Dear Sirs,

IASB Exposure Draft ED/2010/9: Leases

Morgan Stanley welcomes the opportunity to comment on the IASB’s Exposure Draft ED/2010/9 Leases issued in August 2010 (the “ED”).

We have participated in the preparation of the response to the ED submitted by the Association of Financial Markets in Europe (“AFME”) and the Institute of Chartered Accountants in England and Wales (“ICAEW”), and are generally supportive of the views expressed by their members.

We acknowledge that the current accounting by lessees is generally viewed as being conceptually flawed and failing to provide useful and relevant information for financial statement users. Another criticism leveled at the current guidance is that it can, at the margin, create opportunities for structuring off-balance sheet lease arrangements that are in substance financing arrangements. However, although we accept that these perceived issues are to some extent addressed by these proposals, we believe the proposals contain some fundamental conceptual flaws. We are also concerned that the proposals as drafted will result in significant costs and complexity for preparers which will not be outweighed by the benefits for users.

We are also concerned about the presentation of interest, which is calculated on the obligation to make lease payments, within interest expense in the income statement. Such a fundamental change to the presentation of rental expense could have a significant negative impact on certain debt covenants. In addition, this treatment will also have a distorting effect on the net interest margin and other similar ratios of retail banks and other financial institutions, even where lease financing is not a core business of the entity.

In general we do not agree with the proposals for the recognition and measurement of certain contingent rent payments and optional lease periods. We believe that the proposals would result in the inappropriate recognition of liabilities that do not meet the definition of such in the conceptual framework. In this respect, we agree with the alternative view of Stephen Cooper in that the proposals would result in a potential overstatement of the financial leverage of lessees that would not provide useful information.
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We are also concerned about the conceptual validity of the proposals in the ED in respect of lessee accounting. We do not believe that the performance obligation approach is consistent with the proposed accounting for the lessee. We do not agree that the lessor has an ongoing performance obligation during the lease term after the lessee has obtained control of the leased asset. We believe that the derecognition approach is more consistent with the proposed guidance for lessees, however we are concerned about the application of this approach with regard to certain real estate leases. We encourage the Boards to consult further with users and preparers on these issues.

Overall, we are not convinced that the benefits of the proposals in the ED would outweigh the costs associated with the practical application of the guidance as it stands. The requirements to separate the service components from the lease payments, to reassess the lease payments on a change of facts or circumstances and to measure the obligation to make lease payments using the effective interest rate method will be particularly onerous for preparers. We are particularly concerned about the requirements to reassess the assets and liabilities arising under a lease on a change of facts and circumstances. This will require an almost continual monitoring, analysis and documentation of each lease contract which will be an extremely costly and time-consuming exercise. We believe that the Boards should do more work to ascertain the potential costs for preparers in implementing and applying the proposed guidance prior to the issuance of a final standard.

Given the proposed fundamental change to the accounting for leases, we would urge the Boards to expose the staff draft of the final standard prior to the standard being issued. In the interests of transparency and due process, we believe it is important that any consequential changes to the requirements following the Boards’ consideration of the comment letters received should be re-exposed.

Our detailed responses to the questions raised in the ED are in the Appendix to this letter. We hope you find our feedback helpful. If there are any comments that are unclear, or you would like to discuss anything further, please do not hesitate to contact me on 0207 276-7716 or Craig Withers on 0207 677 2239.

Yours faithfully,

[Signature]

Alex Brougham
Managing Director
Global Accounting Standards and Control
Appendix

Below are more detailed responses to the questions raised in the invitation to comment.

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?

Although we are not convinced that such a fundamental change to lease accounting is indeed necessary, conceptually we agree that the rights and obligations of a lessee under a lease contract generally meet the definition of assets and liabilities in the conceptual framework and should therefore be recognized as such. A lease contract is not an executory contract under which the lessor has a performance obligation that is satisfied over the term of the contract. Other than embedded service contracts, the lessor typically has no additional substantive performance obligations once control of the leased asset has passed to the lessee. We agree that the lease contract is a financing arrangement under which the lessee acquires a right to use the underlying leased asset through financing provided by the lessor.

We agree with the Boards’ proposal that the lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments. However, we do have some significant concerns regarding the proposed measurement of the liability which represents the obligation to make lease payments. These concerns are detailed in our response to questions 8 and 9.

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?

(a) 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?

We do not agree that the performance obligation approach is consistent with the proposed lessee right-of-use model. Under the right-of-use model the lessee is required to recognize the right-of-use asset and the obligation to make lease payments to the lessor. From the lessee’s perspective the lessor has no further performance obligation once the lease has commenced. However, from the lessor’s perspective, the performance obligation approach reflects the fact that the lessor has an ongoing obligation to perform under the contract. We do not agree with this approach as the lessor does not typically have any continuing
performance obligations, other than those associated with an embedded service component, after the right to use the leased asset has been transferred to the lessee.

As a consequence of this, we believe that the derecognition approach is more consistent with the proposed accounting for the lessee. The risks and benefits associated with the asset that are retained by the lessor, either during or after the lease, should be reflected in the measurement of the residual asset. However, we believe that the derecognition approach for certain leases where only a portion of the asset is leased, or where the lease term is significantly less than the life of the asset, would have some practical issues. This is a particular concern for real estate leases and we would encourage the Boards to consult with preparers and users further on this issue.

We understand that the purpose of the performance obligation and derecognition approaches is to allow lessors to appropriately reflect their business model. Lessors that lease their assets out on a long-term basis to a single lessee would probably adopt the derecognition approach, whereas a lessor that leases assets on a short-term basis to multiple lessees would likely adopt the performance obligation approach. However, we do not believe that there is a conceptual basis for having two different accounting models. Although the business models may be different, they merely reflect diverse financing arrangements which should not lead to inconsistent accounting.

We would also like the Boards to clarify whether the derecognition approach for lessors is meant to be consistent with the derecognition approach for financial assets. Currently under IFRS, the derecognition guidance in IAS 39 Financial Instruments: Recognition and Measurement ("IAS 39") can only be applied to part of a financial asset if certain specific criteria are met. In effect, partial derecognition can only be achieved if there is a transfer of identifiable cash flows pertaining to the financial asset. However, the derecognition proposals in the ED seem to be less restrictive in that partial derecognition of the asset can be achieved if the lessor does not retain significant exposure to the leased asset either during or after the term of the lease. We do not believe that there is a conceptual basis for separate derecognition models for financial and non-financial assets and would therefore encourage the Boards to give this issue further consideration.

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
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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?

Although we acknowledge the Boards’ intention to simplify the accounting for short-term leases and reduce the operational burden on preparers, we do not agree that there is a robust conceptual basis for this proposal. We are also not convinced that these proposals would indeed substantially simplify the requirements as leases with a maximum possible term of 12 months or less are not particularly common in practice. We do not believe it necessary to have a simplified approach for lessees for short-term leases. To the extent the effect of discounting the lease payments is immaterial then the lessee may choose not to do so in order to reduce the operational burden. However, to the extent that discounting is material we do not believe that a simplified approach to short-term leases is conceptually supportable.

Also, the proposed accounting for the lessee and the lessor appears to be inconsistent. The lessee accounts for the short-term lease as a financing arrangement, recognizing the acquisition of a right-of-use asset which has been financed by the lessor. However, the lessor would account for the lease as an executory contract, recognizing lease income over the term of the lease as it performs under the contract by making the asset available for use. If the Boards are to retain a simplified accounting model for short-term leases, we believe that the lessee and lessor model should be consistent.

Definition of a lease

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

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?

We generally agree with the definition of a lease and the criteria that distinguish a lease from a contract that represents a purchase or sale of an asset. We also agree that service components represent executory arrangements and should not therefore be included in the measurement of assets and liabilities arising from lease contracts.
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However, we believe that additional clarification, possibly in the form of application guidance, is required to distinguish a lease from a service contract. It is also not clear from the proposals that certain property related executory costs (e.g. insurance and taxes) would meet the definition of distinct services. We propose that all such executory costs, that are not service components, be excluded from the lease accounting guidance.

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?

We do not understand why leases of intangible assets have been scoped out of the proposed ED, which seems to be inconsistent with the scope of the Revenue from Contracts with Customers proposals. We would encourage the Boards to clarify this apparent inconsistency.

We would also encourage the Boards to confirm that the nature of the right-of-use asset is that of a tangible, rather than an intangible, asset. In the UK and other jurisdictions, the regulatory capital treatment of tangible and intangible assets is significantly different. Although the ED states that the right-of-use asset should be presented as if it were a tangible asset within property, plant and equipment, it stops short of definitively stating that it is a tangible asset. We assume that the right-of-use asset is not intended to be intangible or otherwise a sub-lease of a right-of-use asset would be outside of the scope of the ED, which is clearly not the intention of the Boards.

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:

(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.
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(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 support the IASB proposals as we do not believe that it would be appropriate for a lessor to recognize income under a service contract in advance of satisfying the performance obligation associated with the service component. Although ascertaining the terms of the service contract would be a matter of judgment and subjectivity on the grounds that the service component is non-distinct, nevertheless we believe that this is conceptually the better answer. However, we acknowledge that neither proposal is conceptually flawless, as the proposed accounting for lessees will result in recognizing a liability for services that have not been received thereby overstating their financial leverage.

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?

We agree the exercise of a purchase option should be viewed as a termination of the lease contract and therefore accounted for as a purchase and sale of the leased asset.

Measurement

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

(a) assumes 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 (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).

(b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessor should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.

(c) is updated 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
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option penalties and residual value guarantees, since the previous reporting period (paragraphs 17, 39, 56 and BC132–BC135).

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?

We do not agree with the proposal that the lease term should be the longest possible term that is more likely than not to occur taking into account options to extend or terminate the lease. In respect of this particular point, we agree with the alternative view proposed by Stephen Cooper. We believe that options to extend a lease should only be considered when measuring recognized assets and liabilities if they are reasonably certain of being exercised at the inception of the lease. For example, a lease option renewal should be included in the determination of the lease term if there is an economic incentive for the lessee to exercise the option, or if the lessee is committed to a commercial strategy that means it is virtually certain to exercise the renewal option. Including renewal options in the determination of the lease term that are only more likely than not to be exercised would result in the lessee recognizing liabilities that do not meet the definition of such in the conceptual framework. To the extent that the lessee has no commercial incentive to exercise the renewal option, the lease payments during the lease extension period are not unavoidable obligations of the lessee. We also agree with Mr. Cooper’s view that the lessor’s exposure to the lessee’s credit risk would be overstated as the receivable representing the right to receive lease income would be overstated.

The determination of whether a renewal option is more likely than not to be exercised is subjective and the lessee and lessor are unlikely to reach the same conclusions in all cases. Where the option can be exercised by the lessee, the lessor is unlikely to have sufficient information to be able to determine whether it is more likely than not that the renewal option will be exercised. The lessor is unlikely to be familiar with the lessee’s commercial strategy and intentions and so it is likely that the lessee and lessor will determine a different lease term in many situations.

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?

We do not agree that contingent rentals should always be included in the measurement of assets and liabilities from a lease using an expected outcome technique. We believe that there are two fundamentally different types of contingent rentals that should be accounted for differently. There are contingent rentals
that are within the control of the lessee, such as those that are linked to the level of use of an asset, and those that are outside of the control of the lessee, such as those linked to the value of an index.

Again, we agree with the alternative view of Stephen Cooper in that contingent rentals that are neither a contractual nor a constructive obligation of the reporting entity do not meet the definition of a liability per the conceptual framework. As such, the measurement of those assets and liabilities arising as a result of the proposed accounting should not include such cash flows.

However, we do agree that contingent rentals that are not within the control of the lessee should be included in the measurement of those assets and liabilities. Examples of such contingent rentals include periodic rent review uplifts that are linked to an index or other observable market indicators. It should also include contingent rentals that are within the control of the lessee but the lessee nevertheless has a constructive obligation to make the payments. For example, contingent rentals on retail space that are triggered when a low sales threshold is met, and which is in a strategically important location for the lessee, would be a constructive obligation on the lessee.

We are concerned that the measurement of assets and liabilities using the expected outcome technique will be operationally difficult to apply. The proposed expected outcome is the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes. We believe that this approach will result in significant levels of judgment and subjectivity and will also involve a considerable amount of time and effort. We believe that the measurement of the assets and liabilities should be based on the present value of the expected cash flows, which is based on the most likely cash flows rather than on a probability-weighted outcome. We believe that this approach would be significantly less onerous than that proposed in the ED and no more subjective.

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?

We agree that lessees and lessors should remeasure assets and liabilities arising under a lease when there is a significant change in facts or circumstances. However, under the proposals, preparers would be required to determine whether there had indeed been a significant change in facts and circumstances. We are concerned that this could be extremely onerous on preparers given that each lease contract will need to be almost continually monitored, analysed and documented. We do not believe that this is the intention of the Boards and we would urge the Boards to simplify the approach to reassessment.

Sale and leaseback

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a
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lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

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 agree with the proposed criteria for classification as a sale and leaseback transaction.

Presentation

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

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?

As detailed in our response to question 5, we would also encourage the Boards to confirm that the nature of the right-of-use asset is that of a tangible, rather than an intangible, asset. In the UK and other jurisdictions, the regulatory capital treatment of an intangible asset is significantly more punitive than that of a tangible asset. Although the ED states that the right-of-use asset should be presented as if it were a tangible asset within property, plant and equipment, it stops short of definitively stating that it is a tangible asset.
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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?

We believe that the presentation of the interest cost for the lessee within interest expense could have a negative impact on certain debt covenants. For example, debt covenants that require a borrower to maintain a certain level of interest cover could be technically breached as a result of the classification of the expense as interest. Another consequence of this requirement is the effect on net interest margin and other similar ratios for retail banks where lease financing is not part of the entity’s core business. These measures are considered key performance indicators for retail banks and other financial institutions and the inclusion of rental costs within interest expense could have a distorting effect on the views of users.

As such we believe that preparers should have the option, where material, to present separately interest expense recognized on lease contracts on the face of the income statement.

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?

We have not commented on this question.

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?

We generally agree with the proposed disclosure requirements and support the guidance in paragraph 71 in the ED that provides preparers with some discretion as to the level of detail and emphasis of the disclosure.

However, we are concerned with the requirements set out in paragraphs 73(a)(iii), 83 and 85 which require qualitative and quantitative information about assumptions made regarding lease renewal and termination options. We believe that the provision of such information could be seriously prejudicial to a lessee in respect of lease renewal negotiations. Such information would provide lessors with information on the intentions of a lessee to exercise a lease renewal option, which would necessarily weaken the lessee’s
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negotiating position. As a consequence we do not believe this disclosure should be required to the extent that it is prejudicial to the commercial interests of the entity.

Transition

Question 16

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

We agree with the Boards that full retrospective application of the proposals would be significantly onerous for preparers and should not be a mandatory requirement. We agree with the simplified retrospective approach, however we believe that full retrospective application should be permitted.

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?

As noted in our covering letter, we are not convinced that the benefits of the proposals in the ED would outweigh the costs associated with the practical application of the guidance as it stands.

We are concerned that many organizations will be unable to apply the effective interest rate method for measuring assets and liabilities arising under lease contracts. Many financial institutions struggle to apply this methodology appropriately to the measurement of financial assets and liabilities measured at amortised cost. Consequently we believe that this will be a particularly onerous requirement for many preparers.

The requirement to distinguish service components from lease components will also be particularly onerous, especially on transition. We agree that service components represent executory arrangements and should not therefore be included in the measurement of assets and liabilities arising from lease contracts. However, the terms of service components are not separately documented in most lease contracts. As such, for each individual lease, preparers will need to make an assessment as to whether there is a service component and, if there is, whether that component will be distinct or not distinct.

Another area that could be significantly onerous is the requirement that lessees and lessors should remeasure assets and liabilities arising under a lease when there is a significant change in facts or
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circumstances. As stated in our response to question 10, we would encourage the Boards to simplify the approach to reassessment.

The requirement to include contingent rentals in the measurement of assets and liabilities arising under a lease would also be difficult to apply in practice. The application of a probability-weighted expected outcome methodology would result in preparers having to model potentially complex scenarios which would be time consuming and subjective.

As a consequence of the above, we would encourage the Boards to do more work to ascertain the potential costs for preparers in implementing and applying the proposed guidance prior to the issuance of a final standard. We would also encourage the Boards to consider ways of simplifying the requirements without reducing the relevance and usefulness of information for users.

Other comments

Question 18

Do you have any other comments on the proposals?

In light of our responses above, and if the Boards do decide to issue a final standard based on the current proposals, we would urge the Boards to provide an effective date that gives preparers sufficient time to implement the proposals. We acknowledge that the IASB has issued its Request for Views on Effective Dates and Transition Methods, on which we will comment separately. However, given the significant complexities identified above we feel that there should be a substantial period of time between the issuance of a final standard and the effective date.

With regard to tax matters, many tax jurisdictions currently rely on existing GAAP as a starting point for determining the relevant tax treatment of a lease. Local tax authorities will need to consider how existing tax law needs to be updated to ensure that the changes to the lease accounting rules do not adversely impact the basis for the taxation of affected leasing arrangements. As a result, such changes in statute may potentially have cash tax and effective tax rate implications. We believe that this issue should be carefully considered when determining the transition time for any new standard.

We would also point out that current GAAP continues to cover onerous lease contracts which, we understand, would be replaced by these proposals through impairment of the right-of-use asset. An amendment to existing GAAP will therefore be required to remove the reference to onerous leases.