that the comments expressed herein are solely my personal views.

Scope exclusions

The following have been excluded from the scope of the ED:

- leases of intangible assets
- leases to explore for use minerals, oil, gas etc
- leases of biological assets
- leases between the date of inception and the date of commencement if they meet the definition of an onerous contract

There is no rationale for excluding leases of intangible assets, leases to explore and biological leases. I would recommend that you include these within scope of the ED on leases.
Answers to specific questions raised by the IASB

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?

Yes. The recognition of a right-of-use asset faithfully depicts the legal and economic basis of a lease transaction for lessees. This has conceptual merit, and is an improvement over current lease accounting under IAS 17.

I also agree that a lessee should amortise the right-of-use asset and recognise interest on the liability to make lease payments. However, although the two items are okay in isolation, when taken together they lead to an overstatement of lease expenses early on, and an understatement later on, and therefore an under-reporting of profits early on, and over-reporting of profits later on. I would strongly recommend that you propose a consistent amortisation method on the right-to-use asset and the lease liability, in order to mitigate this distortion in lease expensing, and hence in profit reporting.

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?
No. I recommend that a lessor should apply the derecognition approach to lease accounting. This will provide more meaningful information to users, is a better reflection of the conceptual, legal and economic basis underlying lessor accounting and would aid comparability, transparency and understandability through mandating a single, unified model for lessor accounting. It would also better reflect the conceptual basis underlying lessee accounting by mirroring its right-of-use asset philosophy.

I agree with the boards’ proposals for the recognition of assets, liabilities, income and expenses for the derecognition approach to lessor accounting. This provides meaningful information to users.

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).

(See also paragraphs BC41–BC46.)
Please note that the comments expressed herein are solely my personal views.

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?

Yes. Your proposals will provide some relief for accounting for short-term leases. I would expect that most entities will elect to use the proposed simplification for short-term leases, and that this will aid comparability between entities here. However, I note that the ED proposes to replace one “bright line”, that between operating and financial leases, with another – that between short- and long-term leases. I am concerned that some entities will try to structure their leasing arrangements so that they consist of a series of short-term leases, and thus to try to avoid applying the ED proposals in full. I would recommend that the board should include some wording on substance over form here to mitigate this risk.

Definition of a lease

Question 4

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

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

Yes, the proposed definition of a lease is conceptually fine. It is the same as in IAS 17, and maintains the principles of IFRIC 4, that there is a specified asset, and that there is a “right to use” that asset.

I agree in principle with the criteria for distinguishing a lease from a purchase or sale. However, I note that the criteria in paragraph 9 refer to the transfer of “…control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset”. This is reasonable on its own, but it is inconsistent with your criteria for determining the satisfaction of a performance obligation (sale) under ED/2010/6 Revenue from Contracts with
Customers, which refers in paragraph 25 to “...transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service”. I would advise you to provide more consistency between the definition of purchase or sale in this ED and the definition of sale in ED/2010/6.

Scope

Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

No. Lease accounting should apply to all leases. There is no rationale for the proposed scope exclusions, and the arguments given in BC34 and BC36 seem rather arbitrary to me.

Question 6: Contracts that contain service components and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) the IASB proposes that:
Please note that the comments expressed herein are solely my personal views

(i) a lessee should apply the lease accounting requirements to the combined contract.
(ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
(iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

I agree with your proposals that lessees and lessors should apply the proposals in ED/2010/6 Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components. However, I am not convinced by the IASB’s proposals for lessors that apply the derecognition approach, as they relate to service and lease components that are not distinct. Paragraph B5 (c) states that “…the lessor shall allocate the payments between service components and lease components on a reasonable basis”. This is far too vague. If such allocation is so reasonable, then we should be able to separate the components in the first place. I also notice that this is a departure from ED/2010/6 which only requires accounting for such components separately if they are distinct. I must also say that I find the FASB’s arguments in BC52 thoroughly convincing, whilst the arguments put forward by the IASB in BC53 are spurious, and even admit their own shortcomings. Hence, I would agree with the approach proposed by the FASB, that lessees and lessors should apply the lease accounting requirements to the combined contract.

Question 7: Purchase options

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).
Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

*I accept that this would faithfully reflect the legal and economic basis underlying purchase options. However, this treatment of purchase options would be inconsistent with your proposals for the lease term, and my own recommendation concerning the lease term (see my answer to question 8), in which options to extend the lease term would be effectively recognised and measured. In principle, any option has a value, which can be apportioned into an intrinsic value and a time value. Equivalent to a positive intrinsic value, I agree with paragraph BC64 that bargain purchase options should be considered when determining if a transaction is a lease or a purchase or sale. However, I do not think we should ignore the time value of a purchase option. In principle I would recommend that all options should be recognised and measured in some way, either by incorporating their expected value in the measurement of cash flows, or by unbundling.*

**Measurement**

**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?

*No. I find the theoretical basis for the “longest possible term that is more likely than not to occur” to be rather odd, very subjective and most open to manipulation. Options grant value to the buyer, and are used to speculate, hedge, or manage risk. In this case, a five year lease with an option to extend for five years is more flexible than a ten year lease, and they should not be treated equivalently. I would recommend that you either include options to extend or terminate leases in the probability-weighted measurement of the term, as outlined in BC120 (c), or unbundle them and measure them separately.*
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 that residual value guarantees should be included in the measurement of lease assets and liabilities at their expected amounts, as conceptually any guarantee has a value, and should thus be measured. This is prudent. I believe this is also a better representation of the economics of such guarantees, and an improvement over IAS 17, which included residual value guarantees at the “…maximum amount that could, in any event, become payable”. 

I am not convinced that contingent rentals should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique. I agree that contingent rentals should be included only where they can be measured reliably, for example where their payment is based on an objective factor outside the control of the lessee, such as a price index, but not when their payment is at the discretion of the lessee, or is based on uncertain future lessee behaviour. In this case I would argue that there does not exist a liability to make uncertain contingent rental payments in the future, and this view is consistent with the definition of liability in Appendix A of IAS 37 as a “present obligation of the entity arising from past events”. There is clearly no present obligation here, only a contingent part, which is uncertain and would depend of future events.

1 See IAS 17, paragraph 4.
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?

Yes. This is entirely appropriate and would provide meaningful information to users. I also believe that the board have worded the proposals for reassessment appropriately, by requiring reassessment only where there are significant changes. This increases subjectivity somewhat, but would provide relief to entities from having to reassess all leases for each reporting period.

Sale and leaseback

Question 11

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?

Yes. The criteria in paragraphs 66, B9, B10 and B31 are clear and appropriate. The current ED proposals focus on whether the transfer leg of a transaction represents a purchase or sale. This is a vast improvement over IAS 17, which purely focuses on whether the leaseback leg of a transaction should be classified as either a finance or an operating lease, and not on whether the transaction represents a purchase or sale. This has resulted in considerable structuring of transactions to enable significant off-balance sheet financing, which the current ED proposals will thankfully mitigate.
Please note that the comments expressed herein are solely my personal views.

Presentation

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?

Yes, subject to my comments on scope. I believe a separate presentation of liabilities to make lease payments and right-of-use assets is appropriate, and provides meaningful information to users.

(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?

I do not support the performance obligation approach for lessors. The requirement to present a net lease asset or liability seems spurious anyway, and is inconsistent with the separate presentation of interest income, lease income and depreciation expenses in the statement of comprehensive income (SOCl).

(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?

This seems entirely appropriate to me, subject to my comments on scope.
(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?

This is reasonable. I would support this type of presentation as it will provide more meaningful information to users.

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?

Yes. I fully support the separate presentation of lease income and lease expenses in profit or loss, as this will provide more meaningful information to users.

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?

Yes. I fully support the separate presentation of lease cash flows in the statement of cash flows (financing activities for lessees, operating activities for lessors) as this will provide more meaningful information to users.
Disclosure

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

(a) identifies and explains the amounts recognised in the financial statements arising from leases; and
(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows

(paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

In principle yes. The proposals are similar to the disclosure requirements in ED/2010/6 Revenue from Contracts with Customers (paragraphs 69-71), and the disclosure requirements in ED/2010/8 Insurance Contracts (paragraphs 79-81). I also appreciate the principles-based elements in paragraph 71, which allow an entity some discretion in order to satisfy the disclosure requirements.

I fully agree with paragraph 83 which requires an entity to disclose information about significant assumptions and judgements, and changes in assumptions. However I would also recommend that sensitivity and scenario analyses should be disclosed on the significant judgements, estimates and assumptions used. This will allow users to judge management's effectiveness in understanding, and controlling their business and risks.

Transition

Question 16

(a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
I agree with these proposals in principle. The proposed simplified retrospective approach will provide significant relief compared with a full retrospective application which would be required under IAS 8.

(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

Yes. There is no reason not to allow this for entities which are willing to do this. I think this would be rare in practice.

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

There is a gap in the transition proposals concerning the reclassification of certain transactions through transition. I would suggest that you consider, for example, the treatment of leases under IAS 17, which would be classified as purchases or sales under the current proposals, and the treatment of sale and leaseback transactions under IAS 17, which would not be classified as such under the current proposals.

Benefits and costs

Question 17

Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

Yes I do. I do not underestimate the cost, time and effort involved during transition, and on the first application of the proposals, but these proposals, subject to some caveats, are a vast improvement over current lease accounting under IAS 17.
Other comments

Question 18

Do you have any other comments on the proposals?

No.

Summary of my main recommendations to the board:

- Adopt the derecognition approach for lessee accounting
- Propose a consistent amortisation approach to (lease) assets and liabilities
- Scope in intangible assets, leases to explore and biological assets
- Propose substance over form wording to mitigate abuse of the simplified requirements for short-term leases
- Adopt the FASB’s requirements concerning contracts that contain service components and lease components
- Adopt the recognition and measurement of purchase options, and options to extend or terminate leases
- Do not include contingent rentals in the measurement of assets and liabilities, where they cannot be reliably and objectively measured
- Disclose sensitivity and scenario analyses on the significant judgements, estimates and assumptions used
- Permit a full retrospective application of the lease accounting requirements
Please note that the comments expressed herein are solely my personal views.

Yours faithfully

[Signature]

Chris Barnard