Dear Sir

IASB Exposure Draft ED/2010/09: Leases

We are pleased to comment on the above exposure draft (the ED). Following consultation, this letter summarises the views of the BDO network.

We are supportive of the Boards’ continued efforts to develop, maintain and promote high quality accounting standards, and of their continuing efforts to achieve international convergence of accounting standards. We agree with the Boards’ stated objectives to remove inconsistencies and weaknesses in current lease accounting guidance, provide a more robust framework, improve comparability and simplify requirements.

While we agree with the broad objectives and principles set out in the ED for the right-of-use model for lease accounting, we disagree with certain of the proposals and have significant reservations about some others, calling into question the operationality of certain aspects of the proposals, particularly in determining the lease term, quantifying related lease payments and the periodic reassessment of the quantum of lease payments. These have been highlighted below. We believe that these need to be addressed in a final standard in order for us to be supportive of it, and to avoid the risk that the costs involved in its implementation outweigh the benefits to be obtained from the improvements in financial reporting. We note that the proposals in the ED, both from a preparer and auditor perspective, would be likely to place substantial pressure on reporting timetables, in particular in those jurisdictions where entities are required to report on a quarterly basis, and believe that changes are needed to the proposals in order to make the requirements practicable for all entities.

Scope

While we acknowledge the comments in the Basis for Conclusions (BC33-36), we do not agree with the proposed scope, which excludes leases to explore for or use natural resources and leases of intangible assets.

If the publication of a new accounting standard for the exploration and use of natural resources was imminent, then we would find the proposed exclusion more compelling; however, it is likely to be some time before a new accounting standard is issued, and we believe that there is diversity in practice that could be addressed if these arrangements were scoped into the new leases standard. If consequential amendments to the lease accounting requirements are needed once a new accounting standard for the exploration and use of natural resources has been issued, they can be made at that time.
Similarly, we do not agree that intangible assets should be excluded from the scope until the accounting for those assets has been considered more broadly. Again, it is likely to be some time before a new accounting standard is issued and we see no reason why improvements to the accounting for leases of those assets should be postponed for what might be a significant period.

We also note that paragraph B31 of the exposure draft Revenue from Contracts with Customers appears to bring the sale of intangible assets into the scope of the proposed guidance. As the Boards appear to have considered the accounting for the sale of intangible assets, we believe that it would be consistent for leases of those assets to be considered and brought within the scope of the leases standard. Regardless of whether this change is made, it will be appropriate to revisit the precise scope and requirements of the revenue standard to ensure that the requirements for revenue recognition and lease accounting do not overlap or conflict.

As noted in our response to question 5, we believe that there should be a clear restriction on the scope of a new accounting standard based on the proposals, to avoid the potential for arrangements that are executory in nature from being accounted for as leases. This could be achieved by restricting the scope of the new leases standard to assets that, if purchased or constructed/developed by the lessee would be required to be included on its Statement of Financial Position by other specified accounting standards.

Proposed dual model approach for lessors

We do not support a dual model approach for lessors and believe that a single derecognition model should be taken forward. We consider that the proposed performance obligation approach is inconsistent with the model proposed for lessee accounting and are concerned about the wider effect of adding very substantial amounts of right-of-use assets to the Statement of Financial Position of lessees with no corresponding derecognition from the Statement of Financial Position of lessors. We are in favour of an approach which would result in symmetry of accounting for both lessees and lessors (although we do acknowledge that not all existing accounting requirements give rise to a symmetrical approach). We also note that the performance obligation model would result in (what we believe to be the inappropriate) double counting of assets from the lessor’s perspective, as none of the underlying asset would be derecognised and an asset would be recognised for the lease receivable.

We also believe that the derecognition approach is consistent with the ‘transfer of control’ concept proposed in the exposure draft Revenue from Contracts with Customers and that the performance obligation model is not.

Lease term

We disagree with the proposed threshold of ‘more likely than not’ to be applied to lease extension options; we believe that there needs to be a greater degree of certainty and would support retaining the existing, higher ‘reasonably certain’ threshold. In order to counter concerns about entities establishing unrealistically short lease terms (whether on initial recognition or subsequently) for leases that contain a series of renewal options, this threshold should be applied in the context of an entity’s economic position and related period during which it will realistically need to use the underlying asset; this should be linked to an entity’s economic need to have the use of certain assets in order to be able to continue to run its business, and the consequent economic compulsion to exercise lease extension options.
Lease payments - contingent rentals and expected payments

While we support conceptually the inclusion of contingent rentals and expected payments, and note that the proposed approach for contingent rentals is in principle similar to the accounting for a loan with interest payments linked to profits, we have significant concerns about the operationality of this element of the ED for certain industry sectors. Accordingly we believe that the guidance needs to be simplified and that the resulting changes are subjected to robust field testing to avoid a very significant and onerous burden being placed on some entities.

We also note that the liability recognised by lessees could include amounts that do not meet the definition of a liability under the conceptual framework, as payment could be avoided through the exercise of an option (or by not exercising an extension option). We acknowledge that the proposed approach does represent a practical expedient with which we agree (the potential alternative being a requirement to measure options at fair value), and note that our suggested alternative approach to contingent payments would not eliminate the inconsistency with the conceptual framework. However, it would be helpful for this inconsistency to be discussed in the application guidance and basis for conclusions, including why leases are conceptually different from other, executory, contracts.

Reassessment

While we agree that periodic reassessment should be required, with associated changes being made to amounts recorded in an entity’s financial statements, we believe that the proposals could give rise to significant practical difficulties and that in some cases the proposals might not be operational. This is particularly the case for jurisdictions where quarterly financial reporting is required; we note that the proposals refer to the end of ‘each reporting period’ and not the end of ‘each annual reporting period’.

We believe that it would be appropriate for an annual reassessment to be required at a minimum, with an interim reassessment being carried out if certain ‘trigger events’ have taken place that indicate that there might be a significant change. These trigger events could be similar in nature to those that give rise to an impairment test.

Sale and leaseback transactions

We believe that sale and leaseback accounting should be extended to cover arrangements which involve part of an underlying asset as well as the whole of an asset. While we note the Boards’ concerns at paragraph BC161, we do not consider that a distinction should be made and note that it appears inconsistent with the partial derecognition approach to lessor accounting. We are also concerned that a bright line distinction as proposed could give rise to the structuring of arrangements to obtain a particular accounting result.

Financial statement presentation

While we agree that assets and liabilities arising from leases should in general be shown gross on the face of the Statement of Financial Position, if a decision is taken to continue with the proposed dual model for lessors we believe that it would be appropriate for lessors to present the underlying assets, rights to receive lease payments and lease liabilities arising from the performance obligation model as a single net amount on the face of the primary statement, with the gross amounts being disclosed in the notes.
Implementation and transition

The proposals represent a significant change in practice that may, for some entities, impose a significant burden. We have illustrated a number of our comments in response to the specific questions included in the ED with issues that are likely to be faced by entities in the retail sector; entities in the real estate sector would also often need to carry out a particularly significant amount of work to comply with the ED. As noted in this letter, we believe that certain aspects of the proposals could be simplified and we strongly encourage the Boards to give careful consideration to these in order that the costs of implementing the new lease accounting requirements do not outweigh the benefits to be obtained from them.

Similarly, in the light of the significant change, it would be appropriate for consideration to be given to the time and expense involved in transition to the new requirements when setting the effective date. In this regard, we note the Request for Views which has been issued, requesting input from constituents about how best the implementation of the range of new accounting standards that are due to be issued can be managed, in respect of both the pace of change and the cost of compliance.

Our responses to the specific questions included in the ED are set out in the attached Appendix.

We hope that our comments and suggestions are helpful. If you would like to discuss any of them, please contact Andrew Buchanan, our Global Head of IFRS, at +44 (0)20 7893 3300 (email: abuchanan@bdoifr.com) or Lee Graul, National Director of Accounting at +1 312 616 4667 (email: lgraul@bdo.com).

Yours faithfully

BDO IFR Advisory Limited

BDO IFR Advisory Limited
Appendix

The accounting model

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?

We agree that a lessee should recognise a right-of-use asset and a liability to make lease payments. However, as noted in our responses below, in particular those covering questions 8 and 9, we have significant reservations about certain of the proposals (in particular the determination of the lease term and lease payments) and believe that these need to be amended in order for a final standard based on the proposal to be fully operational in practice.

(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 a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments.

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?

We do not agree with the proposed dual model for lessors, and believe that the derecognition approach should be applied to all transactions within the scope of the proposals. This would result in a more consistent approach being applied for both lessor and lessee accounting. We are concerned about the effect that the performance obligation model would have on financial statements, as lessees would add potentially very large carrying values of leased right of use assets and associated liabilities to their statements of financial position, with no corresponding transfer of part of an asset from the lessor’s statement of financial position.

We note that the derecognition approach is consistent with the “transfer of control” concept proposed in the ED Revenue from Contracts with Customers. As the income that lessors receive is in substance a form of revenue (and will, in some cases, properly be regarded as revenue as leasing represents an entity’s principal business activity), we believe the ‘transfer of control’ model more closely matches the economic substance of leasing transactions by lessors and should be retained as the sole model to be used by them.

However, in some cases, although a leasing contract may exist in legal form, in substance a lessor will retain all but a trivial amount of the risks and benefits associated with an underlying leased asset. In such cases, we consider that the lessee should be regarded as operating the leased asset on behalf of the lessor, and that the arrangement should not fall within the scope of the leasing standard. In such cases, the lessor would continue to recognise the asset in its entirety. This would be consistent with the definition of a lease,
where 'the right to use' an asset is conveyed for a specified period of time; it is implicit within this definition that there needs to be a transfer of exposure to the risks and benefits of the leased asset.

We believe that if a dual model approach was retained, further guidance would be required regarding the assessment of which model to use, as assessment without such guidance could lead to an arbitrary distinction and the risk of structuring of contractual arrangements to achieve a particular result, which exists under the current accounting standards for leases. Although the ED includes application guidance in paragraphs 28-29 and B22-27, this is not entirely clear and may not be comprehensive enough to ensure that consistent conclusions are reached by different entities regarding which model to use. As examples of where difficulties could arise, the following types of provisions can be included in lease agreements in practice:

(a) Environmental indemnity provision - A lessor holds a put option which allows the lessor to require the lessee to purchase the building at a fixed or market price during or at the end of the lease term if the land/or building become contaminated during the lease term. How would such a provision affect the assessment of whether the lessor retains significant risks or benefits associated with the underlying asset? An environmental indemnity provision tends to transfer the risk associated with the property to the lessee and as such might suggest that the lessor should use the derecognition approach. However, environmental indemnity provisions are most often present in leases for land and the basis for conclusions in the ED (paragraph BC38) seems to indicate that in most cases leases for land would be classified under the performance obligation approach. Would the presence of this one provision be sufficient to warrant a derecognition approach by the lessor? In this regard, we note that the put option could be regarded as a form of residual value guarantee and therefore might be included within estimated lease payments receivable.

(b) We acknowledge the guidance in paragraph B27, which states that risks associated with counterparty credit risk should not be taken into account by a lessee in its assessment of the extent to which it retains exposure to the underlying asset during the expected lease term. However, could default covenants linked to the financial performance or credit rating of the lessee affect the lessor’s classification of the lease due to their potential effect on estimated rentals receivable, given that the provision could affect the right of the lessee to use the property during the lease term?

We believe that in the event a dual model is retained, the Boards need to consider adding guidance that addresses these and other complex provisions in lease agreements that are not currently addressed in the ED.

(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?

We agree with the boards’ proposals for the recognition of assets, liabilities, income and expenses for the derecognition approach to lessor accounting.

However, we do not agree with the boards’ proposals for the recognition of assets, liabilities, income and expenses for the performance obligation approach to lessor accounting. The
performance obligation approach results in the effective double counting of part of an underlying leased asset, as the asset is partially reflected as a right-of-use asset in the books of the lessee and in its entirety as an asset (typically an item of property, plant and equipment) in the books of a lessor. It also creates two assets on the books of the lessor that must both be tested for impairment. It is unclear from the guidance in the ED whether and to what extent the cash flows and other inputs that a lessor would apply to test the right to receive lease payments for impairment should be the same as those used to test the underlying asset for impairment.

As noted in our response to question 12 (b), if the proposals for a dual model for lessors are taken forward, we consider that the three balances in the statement of financial position of lessors that arise from the application of the performance obligation approach should be aggregated into one line item on the face of the primary statement, with the disaggregated amounts being disclosed in the notes.

Question 3: Short-term leases

This 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.)

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 agree that simplified accounting should be permitted for short-term leases, and with much of the proposed approach. We note that the proposal for lessors not to recognise assets and liabilities arising from a short term lease is a practical expedient, linked to (for example) those entities that rent large numbers of items of equipment to customers for periods of days or weeks.

We are aware of some suggestions that an option not to recognise assets and liabilities from short term leases should be extended to cover lessees. While this might appear attractive, we have concerns that this might lead to the inappropriate structuring of contractual arrangements such that in legal form they met the definition of a short term lease and thus qualified not to give rise to the recognition of assets and liabilities. Consequently we do not support such an exemption and agree conceptually that lessees should recognise assets and liabilities arising from short term leases. However, some entities may have a large number of
very short term leases, meaning that the cost and effort involved in complying with the proposed requirements could be significant, even if this is simply to conclude that the effect of accounting for the leases as proposed would be immaterial (this links to our comment below in respect of the presentation of the Statement of Comprehensive Income; the question of materiality might be relevant in the context of individual line items and subtotals if there could be different presentations in the Statement of Comprehensive Income, as well as amounts recorded in the Statement of Financial Position). Accordingly, the effect of this requirement should be field tested; it may be appropriate for the focus to be on whether, at a reporting period end, the effect on an entity’s assets and liabilities from recording its short term leases would be material.

We note that it is proposed that the simplified approach may be applied on a lease by lease basis. While this may be a practical approach, we note the potential for inconsistent accounting depending on whether the simplified approach is followed, meaning that two identical leases could be accounted for differently. It may therefore be more appropriate for the adoption of the simplified accounting approach by lessors to be an accounting policy choice.

With regard to the proposed guidance, we believe that it would be appropriate for the requirements of paragraphs 64 (lessee accounting) and 65 (lessor accounting) to be clarified.

Paragraph 64 notes that a lessee is permitted to measure a short term lease asset and liability at undiscounted amounts, but is silent about their recognition in the lessee’s statement of financial position. This might be taken to imply that off balance sheet accounting for lessees might be possible; while we believe that it is appropriate to interpret paragraph 64 such that recognition is required, a more aggressive interpretation might differ. The paragraph could be redrafted to read:

‘....may elect on a lease-by-lease basis to measure, and recognise in its Statement of Financial Position, both at initial recognition and subsequently........’

Linked to this observation, the guidance in paragraph 64 for the recognition of lease payments is confusing as it appears to ignore the existence of the short term lease asset and liability and replicates the guidance in paragraph 65 for lessors by requiring that:

‘Such lessees shall recognise lease payments in profit or loss over the lease term.’

If a short term lease for a lessee gives rise to a right of use asset, it is unclear why the guidance in paragraph 64 would not instead state that the lessee is required to recognise the amortisation of the right-of-use asset over the lease term, with lease payments being set against the carrying amount of the lease liability. If this approach is not followed, it is not clear how the asset and liability would be eliminated over the lease term, unless the amount of both the amortisation of the asset and the release of the liability were equal in all periods and were offset in the Statement of Comprehensive Income.

We also note that the guidance as drafted in both paragraphs 64 and 65 require lease payments to be recognised in profit or loss over the lease term, but provide no guidance for the pattern of recognition. The same issue would arise for the pattern of amortisation of the lessee’s right-of-use asset if our suggested amendment were to be made. We suggest that an explicit requirement is added to clarify that the charges/credits arising from short term leases should be recognised in profit or loss on a straight line basis over the lease term.

It is not entirely clear how short-term right-of-use assets should be classified within the Statement of Financial Position of lessees. While paragraph BC41 states that the ‘...definition regarding short-term leases is consistent with the distinction between long-term and short-term items...’,” paragraph 25(b) states that a lessee shall present a right-of-use asset ‘...as if
they were tangible assets within property, plant and equipment..." The two paragraphs appear to be inconsistent, as property plant and equipment is typically classified within long-term assets. We believe short-term right of use assets should be classified within current assets, consistent with the guidance in paragraph BC41.

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, 9, 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?

We agree that a lease is defined appropriately 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.

(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 do not agree with the criteria, and are concerned that the guidance contained within the leasing proposals are inconsistent with those for revenue. It appears that transactions that meet the conditions for recognition as sales under the leasing proposals (due to bargain purchase options) might not qualify for revenue recognition under the revenue proposals. We suggest that either the two sets of proposals are made consistent in this regard or that, where a lease transaction meets the criteria to be recorded as a sale in accordance with the revenue proposals then it is accounted for in accordance with that standard and, if not, it is accounted for in accordance with the leases standard. While this latter approach would not eliminate the inconsistency, it would provide a clear dividing line for the scope of the two accounting standards.

We disagree with the boards’ conclusion that assessment as to whether a contract is a lease or a purchase/sale should be made once at inception and not subsequently be reassessed. We believe there are many situations in practice where a lease contract is amended after inception resulting in a significant change in facts and circumstances that could lead to a different conclusion for the lessor and lessee regarding lease versus purchase/sale accounting. It would be appropriate for guidance regarding the accounting for amendments to lease contracts to be included in a final standard based on the ED as, under the proposals, it is unclear whether revisions to lease agreements after initial recognition should be ignored, with the contract continuing to be accounted for as originally written. We do not believe that this would be appropriate under these circumstances, and that there should be a requirement to revisit the accounting approach when the contractual terms of a lease are changed. In addition, the extent to which extension and other options are exercised in practice, in comparison to original estimates, may vary. This could result in the classification changing (for example, where it was judged on inception that an extension option that extends a lease for the whole of the useful economic life of the underlying asset would not be exercised, but
in the event the option was exercised). Again, we believe that the accounting approach should be revisited in such circumstances.

(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 agree that guidance in paragraphs B1-B4 for distinguishing leases from service contracts is adequate.

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 agree with the proposed scope of ED. Although this is similar to the scope of existing lease accounting requirements, we believe that this should be extended to apply to leases to explore or use natural resources and to leases of intangible assets.

While we note the comments in the Basis for Conclusions (BC 33-36), it may be some time before a new accounting standard for the exploration and use of natural resources is issued, and we believe there is diversity in practice that could be addressed if the new leasing standard included these assets.

We also believe that leases of intangible assets should not be excluded from the scope of the lease ED. Paragraph BC36 indicates that the board decided to exclude intangible assets from the scope of the lease ED “until they had considered the accounting for intangible assets more broadly.” However, we note that paragraph B31 of the ED Revenue Recognition appears to scope the sale of intangible assets into the revenue recognition guidance. As the board appears to have considered the accounting for the sale of intangible assets in the revenue ED, we believe the lease of intangible assets from both a lessor and lessee perspective should likewise be considered and scoped in to the lease ED. In addition, and consistent with our view that arrangements to explore or use natural resources should be brought with the scope of the new leasing standard, we do not consider that the potential for a new accounting standard to be issued at some point in the coming years is sufficient reason to restrict the scope, unless the new standard is expected to be issued in the short term. If necessary, appropriate consequential amendments can be made when the new requirements for intangible assets are issued.

We have suggested, in our response to question B, that the determination of the lease term in the context of options to extend or terminate the lease should take into account a lessee’s operational necessity to have continued use of the leased asset and, in consequence, its economic compulsion to exercise lease extension options or not to exercise termination options. We believe that this would result in lessees recognising liabilities for amounts that, economically, are likely to be incurred, while excluding amounts that the lessee could realistically avoid (from both a contractual and an operational perspective).
However, the same rationale might be used to suggest that, for example, assets and liabilities should be recorded for employees as an entity might be compelled to employ staff to run its business. We therefore believe that there needs to be a clear restriction on the scope of the new leases standard. This might be achieved by limiting its scope to leases involving assets that, if purchased or constructed/developed by the lessee, would be required to be included on its Statement of Financial Position by other accounting standards (including IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets, IAS 40 Investment Property and IFRS 6 Exploration for and Evaluation of Mineral Resources).

**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.

(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?

While we agree with the approach to accounting for leases that contain service and lease components, we believe the guidance is oversimplified and needs to be expanded to address arrangements such as (a) leases that combine executory costs that are not service in nature (such as property taxes and insurance, which may be passed on to the lessee at no mark-up) with lease costs and (b) leases that combine charges for significant services with lease costs but do not separately identify those costs in the lease contract. We consider that the approach for executory costs should be consistent with the approach that would be adopted for owned assets, where (for example) future property taxes and maintenance charges would not be capitalised as part of an item of property, plant and equipment.

Under the proposed accounting model for lessees, the accounting for the lease itself and for service components will be different. Therefore it will be important for companies to be able to distinguish clearly and consistently between the service and lease components of a given contract. In the two situations described above, while the service components of the lease contract may be significant, under the proposed guidance in paragraph B7 they may not meet the criteria for separation from the lease costs as they may not be distinct. It would be helpful to include further implementation guidance to illustrate (a) what constitutes a
distinct (separable) service and (b) how to split a single contract into its lease components and distinct service components.

In addition, we are not convinced by the IASB’s proposal to require a lessor that applies the derecognition approach to a lease with a non-distinct service component to account separately for the lease components and the service components of the lease. As noted above, we believe guidance is needed to distinguish a distinct service component from a non-distinct service component.

**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 B8, 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 that a lessee or a lessor should account for purchase options only when they are exercised. We note that an arrangement which contains a bargain purchase option will normally be excluded from the scope of the new leasing standard, as the arrangement will typically be viewed as a sale from the outset (see paragraph B10).

**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). Lessors 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 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 agree that a lessee or a lessor should take into account the effect of any options to extend or terminate the lease. However, we are not wholly convinced that the threshold of ‘more likely than not’ is appropriate, and we believe that further guidance is needed to assist in determining the appropriate lease term.

In particular, we note that under the proposed recognition threshold, it appears that amounts would be recognised as lease liabilities that do not meet the definition of a liability in the Framework. In consequence, the Boards should consider retaining the current (higher) threshold of ‘reasonably certain’ which, in conjunction with other enhancements to the application guidance (see below) would better align amounts that are required to be recorded as lease liabilities with the definition of a liability in the Framework. We note that the ‘reasonably certain’ threshold is well understood and is operational in practice.

Linked to this last point, we consider that there may be significant operational difficulties in determining the lease term under the proposed recognition threshold, where extension options relate to periods that are far into the future. Our suggested amendment to the threshold would go some way to address this point as the number of extension options that would be taken into account would be reduced, although it might also bring the associated risk that entities could assert that a particular lease reflects an inappropriately short lease term. However, strengthening the guidance set out in Appendix B would assist in reducing the ability of entities to suggest that they do not intend to exercise lease extension options when in reality there is economic compulsion or operational necessity to do so. While we acknowledge the guidance at paragraph B18, we consider that (for example) subparagraph (c) should be expanded. As drafted, this suggests that business factors should be considered, such as ‘whether the underlying asset is crucial to the lessee’s operations, or whether the underlying asset is a specialised asset or the location of the asset.’ We would include a stronger and wider link to the entity’s economic need to have certain assets to run its business, whether this is an airline that leases aircraft, a retailer that leases retail premises, or a professional services firm that leases office space or otherwise. Taking these three as examples:

- It is likely to be appropriate for an airline which leases new aircraft and intends to continue to operate as a going concern to presume the exercise of lease extension options up to the point at which the aircraft will be technologically superseded or will be replaced (with the estimated replacement date being linked to industry practice and entity specific experience). The assessment of the lease term could also be linked to other operational aspects such as the existence and duration of rights over routes and landing slots.

- The extent to which retailers might be expected to exercise lease extension options will vary depending on the type of retailer and the location of the underlying premises. For example, a well established and reputable retailer will typically want to continue to occupy premises in significant cities and other locations (such as significant shopping malls), and would be expected to stay in some of them for a substantial period. In contrast, a cut price mobile phone retailer may often be more concerned about obtaining the lowest rental possible and will be less concerned about staying at a particular location.
A professional services firm will typically have a need to be represented in major economic areas and, in addition, may have reputational risk that arises from the location of its premises. As an example, a professional services firm might occupy space in what is regarded as being a particularly high-quality building in a major city; to move elsewhere could give a negative signal to its client base which that firm would wish to avoid; this aspect needs to be included in the assessment of the building lease term, as well as other aspects such as its age, condition and consequent future utility.

We believe that the approach we have outlined above, of raising the recognition threshold and, at the same time, requiring economic compulsion and operational necessity to be taken into account more clearly, would result in lessees recognising liabilities for amounts that, economically, are likely to be incurred, while excluding amounts that the lessee could realistically avoid (from both a contractual and an operational perspective).

The logic behind the application of the definition of a lease term in the illustration in paragraph B17 of the ED is not entirely clear. The illustration concludes:

'The lease term is 10 years, there is a 60 percent chance that the term will be 15 years or longer, but only a 30% chance that the term will be 20 years. Therefore there is a 60 percent chance that the lease term will be 15 years, which is the longest possible lease term that is more likely than not to occur. Therefore, the lease term is 15 years.'

While we understand the approach taken, which is to look at the probabilities from the longest possible lease term and work backwards through increasingly short lease terms, it would be helpful for this to be made explicit.

In addition, while (as noted above) we agree that the guidance needs to require consideration of extension options to avoid the potential for the structuring of lease agreements, it may be challenging in some cases to obtain reliable estimates of the actual lease term. For example, in one jurisdiction the law allows for property to be leased for a period of only nine years, with there then being a legal right for the lessee to extend the lease term. In such cases, it may be difficult for the lessee and/or lessor to determine the lease term as defined in the proposal. Certain leases are also structured on a rolling monthly basis; again, it may be difficult to determine the lease term under these arrangements, particularly if the parties to the lease have limited experience of doing business with each other or limited experience with these types of lease agreements. While we believe that, if our suggested amendments set out above are made, it will be more straightforward to determine lease terms, it would be helpful for additional examples to be included in the final standard to illustrate how more judgemental and difficult to estimate, lease terms might be determined.
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 agree, in principle, 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. We note that their inclusion is consistent with (for example) the expected cash flow approach to accounting for financial instruments that are measured at amortised cost. However, we have significant concerns around the operationality of the proposals for certain industry sectors, and believe that the Boards need to ensure that the guidance included in any final standard has been fully field tested, including lease contracts that contain contractual terms at the extreme ends of the scale. For example, we are particularly concerned that, what may be determined to be relatively long term leases that have turnover or profit linked lease payments, may give rise to highly judgemental and difficult to support amounts being recorded in an entity’s financial statements. While in principle this is no different from the accounting for a profit linked note, we believe that a significantly wider range of entities will be affected by the proposed lease accounting requirements than have issued profit linked notes. We believe that, if the proposals for contingent rentals are taken forward, practical expedients need to be included in a final standard such that entities are in a position to prepare their financial statements in a reasonable timescale without incurring excessive costs. This is particularly the case in jurisdictions where entities are required to report quarterly results (see our comments in response to question 10 below, which covers reassessment).

We 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.

We note that it could be argued that amounts to be recorded as assets or liabilities in respect of lease payments receivable or payable might not, in fact, meet the definitions of assets and liabilities (for example, a lease liability recorded by a lessee may include amounts that will only be paid if the lessee exercises an extension option; the lessee could therefore avoid the related payments by choosing not to exercise the option). However, we acknowledge that the approach set out in the ED represents a practical expedient which we support, although we consider it important that our comments set out above in response to question 8 are reflected in a final standard based on the proposals.

We note that the proposals would require a lessee to record the assets and liabilities that arise from leases at amounts, on initial recognition, that are based on the present value of the lease liability. In particular where a lease contains substantial contingent payments, it would be appropriate to require consideration of the fair value of the (leased portion of) the underlying asset, as this would act as a check on whether the amounts recorded in respect of the lease contract appear appropriate. A similar approach may be appropriate for lessors.
Given the significant change in practice that would result from the proposed accounting for lease payments, additional implementation guidance needs to be included, including examples that provide guidance for more judgemental scenarios. It may also be appropriate to include practical expedients, in order to balance the requirements of the accounting standard and the time and effort required to comply with them. For example:

- In the retail sector companies often enter into turnover linked rental agreements over periods of ten years or longer. In these situations, it is unlikely that entity specific forecasts will exist for all of these periods and, in consequence, it may be impossible from an operational perspective to obtain the relevant entity specific information to estimate contingent rentals. As noted above, we believe that practical expedients need to be included in any final standard based on the proposals, with these being subject to appropriate and extensive field testing to ensure that they are operational. As an example, an approach similar to that used in IAS 36 for the purposes of impairment testing might be considered, where industry averages rather than entity specific amounts are used for projections after the end of the period for which entity specific forecasts have been prepared. Alternatively, forecasts that assume no additional growth in real terms might be assumed for those projections based on an entity's forecasts for the period furthest into the future, subject to consideration of whether the entity specific forecasts showed a decline in turnover over a number of reporting periods or a trend towards a decline. Consideration might also be given to the limit of five years which is included in IAS 36 for entity specific forecasts.

- The ED does not address how to account for landlord incentives and allowances, and their related effect on the calculation of the lease asset and liability for lessees and lessors. It may be appropriate to incorporate existing guidance, such as that set out in SIC-15, in order to clarify the approach and reduce the potential for diversity in practice.

In addition, as we believe the proposed accounting for lease payments will impose a significant burden for many entities, in particular those that are heavily involved in leasing activities, we believe that the boards need to give careful consideration to the time and expense that companies will incur in implementing the new standard before concluding on the transition method and effective date.

**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, given the potential effect of estimates in the determination of amounts to be recorded under the proposals, periodic reassessment should be required. However we believe that, under the proposals for determining the lease term and lease payments, very significant practical difficulties may be created for some entities and, in some cases, that the reassessment proposals do not appear to be operational.

We note that the proposals refer to a potential reassessment at the end of each reporting period (rather than at the end of each annual reporting period). We assume that the
distinction is intentional. In order to avoid an excessive burden being placed on preparers, we believe that it would be appropriate for reassessment to be carried out on an annual basis, with an interim reassessment being carried out if certain ‘trigger events’ have taken place that indicate that there may have been a significant change (this should be set at a higher threshold than ‘facts and circumstances’ as currently included in the proposals). These ‘trigger events’ could be similar in nature to those that give rise to impairment tests. We believe that this higher threshold is necessary, in particular for those jurisdictions where quarterly financial reporting is required.

We also believe that, in addition to consideration of whether there has been a significant change from a prior reporting period, consideration is required of whether there has been a significant change that has arisen gradually over a number of reporting periods. This would assist in identifying circumstances such as, for example, a turnover based lease where there has been a gradual decline (or increase) in revenue over a period of years.

It would be helpful to clarify the discount rates to be used in measuring contingent rentals. For the purposes of estimating contingent rentals that are dependent on an index or rate, paragraph 14(a) of the ED notes that:

‘If forward rates or indices are not readily available, the lessee shall use the prevailing rates or indices.’

In order to fix the date that should be used for the purposes of obtaining the index or rate, this might be amended to read:

‘If forward rates or indices are not readily available, the lessee shall use currently prevailing rates or indices’; or

‘the rates prevailing at the inception of the lease’

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 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 do not agree with the proposed approach. Instead, we believe that sale and leaseback accounting should be applicable to both those arrangements that will involve the whole of an underlying asset, and those which involve part of an underlying asset. We note the Boards’ discussion in paragraph BC 161 of the Basis for Conclusions, and the concerns surrounding the complexity that a ‘partial asset’ approach could bring. However, we do not see why a sale and leaseback transaction involving an underlying asset that is partially derecognised by a lessor should be accounted for differently from one which involves the whole asset. If a distinction is made, we also believe that the potential would be introduced for entities to
structure arrangements either to fall within the scope of the sale and leaseback guidance, or outside that guidance, depending on the preferred accounting result.

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?

We agree with the proposals, and note that paragraph 25 would require the separate presentation of lease payments and right-of-use assets on the face of the Statement of Financial Position. We assume that separate line items would be required; it would be helpful for this to be an explicit requirement (this comment also applies to (b) and (c) below).

We also note our comment in response to question 3 that it would be helpful to clarify the presentation requirements for right-of-use assets arising from short term leases.

(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?

As noted in our response to question 2, we do not support the performance obligation approach and consider that the derecognition approach should be applied in all cases.

However, if the performance obligation approach is included in a final standard based on the ED, we do not agree with the proposed requirement to separately present the underlying assets, right to receive lease payments and lease liabilities gross in the statement of financial condition, totalling to a net lease asset or lease liability. We consider that this approach could lead to an excessive amount of information being included in the face of the primary statement, and also note that there may be associated regulatory capital considerations for certain financial institutions. It would be appropriate for a single net amount to be required to be presented in the Statement of Financial Position, with full disclosure on a gross basis within the footnotes.

It would be helpful for the approach to be followed in respect of short term leases to be clarified. An analysis in accordance with IAS 1 would suggest that all of the related balances should be included within current assets (even though the underlying leased asset might normally be recorded as non current). We suggest that this is made explicit in any final standard.
We agree with the proposal that an intermediate lessor should present its liability to make payments under a head lease separately from all assets and liabilities arising from the sublease. It would be appropriate to include a specific reference to the offsetting requirements of IAS 32 to avoid any suggestion that this head lease liability might qualify for offset against a sublease receivable without those requirements being met.

(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?

We agree with the proposals.

(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?

We agree with the proposals.

Consistent with our comment in response to question 12(b) above, with regard to the head lease liability it would be appropriate to include a specific reference to the offsetting requirements of IAS 32 to avoid any suggestion that this liability might qualify for offset against a sublease receivable without those requirements being met.

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 agree that lessees and lessors should present lease income and lease expense separately from other income and expense.

However, we note that leasing may form a lessor’s principal business activity, meaning that all amounts derived from leases might properly be regarded as a form of revenue (including finance income). It would be helpful for the guidance to clarify that this may be an appropriate presentation; in such cases, it may also be appropriate for revenue to be presented as a single amount on the face of the Statement of Comprehensive Income, with the components being disclosed in the notes.

We also note that there appears to be an inconsistency between the guidance in paragraph 44 and the guidance in paragraph 32 of the ED regarding the presentation of lease income and lease expense by lessors applying the performance obligation approach. Paragraph 44 notes that lessors applying the performance obligation approach should present interest income on the lease receivable, lease income from satisfaction of the performance obligation liability and depreciation expense on the underlying asset separately, totalling to a net lease income or net lease expense (presumably on the same line item) in the income statement. Paragraph 32 indicates that a lessor using the performance obligation approach should classify lease income as revenue if it arises in the course of ongoing or central activities. This implies that
paragraph 32 could require lease revenue to be classified on a different line item from lease expense, meaning that a single net amount could not be presented on the face of the primary statement.

As noted in our response to question 2, it is possible that different presentations could arise depending on whether a lessor takes advantage of the relief for short term leases. We suggest that in such cases, short term lease income should be required to be presented separately from income derived from other leases.

**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 agree that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows. We suggest that IAS 7 is amended to require the presentation of cash flows arising from leases within financing activities, other than where an entity’s business activity is that of a lessor, in which case the cash flows should be required to be presented within the operating section.

**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 agree with the proposals, although some might consider certain of the disclosure requirements to be excessive. While some of the proposed disclosure requirements are not new, such as those required by IFRS 7, the effect of the lease accounting proposals may result in a significant expansion of the disclosures. We suggest that, before any new accounting standard is finalised, a further review is carried out for each proposed disclosure requirement of the balance between the cost of compliance and the benefits that will be derived by users of the related financial statements.

However, as discussed in our response to question 12, if the performance obligation model for lessors is taken forward and included in a final standard, we believe that it would be appropriate for amounts related to right of use assets, assets representing rights to receive lease payments and performance obligation liabilities to be presented net on the face of the Statement of Financial Position with the gross amounts being disclosed in the notes.
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 3C186-3C199). 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?

In general, we support the proposed transitional provisions. However, given the significant change in practice that would result from adoption of the standard as proposed, we believe that it will be appropriate for the board carefully to consider the time and expense that will be required to implement this standard before concluding on the transition method and effective date. In this context, we note the issue of the Boards’ Request for Views on Effective Dates and Transition Methods.

If the standard including the transition provisions is adopted as proposed, we believe that as an alternative to the simplified approach, full retrospective application of lease accounting requirements should be permitted, as it would provide the most accurate representation of an entity’s financial position relating to leasing activities. For some entities, it would not be an onerous exercise to apply a fully retrospective approach, and this may be preferable for them as all leases would then be accounted for on the same basis.

In addition, we believe that it would be appropriate for the guidance for transitional arrangements to cover the following issues:

- Incremental borrowing rate to use at initial implementation date - many retail companies will have hundreds or even thousands of leases as of the retrospective adoption date. Can these companies use the same rate to discount the lease payments for all leases? If that were to be the case, an argument could be made that the cumulative lease obligations for all leases outstanding at that point could be treated as being equivalent to one overall debt facility and the company could look to the rate that would be charged to issue such debt.

- Linked to the above point, it would be appropriate to consider whether any consequent remedial amendment is needed to IAS 23. This is because, in the absence of a leased asset meeting the definition of a qualifying asset, it would appear that all lease liabilities would fall within the pool of general borrowings. For entities with a substantial number of leases with different discount rates, this could result in an excessive burden to comply with the requirements of IAS 23.

- It would be helpful to include additional guidance for leases acquired as part of a business acquisition (this might more appropriately be included as a consequential amendment to IFRS 3). For example, upon transition to the new lease accounting requirements under this ED, would an entity continue to account for favourable/unfavorable lease intangibles previously recorded under IFRS 3 / ASC 805,
Business Combinations, or would such intangibles be subsumed into the right-of-use assets/lease payments liability that will be established upon adoption of the new lease standard?

- Under the proposed transition guidance, retrospective adoption would be likely to lead to changes in the carrying values of cash generating units for the prior comparable periods for purposes of IAS 36 / ASC 360 Impairment testing (and for the purposes of US GAAP, reporting units for purposes of ASC 350 goodwill impairment testing). The new carrying values may be higher or lower than those used in impairment tests in prior periods. Would the impairment tests have to be revised and potentially additional impairment recorded for those prior years?

- Unless the SEC provides transition relief as it did with the adoption of FSP APB-14, many public companies will have to retrospectively restate five years of history for purposes of complying with Regulation S-K Item 301, the selected financial data table. If a full five year restatement is required, would it be appropriate for these companies to use their incremental borrowing rate as of the first day of the five year period and apply it to all leases outstanding as of the adoption date, even though not all of these years are presented in the comparative financial statements of the registrant?

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?

Although we agree that the proposals have the potential to enhance the quality of financial reporting, we are not convinced that the benefits of the proposals as drafted would outweigh the costs of compliance. However, our principal concerns are in respect of the determination of the lease term and lease payments (see our responses to questions 8 and 9 above) and, if our suggestions were reflected in a final standard, we believe that it would be more practical and operational. However, as noted in our introductory letter, the proposals represent a significant change in practice that will be very burdensome in terms of time and expense for some entities to comply with; we note the comments from some preparers set out in paragraph BC203. We suggest that the Boards consider whether there are any other aspects of the proposals that could also be simplified.
Other comments

Question 18

Do you have any other comments on the proposals?

We have the following additional observations:

Impairment Testing

We believe clarification is needed regarding the impairment testing of the right-of-use asset and right to receive lease payments:

- Should the right-of-use asset and right-to-receive lease payments be evaluated for impairment separately or as part of a group of long-lived assets (for example, as part of the long-lived assets of a retail outlet)?

- The guidance in paragraph 19 (for lessees) and paragraphs 40 and 57 (for lessors) indicates that the discount rate used to estimate the present value of lease payments (and the associated right-of-use asset and the right-to-receive lease payments) should be estimated at inception and is generally not reassessed after that. When estimating fair value for the purposes of impairment testing of the right-of-use asset and the right-to-receive lease payments, generally prevailing rates should be used, which seems to contradict the guidance in the ED. Further guidance would be helpful.

- Given that fair value must be determined from a market place perspective, but the right-of-use asset and right-to-receive lease payments is estimated based on entity specific assumptions, should all the inputs and assumptions (for example, the currently estimated lease term, estimated lease payment amounts) used in recording the right-of-use asset be the same as the inputs used for purposes of determining fair value for impairment testing?

Interaction of ASC 420 (SFAS 146) (contract termination and accrual of liability) and paragraph 17 of the ED

Requirements for the reassessment of lease liabilities are included at paragraph 17 of the ED. It is not clear how these requirements link to those of ASC 420; specifically, ASC 420-10-30-8 requires that in determining the fair value of the liability for terminated lease contracts, an entity considers ‘sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease’.

Early termination fees

It would be helpful to include guidance covering how a lessee would account for termination fees that it would receive from a lessor in respect of the early termination of a lease or as compensation for the lessee not extending a lease where that extension is made available to the lessee by a country’s laws or regulations. Questions which arise include:

- Would early termination fees be built into a lessee’s assessment of the longest lease term that is more likely than not to occur?
• How would the termination fees be accounted for? Would this be as other income in the period in which the termination occurs (on the basis that the termination is not within the control of the lessee) or would it be included in the estimate of the obligation to make lease payments?
• Would lessor accounting mirror the accounting requirements for lessees?

Question 19

Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

We see no reason why the accounting guidance should be different for private entities. However, not-for-profit organisations often enter into leases which involve peppercorn rentals or rentals at non-commercial terms. In such cases, it could be argued that the proposals would give rise to a lease liability and associated asset of artificially low amounts. Consideration might be given, where leases are not at market rates, to require recognition of the asset at its fair value, with the difference between that fair value and the present value of the lease obligation being recognised in income.

As noted in our response to question 15, we believe that further consideration should be given to whether all of the proposed disclosure requirements are necessary. As an extension to this review, consideration should also be given to whether certain of the disclosures included in a final standard based on the proposals are geared towards listed entities and are less relevant for non-public entities.