Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
  
23 December 2010  
  
Via email: comment letters@iasb.org  
  
Dear Sir David  
  
EXPOSURE DRAFT ED/2010/9: LEASES  
  
BT Group plc welcomes the opportunity to comment on the Exposure Draft ‘Leases’ (‘the ED’). Our main activities are the provision of fixed telephony lines, broadband, mobile and TV products and services as well as networked IT services. In the UK we are the largest communication services provider, serving the consumer, business and public sector markets. Globally, we supply networked IT services to multinational corporations, domestic businesses and government departments. We also provide access to our network and services to more than 1,000 communications providers in the UK and others worldwide.  
  
We support efforts of the IASB to improve the current standard on accounting for leases. We believe that any revised leasing standard should meet the key objectives set out by the IASB in their invitation to comment, being reducing complexity, enabling increased comparability and providing relevant information for users of accounts. However we do not believe these proposals meet these objectives. In our view, the proposed model for lease accounting will not substantially enhance the quality and usefulness of financial information provided to the different user groups of the financial statements. Our primary concerns summarised below and set out in more detail in the Appendix to this letter.  
  
Complexity and comparability  
The ED seeks to reduce complexity and increase comparability of financial statements for users. However, given the large number of judgements and estimates to determine the value of the lease obligation, it may achieve the opposite effect. The ED requires significant judgements and estimates to be made including the lessee’s incremental borrowing rate; the expected lease term and estimates of contingent payments. In our view, the significant number of judgements required will increase the complexity of both preparing and understanding the financial statements and therefore reduce comparability for users.  
  
Furthermore, we are concerned that the income statement impact of leases will not be readily understood by users, nor will it reflect the underlying financial performance or position of an entity. This could lead to an increase in non-GAAP measures being presented in the financial statements to allow users to compare results with similarly adjusted measures of other companies. This would seem to defeat the objective of the revised standard.  
  
The measurement of the liability is inconsistent with the definition of a liability  
The inclusion of factors such as renewal options and contingent rent in calculating a lease obligation does not meet the definition of a liability since there is no existing present obligation for settlement of future contingent outcomes. The inclusion of the ‘largest possible lease length more likely than not to occur’ will result in companies recognising liabilities for amounts over and above their contractual obligation. We believe that the lease term should be limited to the minimum lease term, with the option to extend only recognised when it is considered ‘reasonably certain’ that the lease will be extended.
Lack of consistent approach between lessees and lessors
The proposed standard does not provide a consistent approach between lessee and lessor accounting. The lessee approach is based on control of the assets where the lessor approach is based on risks and rewards. This could result in two entities recognising the same asset in their individual financial statements. Furthermore, the use of the risks and rewards model is potentially inconsistent with the control based recognition principles of the draft revenue recognition standard. We believe the IASB should spend additional time considering the consistency between both lessee and lessor accounting and the accounting proposed by the draft revenue recognition standard.

Sale and leaseback transactions
We believe that the guidance on sale and leaseback transactions is not sufficient to define clearly when a sale occurs and could result in inconsistency with the new revenue recognition standard. The guidance appears to apply a higher hurdle for the sale of assets, which are subsequently leased, than other assets being sold. We believe the definition of a sale should be consistent across accounting standards.

The boundary between leases, sale/purchase and services contracts is not sufficiently robust
We disagree with the adoption of a fundamental change to lease accounting without fully deliberating arrangements that might be similar to leases. The impact on profit or loss, on the statement of financial position and on the statement of cash flows under the proposed lease accounting model might be fundamentally different to the accounting for sale, licensing or service arrangements. In particular, the boundary between leases (particularly those that are currently accounted for as operating leases) and service arrangements is difficult to determine. We are not convinced that the proposed criteria carried over from IFRIC 4 provide the necessary robust and operational distinction to determine (the possibly very different) accounting treatment.

Exclusion of intangible assets from the scope of the ED
We do not believe that it is acceptable to change to a new lease accounting model that is based on the rights to use an asset and thereby excluding intangible assets from the scope of the ED by stating that accounting for intangible assets (after the leasing project) would be considered more broadly. The exclusion of intangible assets from the scope of the ED could result in different accounting for transactions with similar economic substance.

Lack of relief for short-term leases
We are concerned that the proposals will be both onerous and costly to implement in relation to short-term leases. We do not agree that the proposals in the ED represent any significant level of relief to preparers as the main burden of applying the proposed model is the cost of identifying and tracking a large number of expected lease payments, rather than the cost of discounting those lease payments.

Cost benefit analysis
We are concerned that insufficient work has been done to collect information about the costs and benefits of the proposed requirements. We believe that the costs for preparers on implementation and ongoing application are likely to exceed the benefits for users. In order to meet the requirements, every lease or contract that may contain a lease will need to be reviewed which will result in significant management time and cost. Furthermore, this cost will continue throughout the term of the leases due to the requirement to revisit assumptions on lease payment, term and contingent rentals. The inclusion of non-core and short-term assets will increase the administrative burden considerably, especially when the difference between leases and service contracts is unclear.
Transitional provisions
We believe further thought needs to be given to transitional provisions. In particular:

- The transitional provisions will result in a higher impact to the income statement in the early years of adoption than would be the case with retrospective adoption.
- There are no transitional provisions for sale and leaseback transactions and hence it is unclear whether assets current lease and previously owned would be simply treated as leased assets or whether consideration will be required as to whether the original sale and leaseback would meet the definition provided in the ED.
- It is also unclear what treatment will be applied to current onerous lease provisions and the treatment of right-to-use assets relating to leases considered onerous.

In summary, we do not believe that the proposals represent an improvement in financial reporting and are concerned that the timetable the Board is working to will not allow for the development of a high quality standard. If the IASB does decide to continue to develop the right-to-use model, we strongly believe that any revised accounting standard should be represented as an ED and a further comment period permitted. Our detailed responses to the ED's questions are included in the Appendix to this letter.

Yours sincerely

GLYN PARRY
Director, Group Financial Control
BT Group PLC
## 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?

1(a)

Whilst we understand the recognition of a right-to-use asset is attractive in principle, we do not believe it is practical to apply. In addition, we are not convinced that the definitions of assets and liabilities are met for elements of more complex lease arrangements. We have raised a number of concerns about certain aspects of the model in our responses below, in particular to question 8 (lease term), question 9 (lease payments) and question 10 (reassessment) but should note that, even if these areas are addressed, significant practicality issues remain.

We also disagree with the adoption of a fundamental change to lease accounting without fully deliberating arrangements that might be similar to leases. The impact on profit or loss, on the statement of financial position and on the statement of cash flows under the proposed lease accounting model might be fundamentally different to the accounting for sale, licensing or service arrangements. For example the boundary between leases (particularly those that are currently accounted for as operating leases) and service arrangements is difficult to determine. We are not convinced that the proposed criteria carried over from IFRIC 4 provide the necessary robust and operational distinction to determine (the possibly very different) accounting treatment.

Furthermore in our opinion it is not acceptable to change to a new lease accounting model that is based on the rights to use an asset and thereby excluding intangible assets from the scope of the ED by stating that accounting for intangible assets (after the leasing project) would be considered more broadly. The exclusion of intangible assets from the scope of the ED could result in different accounting for transactions with similar economic substance.

1(b)

While we agree that this approach is consistent with the right-of-use model, we do have concerns about the implications of replacing rental expense for leases currently classified as operating leases with a combination of amortisation and interest expense. For many leases, the total lease expense recognised (i.e. the sum of interest expense and amortisation) will be higher in earlier periods of a lease and lower in later periods. The ED’s proposal to require a simplified retrospective approach exacerbates this front loading issue by effectively treating all leases in place at the initial application date as if they were new leases, whereas in practice most lease portfolios contain leases in different stages of their life cycle. This concern is addressed in more detail in our response to question 16.
Question 2 - Lessors

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

We do not agree with the proposed hybrid approach to lessor accounting. We agree that a lessor's right to receive rentals under a lease meets the definition of an asset and support having a single approach to lessor accounting being the derecognition approach. In our view, the derecognition approach is consistent with the substance of a leasing arrangement whereby the lessor's asset is no longer the whole leased item but is the portion of the leased item remaining after the lessee's use thereof. This approach is also consistent with the lessee accounting model because the lessor must have transferred an asset in order for the lessee to have acquired an asset from the lessor.

We do not support the use of the performance obligation approach. We are particularly concerned that the performance obligation approach creates for the lessor an asset to receive rentals while at the same time retaining the leased asset in property, plant and equipment. This results in two assets being recognised for one economic resource. Moreover, the effect is that the same asset is capitalised by both lessee and lessor.

Question 3 – Short term leases

The ED 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 are concerned that the proposals will be both onerous and costly to implement. We do not agree that the proposals in the ED represent any significant level of relief to preparers as the main burden of applying the proposed model is the cost of identifying and tracking a large number of expected lease payments, rather than the cost of discounting those lease payments. Also, the application of the accounting model for lessees may prove complex, especially when the contract includes contingent rentals.

We agree that short-term leases are not inherently different from other leases. However, we believe that the proposed approach for lessors should also apply to lessees which would mean it would not be necessary for the lessee to recognise asset and liabilities for short terms leases. In addition, we consider that the lease term should be limited to the non-cancellable lease term and that optional lease periods and contingent rentals should be recognised only when those options and contingencies are outside the control of the lessee or lessor.

We believe that the above approach should provide sufficient relief from the ED's proposals in those circumstances where the application of those proposals would be onerous.

**Question 4 – Definition of a lease**

(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??

Whilst we note the definition of a lease which is 'a contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration' is largely unchanged from IAS 17, in our view there is insufficient guidance on the definitions of a service contract and sale/purchase contract and clarification as to the nature of the boundaries between lease contracts, sale/purchase contracts and service contracts.

The ED identifies sale/purchase contracts as those that transfer 'control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset'. We are concerned that 'all but a trivial amount' is not clearly defined. Unless this is clarified, it could be interpreted inconsistently. We are also concerned that these proposals are inconsistent with the revenue recognition proposals which only require the transfer of control as a condition to recognise a sale. A preferable approach would be for the leasing proposals to be consistent with the revenue recognition proposals so that if a contract meets the definition of a sale under the revenue recognition proposals, it should also be classified as a sale under the leasing proposals without additional reference to risks and benefits.

We are not convinced that the criteria which have effectively been carried forward from IFRIC 4 provides a clear distinction between leases and service contracts. The focus of the criteria is on the physical delivery or access to the asset, rather than focusing on the rationale for the transaction.
We believe that a key feature is whether the asset used is easily exchangeable or replaceable by another that can provide substantially the same level of service. When transactions involve the use of non-specialised assets, those transactions are more likely to be entered into by the customer to obtain a service rather than the right to use the underlying asset. Such an asset is an unavoidable necessity rather than something the customer sets out to acquire. Furthermore, we believe the ability of the supplier to replace the assets and continue providing the same level of service demonstrates whether the customer is interested in the asset or the service which is being provided through the use of an asset. In this context it is irrelevant that the supplier may not have a practice of replacing the assets.

Therefore, where the lessee is mainly interested in receiving a service, and is indifferent to the asset used, we believe the transaction should be treated as a service arrangement.

**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 consider that there is no reason to exclude intangible assets from the scope of the ED. Contracts may often include elements of intangible and tangible assets, particularly in relation to the IT services industry where software and hardware components may be included in the same contract. The exclusion of intangible assets from the scope of the ED could result in different accounting for transactions with similar economic substance.

**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, B6-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 that the lessee and lessor should apply the lease accounting requirements to the combined contract.

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

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?
We believe that service components should be accounted for separately from lease components and that they should be required to be separated and account for each portion under the appropriate standards. However, if an entity is unable to make a reliable apportionment, the entity should be required to determine whether the contract is predominately a lease contract or predominately a service contract and then apply to the whole contract the relevant standard (i.e., the proposed revenue standard or the proposed leasing standard).

**Question 7 – Purchase options**

The exposure draft proposes that a contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract is accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraph 8 and 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 see no valid reason to treat options to purchase and options to extend a lease differently and are concerned that the proposals regarding purchase options result in very different accounting for scenarios that are similar. Under the proposals, the presence of a bargain purchase option results in treating the arrangement as a purchase; but when the option is not considered a bargain purchase option, then it is to be ignored until it is exercised. This difference in treatment is likely to give rise to application issues.

Therefore, we disagree with the proposal that options to purchase should be ignored until they are exercised. We believe that they should be separately recognised and measured using the same approach with options to extend as set out in our response to question 8—only when they are reasonably certain of being exercised.

**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 to include amounts under renewal options in the measurement of the lease payable and receivable. The lessee does not have an unconditional obligation to pay rentals during an optional lease extension period unless the option is exercised. Similarly, the lessor has neither an unconditional right to receive these payments nor control over them until the lessee exercises its options. Therefore, we believe a lessee or lessor should not recognise an asset or liability relating to renewal options as they do not meet the definitions as set out in the Conceptual Framework.

We suggest that the lease term should be limited to the minimum lease term, with the option to extend only recognised when it is considered 'reasonably certain' that the lease will be extended, which is consistent with the approach currently set out in IAS 17.

The Board's proposals include narrative disclosures about optional lease periods. We believe that the above approach alongside such disclosures will provide more useful information for the users of the financial statements than the recognition of overstated assets and liabilities associated with optional lease periods.
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 avoidable contingent rentals (for example, those that are revenue based), term option penalties and residual value guarantees should be included within the estimate of lease payments when measuring the lease liability and right-of-use asset at inception, as it requires an entity to measure an obligation which is has not yet incurred and which it can avoid through its own actions.

We believe the current treatment should be continued whereby contingent rentals are only recognised when incurred, supplemented by additional explanatory disclosure in the notes to the financial statements where such amounts are material. Term option penalties and residual value guarantees should only be provided for when it is probable they will be incurred and their value can be measured reliably, similar to the proposed recognition criteria for lessors.

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?

As mentioned in our responses to questions 8 and 9 above, we do not support the proposal that options to extend the lease term and contingent rentals based on performance or usage are included in the measurement of lease receivables and payables as proposed by the ED.

However, if the IASB were to proceed with this proposal, then we believe that requiring a periodic reassessment could be extremely onerous. Therefore, we support the proposal that reassessment should only be carried out in the limited circumstances where there is a significant change. However we are concerned that the process of determining whether a reassessment is required will be a matter of considerable judgement. In particular, we are concerned that ‘significant change’ is not clearly defined and could therefore be interpreted inconsistently in practice.

In particular, we are also concerned that the only effective way to determine whether a change in facts or circumstances will have a significant impact will be to undertake detailed calculations, which may ultimately prove to be of little benefit. A reassessment may involve
a significant amount of work, especially if a large number of leases are affected by similar factors. In such circumstances, we would suggest that the reassessment can be undertaken on a portfolio basis. In some cases this may be the only feasible way of implementing the proposed requirements.

We agree that where the impact of changes to lessees’ estimates of contingent rentals from current or prior periods, they should be recorded in the income statement and where they relate to future periods, they should be recorded as an adjustment to the carrying amount of the right-of-use asset.

For lessors, they should apply the derecognition approach in all cases, and we agree that the impact of changes to estimates of contingent rentals should be recorded in the income statement.

If lease extension options are only be taken into account when ‘reasonably certain’ to be exercised, we believe that changes in estimates of lease term will be rare. However, where they do occur we agree with the Board’s view that the impact should be adjusted to the lessee’s right-of-use asset and to the lessor’s residual asset in the manner proposed.

**Question 11 – Sale and lease back**

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?

As noted in our response to question 4, we believe that additional clarification is required of the distinction between sale/purchase agreement and lease contracts. We do not believe that there should be a higher threshold applied to sale and leaseback transactions when determining whether a sale has taken place (as described in paragraph B31) as compared to a sale with separate lease transactions. Consistent with our response to that question, we believe that sale and leaseback accounting should only result in a sale if the criteria within the proposed revenue recognition standard are met.

We also believe there is a need for additional guidance on the transition provisions for sale and leaseback transactions. It is unclear from the transition requirements how sale and leaseback transactions previously entered into would be accounted for at the date of initial application and whether a reassessment of the transaction under the proposed criteria would be needed.

**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?

12(a)
We do not believe that a lessee’s obligation to pay rentals should always be presented separately on the face of the statement of financial position. We would prefer disclosures to be in the notes to avoid the primary statements becoming too cluttered.

We believe that the right-of-use asset should be presented according to the nature of the underlying leased item, that is, included within property, plant and equipment or investment properties rather than a separate intangible. Again, mandatory disclosure on the face of the statement of financial position is not considered necessary. Leased and owned items can be separately disclosed in the notes.

12(b)
We do not support the performance obligation approach, but support the de-recognition approach. However, if the Board decides to proceed with allowing both approaches, a lessor applying the performance obligation approach should present on the net amount on the face of the statement of financial position and the gross amounts in the notes to the financial statements.

12 (c)
A lessor applying the derecognition approach should, on the face of its statement of financial position, present all financial assets and property, plant and equipment together with other items which are similar in nature. Only in the notes to the financial statements should the lessor disclose rights to receive lease payments separately from other financial assets and residual assets separately within property, plant and equipment.

12 (d)
We agree that lessors should distinguish assets and liabilities that arise under a sublease. These balances arise from arrangements with different counterparties and should not automatically be offset. However, distinguishing these assets need not be on the face of the statement of financial position, but could be included within totals of similar assets and liabilities and the detailed composition disclosures in the notes to the financial statements.
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, and 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 do not agree that for lessees the amortisation of the right-to-use asset and interest expense should be disclosed separately in the statement of comprehensive income as they are not distinct from other types of amortisation and interest at that level. We would prefer disclosures generally to be in the notes instead unless separate presentation is relevant to an understanding of the entity’s financial performance.

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 are concerned about the requirement to classify lessee cash flows as financing cash flows. In practice entities enter into leases for many reasons, sometimes as an alternative source of finance and sometimes for operational reasons. We believe, therefore, that it should be the decision of the entity where the cash flows from leases reside. The proposed approach in the ED also contradicts the approach for lessors where by all cash flows are assumed to be operating in nature. Where an entity sub-leases an asset it is unclear whether the cash flows should be presented gross or net or within operating or financing.

We agree cash flow from leases could be shown separately on the cash flow statement. However, with this approach there is a risk that the primary statements could become too cluttered with important information being obscured. Therefore, consistent with our response to questions 12 and 13 above, our preference would be to include a complete and concise disclosure note to the financial statements covering all leasing activities. We believe this would provide users with far more meaningful and understandable information than would the separate disclosure of lease related amounts throughout the financial statements and notes.

Question 15 - Disclosure

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

(a) identifies and explains the amounts recognised in the financial statements arising from leases; and

(b) describes how leases may affect the amount, timing and uncertainty of the entity’s future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

We agree with the disclosure principles set out above. However, we consider it imperative that the disclosure requirements do not become so detailed that significant issues or material items are obscured, or that financial statements become so complex that the vast majority of users are unable to understand them.
As noted above, we do not agree with the proposed presentation of an asset and liability in relation to all leases (specifically short term leases). Hence we do not agree with the proposed disclosures in the ED. In particular, we are concerned that the disclosure of detailed reconciliations (in paragraphs 77 and 80 of the ED) may require voluminous and detailed disclosure. We would recommend that the Board clearly states that all of the disclosures listed should not be regarded as mandatory in all situations. If the intention is that they must be disclosed in all instances we would not support the inclusion of such voluminous requirements.

In addition, some of the disclosure requirements reflect the existence of a hybrid model for lessors or diverging recognition requirements for different options. As mentioned above, we do not support a hybrid model or a different treatment of options.

**Question 16 - Transition**

a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

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 that mandatory full retrospective application would be too onerous in many cases and we therefore agree that some simplified transitional arrangements are necessary.

However, what the Board is proposing is not a suitable solution and we share the concerns raised in the alternative view; the proposed approach will lead to a misleading reduction in lessees’ profits on transition and increased profit growth in subsequent periods with the opposite effect for lessors.

In common with the alternative view, we believe other transitional provisions should be considered for both lessees and lessors. Full retrospective application should be permitted or the transitional provisions adjusted so that the right-of-use asset is not necessarily set equal to the transition liability, but instead takes account of the impact of the remaining lease term compared to the original lease period.

**Question 17 – Benefits and costs**

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?

We are concerned that insufficient work has been done to collect information about the costs and benefits of the proposed requirements. We believe that the costs for preparers on implementation and ongoing application are likely to exceed the benefits for users. Some of the significant costs incurred by preparers may include: additional resource to revisit key assumptions each financial period and to calculate the impact of any changes, in addition to extra resource required to implement the initial changes, incremental accounting systems costs and time incurred to educate prepares and users of an entity’s financial statements.
The recent announcement from the UK tax authority (HMRC) that the distinction between finance and operating leases will continue to be relevant for tax purposes will further add to the burden of the change in accounting on preparers as they will be required to maintain parallel sets of accounts for tax and accounting purposes.

Although some of the costs arising from the proposals would be reduced if our suggestions relating to renewal options, contingent rentals and short-term leases were incorporated into any new standard, we also believe that the IASB should undertake further work to ensure that the benefits of the proposals do not outweigh costs.

**Question 18 – Other comments**

**Do you have any other comments on the proposals?**

*Foreign exchange impacts*

We are concerned that if an entity’s leases are denominated in a foreign currency, the ED may create a significant accounting mismatch between the right-of-use asset (which is unlikely to be restated for exchange rate movements) and the obligations to pay rentals (which is likely to be restated for movements in exchange rates). It is unclear whether, under the ED, the obligation to pay rentals is considered a monetary liability and therefore should be restated for movements in exchange rates. We believe this would be the case. In contrast, the right-of-use asset being a non monetary asset, would we believe be denominated in the entity’s functional currency and therefore would not be restated for changes in exchange rates subsequent to the inception of the lease.

*Discount rate*

The discount rate which the ED requires entities to apply to calculate the present value of lease payments is extremely onerous. Entities could use different rates for leases in different countries, different group entities and over different periods. We recommend that additional guidance is provided on how to calculate discount rates and allow a standard discount rate (eg the group weighted average cost of capital) to be used. This would reduce the administrative burden imposed on preparers, as well as improving comparability across companies for users of accounts.