Dear Sir/Madam,

**Exposure Draft: Leases**

We are responding to the invitation of the IASB to comment on the exposure draft *Leases* (the ‘exposure draft’ or ‘proposed standard’). Our main concerns were also presented by representatives from the shipping company Dampskibsselskabet NORDEN A/S (Mr. Michael Toennes Joergensen and Mr. Kristian Waerness) to the Board (represented by Ms. Barbara Davidson and Ms. Li Li Lian at a video conference on 26 November 2010).

We agree with the board’s objective to report relevant and representational faithful information to users of financial statements about the amounts, timing and uncertainty of cash flows arising from leases. We acknowledge that the current model for lessees has long been criticised for failing to meet the needs of financial statements users. We believe the proposed right-of-use model as contained in the exposure draft as intended addresses a number of these criticisms.

Although we support the board’s overall objective, we do not believe that the proposals contained in the exposure draft fully meet this objective in a number of key areas which should be reconsidered by the board. These key areas include wrong picture of profit/loss due to “front load” of costs, the measurement of more complex leases, specifically term extension options and lessor accounting and transition provisions. In connection with each of these areas, we propose a number of solutions in this letter which we believe will enhance the benefits for users whilst in many cases also reducing the cost and complexity for us as preparers. Furthermore, the debt/equity ratio is influenced which may cause challenges in relation to covenants in loan agreements.

In addition, while we acknowledge that the proposals try to address the primary concern, that is, the recognition of assets and liabilities arising out of lease contracts, we observe that the application of the proposals has the potential to result in a perceived decrease in the income statement’s usefulness to many users. A consequence of the right-of-use approach to lessee accounting is that total expenses will be higher in the earlier years of a lease and vice versa for lessor accounting. Considering the example of a typical lease of a vessel, applying a straight line-based amortisation approach will produce higher expense in the earlier periods of lower revenue and vice versa for lessor. As a consequence, we understand that some users may continue to make adjustments to reported amounts. One adjustment could be to amortise on a basis that reflects the future economic benefit flowing in or out thereby maintaining the same level of expense/income over the hiring period if payments are constant. Otherwise, users may end up solely using the cash flow statements.

We also believe that the proposals will result in significant cost and complexity for preparers in the shipping industry.

Furthermore, there are a number of matters which are not addressed in the exposure draft but which we believe should be addressed or further clarified in the final standard, including whether a short-term hire of vessels (time charters) is a service rather than a lease, lease extension, the impact of the sublease presentation. These issues appear in greater detail from our response in the appendix which has been sent.
to the board representatives in connection with the video conference referred to in the introduction to this letter. The appendix contains a simple Excel model with some time charter in and out examples.

**Short-term lease – service agreement versus lease**

We do not believe that the proposed draft accomplishes the board’s aim to develop a model where assets and liabilities arising under a short term hire of a vessel on a “time charter” are recognised in a principled manner. The exposure draft would, according to your understanding, lead to a classification as a lease which is wrong as it is a service contract. Accordingly, we do not agree that a shipping entity with a time charter in (lessee) at least for short-term time charters should recognise an asset representing the right to use an underlying right-of-use asset during the hiring period (lease term) and a liability to make lease payments. It is part of the shipping business model to deliver transport services either by a “contract of affreightment” or by a vessel on time charter. The two alternatives to deploy vessels substitute each other. For the users, it would be difficult to understand the reason for the difference in income recognition between freight (service) and time charter (lease).

In general, we have found it challenging to apply the current criteria for determining whether an arrangement contains a lease outlined in IFRIC 4, and we believe that these challenges will become more pronounced in connection with the adoption of the proposed guidance on lease accounting. We would urge the board to take this opportunity to address many of the known issues with IFRIC 4 as part of the proposed standard. We do not believe that the proposed right-of-use approach accomplishes the board’s aim to develop a model where assets and liabilities arising under a short-term hire of a vessel on a “time charter” are recognised in a principled manner (see our comment to definition above). Should the board continue with the proposal in which short-term time charter contracts are by definition a lease, there should at least be a simplified requirement for short-term leases which gives lessee the same opportunity as lessor to elect not to recognise assets and liabilities and continue to recognise time charter (lease) payments in profit or loss over the hiring period (lease term).

We believe that the proposed right-of-use approach accomplishes the board’s aim to develop a model where assets and liabilities arising under a “bare-boat” lease and for leasing in some long-term time charters are recognised in a principled manner. In these situations, we agree that a lessee should recognise an asset representing the right to use an underlying asset during the lease term (the right-of-use asset) and a liability to make lease payments. However, we disagree with the board on the measurement of the right-of-use asset and liability to make lease payments for more complex leases that contain options.

**Lessee accounting – P/L statement**

A consequence of the right-of-use approach for lessee accounting is that total expenses will be higher in the earlier years of a lease and vice versa for lessor accounting. Considering the example of a typical lease of a vessel, applying a straight line-based amortisation approach will produce higher expense in the earlier periods of lower revenue and vice versa for lessor. The problem is of course most significant for long-term time charters.

The “front load of cost” on a 5 year time charter in is illustrated below.
Shipping markets are very volatile and timing of time charter in (cost) and the cover (revenue) is therefore paramount. By de-connecting the recognition of time charter (in and out) from the agreed payments (cash flow), the commercial basis of the business is no longer reflected in the financial reporting.

Besides the distorted presentation of the commercial performance, the comparability of shipping companies will be more difficult as the new ED requires a large extent of management judgment, i.e. discount rate, decomposing of payments, probability of extension options which have great influence on the financial reporting over time.

Revenue for many shipping companies is typically generated by COA (Contracts of Affreightment) which is an obligation to transport a cargo or a number of cargoes, but also time charter out for a shorter or longer period is used to generate revenue. In both cases, the calculation of the profitability is made on the basis of a “time charter equivalent” and compared to the market conditions at the time of agreement. However, the two ways to generate revenue will be reflected quite differently in financial reporting as illustrated below.

**More complex leases containing term extension options**

We disagree with the board’s proposal that the lease term should be measured as ‘the longest period more likely than not to occur’. We believe that optional extension periods should be included in the determination of lease term (and hence the measurement of the right-of-use asset and obligation to pay rentals) only where it is ‘virtually certain’ that the option will be exercised, that is, structuring of the contractual terms as if an option was non-substantive.
As the shipping markets are very volatile, the probability of exercising a time charter extension option will vary significantly over time, which will give rise to adjustments in the P/L that have nothing to do with the actual costs and revenues of the business.

Below is illustrated the effect of a reassessment of an extension option resulting in adjustments to the P/L which is deconnected from the “true and fair” financial performance.

We observe that, whilst still maintaining consistency with the broad principles and goals espoused by the board, this change would also address many of the concerns currently being voiced by us as preparers in shipping, including increasing the objectivity of the standard and reducing its complexity, the frequency of reassessment changes in the benefit of true and fair view and comparability across shipping companies.

More complex leases containing service components

Should the board continue with the proposal without the acknowledgement that short-term charters are a service contract rather than a lease, we disagree with the board on the requirement to separate distinct services in a contract containing service components and lease components. We believe that it is not possible to reliably identify the two components within a time charter contract, and the requirement will lead to inconsistent measurement for lessee’s payables and lessor’s receivables. Estimates of lease and service components will be of significant cost and complexity for us as preparers in the shipping industry and will not increase the user benefit in understanding the financial performance of shipping companies.

Lessor accounting - time charter out

We agree with the board’s aim to develop a consistent model for both lessees and lessors. The ED allows lessor on a lease-by-lease basis not to recognise short-term leases with additional assets and liabilities arising from the lease contract in the statement of financial position and not to derecognise any portion of the underlying asset. We agree in this approach on the same arguments as for the lessee (service rather than lease) and find that the same option should be available to lessee. For long-term time charters, lessor will have the same challenges with “front load” of income.

We agree that there must be symmetry in the treatment of lessee and lessor accounting.

Transition

While we believe the ‘simplified retrospective approach’ may be effective for many shipping companies, we believe that in some cases, a ‘full retrospective approach’ may yield a more faithful representation and accordingly, an option to apply such a method should be available to those willing to undertake the additional effort and cost.
Effective date and next steps

In respect of the proposed leasing standard, we believe that the implementation will be complex and costly, and for this reason, the time span leading up to the effective date for this proposed standard should be relatively long to reflect this complexity.

Our answers to the specific questions in the exposure draft are attached in the appendix to this letter.

If you have any questions in relation to the letter, please do not hesitate to contact Dorte Rolff, (+45 33 48 92 85).

Yours faithfully,

DANISH SHIPOWNERS' ASSOCIATION


Dorte Rolff
Appendix

Responses to detailed questions in the exposure draft

Question 1

(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?

We support the proposed right-of-use model for lessees. We acknowledge the criticism stating that the existing leasing model in IAS 17 fails to meet the needs of the users. However, it will result in an exacerbation of the issues already experienced by preparers distinguishing between a lease and a service contract. As further explained in our response to question 4, we believe it is critical that the definition of a lease be further improved to diminish this issue for the shipping industry.

Furthermore, we have some concerns around the short-term time charter agreement widely used in shipping, measurement of more complex leases under the right-of-use approach, in particular regarding extension options and the split of service and lease components. These concerns are discussed in further detail in our response to questions 8 and 9.

(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?

We agree that if the ‘right-of-use’ model is adopted, a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments.

However, we observe that the application of the proposals has the potential to result in a perceived decrease in the income statement’s usefulness to many users. Specifically, we are aware that a number of users in shipping have expressed concerns regarding the front-loading of expenses as a consequence of rental expense being replaced by a combination of amortisation and interest expense. Accordingly, we are in favour of reconsidering the pattern of amortisation of the right-of-use asset leading to a constant total expense in the P/L statement. For example, if the interest expense arises in the pattern 9, 8, 7 in the first three years of a lease, the amortisation of the right-of-use asset would be in the pattern 1, 2, 3, therefore always resulting in a total expense of 10.

Question 2

(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?

We acknowledge the board’s aim to develop a consistent model for both lessees and lessors.

We believe that there are practical issues of applying the derecognition approach for certain leases where only a portion of the asset is leased or where the lease term is substantially shorter than the life of the asset, including time charter shipping. We foresee problems also in the performance obligation approach. We urge the board to undertake further outreach regarding these practical issues.
(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?

See our response to question 2(a).

Question 3

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 profit or loss, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other guidance and would recognise lease payments in profit or loss over the lease term (paragraph 65). (See also paragraphs BC41–BC46).

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

We believe that both lessees and lessors should be able to apply simplified requirements to their short-term leases. Although we agree with the board's proposed simplifications for lessors, we do not believe that the board's proposals for lessees go far enough. We believe the main burden for a lessee is the cost of identifying and tracking a large number of short-term leases, rather than the cost of measuring the leases thereby identified on a present value basis. Further, if the goal of the standard is to provide users with more information on the long-term obligations of a reporting entity, we believe that there is little incremental informational value provided by grossing up the lessee statement of financial position to include lease assets and liabilities that are short-term in nature. In short, although we accept that the value of these short-term leases may in some cases be significant in aggregate, we do not believe that they are normally material to the economic decisions made by users.

As such, we propose that the simplified requirements for lessees should mirror those of the lessors such that lease rentals should be recognised on an accruals basis similar to the current operating lease accounting by lessees under IAS 17. We also observe that the exposure draft does not describe how these lease payments should be characterised (as 'rent' or as amortisation) or their recognition pattern in the income statement (straight line or as they fall due), and we would encourage the board to clarify this in the final standard.

We acknowledge that this proposal may result in assets and liabilities not being recognised on the lessee's statement of financial position. However, we feel that the costs of complying with the board's proposed requirements will far outweigh the benefits for the users, who could be just as well served through disclosure. For example, there could be disclosure of the annual expense relating to short-term leases which would give users information about the magnitude of such leases without the lessee incurring substantial cost and effort to identify such leases in progress.
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?

As the definition of a lease is substantially carried forward from IAS 17, we generally agree that a lease is defined appropriately. However, we believe that the board needs to provide further guidance to assist preparers in applying the definition to their lease contracts and separate them from service contracts. See our response to question 4(c).

(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?

We are concerned what the sale/purchase guidance contained in the leasing proposal could lead to in shipping. An example of this could be a lease contract of a vessel containing a bargain purchase option. This bargain purchase option could meet the definition of a sale/purchase according to the guidance in the leasing exposure draft and would therefore fall outside the leasing exposure draft. However, due to the high volatility in the shipping market and the markets value of vessels, such options may not reliably constitute a purchase or a sale, hence resulting in a failed purchase or sale.

(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?

We do not believe the guidance contained in paragraphs B1-B4 is sufficient for distinguishing leases from service contracts. The guidance resembles the existing provisions of IFRIC 4 Determining whether an Arrangement contains a Lease. Under IFRIC 4, distinguishing between a lease and a service contract does not have significant accounting ramifications, as in many cases the expense recognition pattern is similar in an operating lease and a service arrangement. Under the proposed standard, the consequence of concluding whether a transaction represents a lease or a service contract is more pronounced, because all leases will be recognised on the statement of financial position and as a result of the expense front-loading issue outlined in our response to question 1(b).

It is part of the shipping business model to deliver transport services either by a “contract of affreightment” or by a vessel on time charter. The two alternatives to deploy vessels substitute each other. For the users, it would be difficult to understand the reason for the difference in income recognition between freight (service) and a time-charter (lease).

We have found it challenging to apply the criteria outlined in IFRIC 4, and we urge the board to take this opportunity to address many of the known issues with IFRIC 4 as part of this proposed standard. These issues include the following:

- The meaning of ‘ability or right to operate’, which can be unclear in the context of certain time charter shipping transactions where the ship is operated by people who are not employees of the ‘lessee’.
- Greater exploration of what are specific assets, especially in the context of fungible assets and an entity’s practice of switching assets. This matter is of concern to entities in the shipping industry where a transport of freight or a time charter of a vessel may be explicitly allocated to a specific ship even though the end user is indifferent as long as the service obligation is fulfilled.

Question 5
The exposure draft proposes that a lessee or a lessor should apply the proposed guidance 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 guidance? Why or why not? If not, what alternative scope would you propose and why?

We agree with the proposed scope.

Question 6

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:
  (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?

We agree with the board’s proposal that distinct services components should be accounted for in accordance with the proposals in the exposure draft: Revenue from contracts with customers.

Indicators that a performance obligation is distinct could include:

- The goods or services are sold separately by the entity or other entities in the entity’s principle market or similar market.
- The goods or services are delivered to the customer at different times.
- The performance obligation can be satisfied independently from other performance obligations in the contract.
- The goods or services are not highly interrelated.

We also suggest clarifying that no single indicator determines whether a performance obligation is distinct, and that the indicators should be considered in their entirety.

'Executory costs’ in today's accounting guidance generally include insurance, maintenance and taxes and, some may argue, other similar shared operating costs. In shipping practice cost to crew is included in timer charter contracts.

It is not clear that these normal shipping service/executory costs would meet the ‘distinct service’ definition. Further, in many cases, items that might meet the definition of a distinct service are intertwined with those that do not meet the definition. Given the high volatility in market rates of time charter rates, the service component can be relatively “distinct” at some point, but not at another point,
leading to inconsistence and non-comparable recognition of this component for the entity and between companies.

Stripping out these executory/operating costs was not significant in many cases under the current lease accounting model because no balance sheet effect and income statement recognition pattern was similar or identical. However, this distinction will become significant under the proposed leasing model because of the impact their inclusion would have on the balance sheet and the impact on the recognition pattern in the statement of operations.

We believe the board should reconsider whether the split is needed or at least clarify explicitly that executory/common operating costs are also considered distinct for purposes of applying the proposed standard.

Question 7

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?

We disagree. We believe that conceptually there should be no difference in the accounting treatment between a purchase option and a lease extension option as both types of provision can be used by a lessee to provide some level of control of the asset beyond the initial lease term. We observe that one can view a contract that contains renewal options for the whole of the useful economic life of an asset as being no different in substance from a purchase option. We are concerned that if the final standard contains guidance regarding purchase options that would result in very different accounting from that of renewal options, this could result in significant structuring opportunities. We believe that there should be consistent accounting between purchase options and extension options included in a lease contract. As such we believe, consistently with our proposals for lease extension options, that purchase options should be included if it is virtually certain that they will be exercised. See our response to question 8 regarding our detailed views on how lease extension options and hence purchase options should be reflected.

Question 8

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?

In shipping contracts regarding hiring, a vessel often has extension or purchase options. Due to the high volatility in market rates for hiring vessels and the market price of vessels, it is probably not reliable to take these into consideration. We disagree with the board’s proposals that the lease term should be 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. We believe that the board’s proposals would result in entities recognising assets and liabilities associated with extension option periods that do not meet the definitions set out in the conceptual framework with respect to the relevant portions of the lease liability for lessees or the right to receive lease payments for lessors. Instead, we believe that the lease term should include only those extension periods in respect of which the exercise of an extension option is virtually certain.
Conceptually, we believe that options (renewal or purchase) contained within lease contracts should be accounted for separately. Accordingly, in principle the amount paid for the right to extend the lease term should be identified upon initial recognition and subsequently measured at cost. However, we understand that there is limited demand for this information from users and recognise that separately identifying and accounting for such options may be difficult in practice. We therefore agree with the board’s proposal that options contained within lease contracts should not be separated.

We believe that potential payments during optional extension periods should be included in the calculation of the obligation to make lease payments, and hence the right-of-use asset, only where the terms of the lease and the nature of the leased item mean that exercise of the extension option is virtually certain, in other words, where the lessee does not have any option economically but to extend the lease. The higher the hurdle, less frequent the need to remeasure and therefore, less associated volatility. It will also reduce the amount of estimates and judgments involved in determining the right-of-use asset and obligation to make lease payments for lessees and, as a result, reduce the costs of implementing and applying the new standard for a preparer.

Whilst we acknowledge that the board’s aim was to provide users with information about the amounts, timing and uncertainty of cash flows, we believe that this aim with respect to extension options would be better achieved through disclosure rather than through recognition on the statement of financial position.

**Question 9**

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 lessees and 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?

In shipping, contingent rentals and payment are not a major part of business and the practical implications do not seem to be a major issue. However, as a matter of principle, we do not agree that contingent rentals and expected payments under term option penalties and residual value guarantees should be included in the measurement of assets and liabilities arising from a lease. Assuming the board accepts our proposals on increasing the lease term hurdle to virtually certain, as outlined in our response to question 8, we believe that only those contingent payments that are not within the control of the lessee should be included in the calculation of lease payments. Contingent payments that are within the control of the lessee should not be included in the lease payments.

**Question 10**

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?

We agree that there should be reassessment of estimates of both lease term and contingent payments. We agree with the board’s assessment in the basis of conclusion that users of financial statements receive more relevant information when entities reassess the lease term at each reporting date as reassessment
reflects current market conditions and not doing so could lead to misleading results. However, we observe that the lower the inclusion threshold ultimately selected by the board for options, the greater the complexity of the reassessment, resulting in more frequent revisions and more volatility. We believe our proposal for including only those lease extension options that are virtually certain to be exercised still meets the aim of providing relevant and current information whilst minimising the cost and complexity for preparers. See our response to question 17 for more discussion regarding the benefits and costs of the proposed standard.

We do not believe that the current guidance articulated in the proposed standard to require reassessment where there has been a ‘significant change’ in each leased asset is useful. Given the level of judgment involved in assessing what is significant, we would propose, similar to impairment analysis, that the requirement should be supplemented by a presumption that reassessment should occur based on certain triggering or reconsideration events and on an annual basis at a minimum. This will help reduce the risk that changes are recorded in an incorrect accounting period.

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?

We have already expressed our concerns about the sales/purchases criteria in our response to question 4b above.

As regards what has been sold, we believe that the seller in a sale and leaseback transaction only relinquishes its right to the residual and that it has merely financed the portion of the asset it retained. We observe that in many cases, the seller retains the rights to utilise the vessel for a substantial portion of its life and that this retained period represents a substantial portion of the sale value. Accordingly, we would support recognition of profit only on the residual which has been sold and not the whole asset as is the case with the proposed guidance. Guidance would then need to be provided on how to recognise the unrecognised gain. We believe that the right-to-use asset should be reduced, which would effectively represent the pro-rata carrying value of the retained rights.

Although the exposure draft contains guidance on linked transactions in the context of sale and leaseback transactions, we believe that the proposed standard should include general guidance in this area.

Question 12

(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?

We agree that an entity should present the obligation to make lease payments separately from other financial liabilities and the right-of-use asset separately from other owned PP&E. We agree that the right-of-use asset should be presented as if they were tangible assets within property, plant and equipment in the statement of financial position.

With respect to reflecting the lease liabilities and right-of-use assets separately, we believe there is sufficient guidance in IAS 1 Presentation of financial statements as to what should be disclosed on the
face of the primary statements based upon materiality and what should be included in the notes. As such, we do not support including any further guidance within the proposed leasing standard.

(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?

If the board continues with the ‘hybrid approach’ as proposed then we would 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.

Similar to our response to question 12(a), we believe there is sufficient guidance in IAS 1 for IFRS preparers.

(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?

If the board goes ahead with derecognition accounting for lessors then, similar to our response to question 12(a), we believe there is sufficient guidance in IAS 1 for IFRS preparers.

(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?

If the board goes ahead with lessor accounting as proposed, we observe that most sub-leases would most likely be reflected under the performance obligation approach (except where the terms and amounts of the lease in nearly match those of the lease out, in which case the derecognition approach might be appropriate).

With respect to whether the intermediate lessor should separately distinguish assets and liabilities arising from the sub-lease in the statement of financial position, similar to our response to question 12(a), we believe there is sufficient guidance in IAS 1 for IFRS preparers.

Question 13

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?

Similar to our response to question 12(a), we believe there is sufficient guidance in IAS 1.

Question 14

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?

Similar to our response to question 12(a), we believe there is sufficient guidance in IAS 1 for IFRS preparers. We believe that an entity should decide whether the split is in the primary statements or the notes based upon materiality.

We do not believe that the cash flows from leases should necessarily be classified entirely as financing. In practice, entities enter into leases for many reasons, sometimes as an alternative source of finance and sometimes for operational reasons. There has been recognition of this dichotomy in the board’s deliberations concerning financial statement presentation. We believe that the model proposed by the board approaches leases as purchases of assets financed by a specific debt, which may not be how preparers and users view all leases.

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?

We agree with the disclosure principles outlined in the exposure draft and believe that they could enhance the information provided to users compared to the current requirements of IAS 17. The list of qualitative and quantitative information required in the exposure draft (paragraph 73–86) is extensive and, if made mandatory without regard to the significance of the leases to a particular lessee or lessor, could result in disclosure of information that is not relevant or material to a user of the financial statements. Given this concern, we welcome the requirement in the exposure draft (paragraph 71) that an entity should consider the level of disclosure appropriate to satisfy the objectives in paragraph 70. We believe it is important that the overarching requirement is consistent with the board’s objective that an entity provides sufficient disclosure to allow a user to understand the amounts, timing and uncertainty of the cash flows arising from its lease portfolio. We have concerns that service components are not disclosed which many users need. The board should reconsider whether this requirement is needed as well.

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?

We agree that a simplified approach to transition is necessary, but we do not believe that the proposed simplified retrospective approach is as simplified as it should be nor necessarily the best presentation in all cases.

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

Yes. We believe that there should be the option to use the full retrospective approach to transition.
(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

There are areas where we believe that the board should provide transition guidance such as in-substance purchases and sales and, if the board continues with its ’hybrid model’ for lessors, consideration of which approach to lessor accounting should be adopted. In each of these cases, the proposals require judgments of lease inception in respect of information that may be unavailable or difficult to obtain at the transition date.

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?

Whilst we acknowledge that the proposals address the primary concern, i.e. the recognition of assets and liabilities arising from lease contracts, we understand from outreach that investment professionals use this information in different ways, and we believe they will continue to make adjustments to the numbers reported by an entity. Therefore, they would rather have disclosure regarding the amount, timing and uncertainty of cash flows than a single number recognised in the financial statements on the basis of significant management estimates and judgements.

For the reasons outlined above, we believe that the benefit to users is limited.

The board must weigh this benefit against the potentially extensive costs imposed on preparers in connection with adopting and applying the proposed model. We believe that if the board was to adopt the proposals to modify the guidance in the exposure draft that we outline in this comment letter (most significantly those relating to clarifying services versus lease, exemption for short term leases for both lessee and lessor, extension options), the costs for preparers would be significantly reduced, whilst not reducing the benefits to the user community.

Whilst we agree with the board’s analysis of costs identified for preparers, we do not believe that the board has captured all of the costs associated with the proposals. We have summarised the key areas in which we believe preparer costs will be significant.

Contracts with business partners

Human capital

Accounting systems

Internal controls and processes

Information gathering

Tax impact
Stakeholder communication

Question 18

Do you have any other comments on the proposals?

There are a number of items that have not been addressed in the exposure draft.

Discount rate
We would encourage the board to provide some clarification regarding this term.

Lease inception vs. commencement date accounting
There are many issues concerning the period of time between lease inception and commencement, which in some cases can be significant. How is the time value of money reflected? What if there are modifications during the period? How are build-to-suit leases dealt with? We believe that the board could address these issues by means of application guidance.