IASB
30 Cannon Street
London EC4M 6XH
United Kingdom

22 December 2010

Dear Sir or Madam,

Re: Exposure Draft Leases

We are pleased to take this opportunity to respond to the exposure draft Leases (the ED).

Some members of BUSINESSEUROPE are not convinced that a change in lease accounting is necessary, either for lessees or lessors. They believe in particular that the current requirements for lessor accounting in IFRS work well and the disruption that a change in these will cause should be avoided. Furthermore, the perceived problems of the abuse of accounting on the lessee side could be largely resolved by the elimination of the use of "bright lines" and the addition of enhanced disclosures. However, it is accepted that there is a fairly widespread wish to change the lessees’ accounting for current operating leases and so our response to this ED is intended to help the IASB produce a standard of high quality. BusinessEurope would like to emphasize that the priority should be to ensure that the resulting standard is of high quality and that the wish to meet a deadline for publication must not be allowed to hamper this objective.

Our discussions with users indicate that although they would prefer to see more of today's operating leases on the balance sheet, the amounts reported on the balance sheet do not provide them with much information of use to them. They tell us that whatever the method used to account for leases they will always require further information in the form of disclosures in order carry out their analyses. The basic information which they require as a starting-point is the minimum committed cash flows. They do not find probability-weighted amounts useful. In view of these comments from users, we query whether the sophisticated and onerous models that the ED proposes represent the best compromise between cost to the preparer and user and benefit to the user.

Taking into account what users have told us and our own analysis, we agree with the alternative view of Mr. S. Cooper that the amounts included in the expected lease payments should be the minimum committed amounts. Optional rental periods should not be included on the basis of probability-weighted estimates and contingent rentals.
varying with usage or performance should not be included in the expected lease payments. If the Board were to persist with its proposals in this area, then we would urge it to require a “most likely amount” approach, as the expected outcome approach is very onerous for preparers and will always provide an outcome which does not actually occur. Disclosure is critical to analysts in this area.

We do not agree with the approach to finance leases/in-substance purchases, which consists in defining them and then scoping them out of the standard. This will lead, in our opinion, to divergent interpretation of what the initial value of such assets should be, and how to account for such assets if the bargain-purchase option becomes unlikely to be exercised because of changes in the economic conditions. The accounting for all leases should be specified in ED not scoped out.

In our view the successful application of this proposed standard is dependent upon a clear definition of a lease. We are concerned that the notion of the “specified asset”, which is one of the fundamental elements in the definition of a lease, is not itself a defined term and that paragraphs B2 and B3 of the application guidance which endeavour to explain what the term means are very confusing. We think that it is essential to decide what the specified asset is intended to be and then to name it and define it with absolute clarity.

Finally, we do not think that it is helpful to impose two different models for lessors as we think that the criteria for choosing between the two approaches are difficult to articulate clearly and this will result in inconsistent accounting between entities. There appears to have been little criticism of the single existing method for lessor accounting. We are not in favour of the performance obligation method because of its inconsistency with the lessee’s right-of-use model, its cumbersome presentation and the difficulty of applying a suitable impairment test. This should be abandoned and a single pragmatic approach developed for arrangements which are not in-substance sales or financing from the lessor’s standpoint.

Should you wish to have any supplementary comments or explanation, please do not hesitate to contact us.

Yours sincerely,

Jérôme P. Chauvin
Director
Legal Affairs Department
Internal Market Department
APPENDIX: ANSWERS TO THE SPECIFIC QUESTIONS RAISED IN THE INVITATION FOR COMMENTS ON THE ED LEASES

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?

(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 deal with Questions 1 and 2 together. Please see below.

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 deal with these two questions together as we think there should be symmetry in the categorization of the leases and expect that the lessor and the lessee will have a similar view of the economic purpose of each of these types. However, this does not mean that the lessor’s and lessee’s accounting for each type of arrangement will always be a perfect mirror-image.

We think that the distinction in the existing standard between operating leases and finance leases recognises that different types of lease have different economic purposes and that it is appropriate that the accounting reflects this. Having said that, current IAS 17 fails to identify a third major category of lease - the lease which is in essence a contract for the provision of a service. There are three broad categories of lease in our view:

(a) Leases intended to provide finance for the purchase of an asset (in-substance purchase);
(b) Leases intended to provide access to the use of an asset while providing flexibility about the term or the intensity of the usage (called rentals below for simplicity); and

(c) Contracts primarily intended to obtain a service where the underlying asset is just a part of the supplier’s process (service).

We would make the following distinction between in-substance purchases and rentals:

- Rentals are not financing arrangements. Lessees are not purchasing the underlying assets but are buying flexibility and the service which consists in being provided with the use of the asset they need for the period that best suits their needs. The lessor is the provider of that service.

- Lease contracts for the use of assets for substantially all their useful life or where ownership is intended to pass to the lessee at some point are financing arrangements for the purchase of an asset. These are in-substance purchases and should be shown as an asset purchase with financing. The lessor is the provider of financing.

We are not sure that the Board has drawn the appropriate conclusions from its analysis of the needs of users or that the intended differences in economic purpose and substance between in-substance purchases and rentals are sufficiently recognised in the proposals.

One of the objectives of financial reporting is to facilitate comparability. In our view, this means that the accounting should show different economic substances differently and not make different substances appear to be the same. It is important to show users that entities do have different business models if they are different. We are not sure that the proposals will achieve this, principally as a result of the way that the ED deals with uncommitted future lease renewals and terminations, and contingent rents, residual value guarantees and term option penalties. The use of the expected outcome approach as defined in the ED will, in our view, tend to blur the real economic differences between leases which have different purposes and present them as though they are the same.

In respect of the needs of users, our discussions with some users has indicated that, whatever the accounting required, the users will always require additional disclosures to enable them to model different scenarios and cash-flow impacts. Some of our members wonder therefore to what extent the accounting for leases, particularly on the lessor side where current accounting under IAS 17 appears well accepted, really needs to be changed. Perhaps it is disclosures focused on the users’ needs that are actually required.

However, other members of BusinessEurope agree that non-cancellable commitments to use an asset on an exclusive basis for a specified period of time do represent an arrangement which should be recognised on a balance sheet, and to that extent accept the need for a change in lessee accounting. If the Board pursues its proposals, we would suggest that a number of changes that could be made to improve the general
understanding of the principles of the models and to enhance the practicality of its application.

We think that the finance lease model of IAS 17 deals appropriately with the in-substance purchase from the point of view of the lessee and the lessor, in that the former recognizes the entire asset and the financing balance and the latter recognizes the investment in the lease and derecognizes the asset.

In contrast, the ED identifies and then surprisingly scopes out the more straightforward transactions of this type (those where control passes or is reasonably certain to pass by the end of the lease term), without specifying the accounting to be applied (such as, is the value of initial recognition the present value of the payments or the fair value?). We think that it is important not to scope out purchases and sales lease transactions, but rather to define them carefully and to specify fully the appropriate accounting in the proposed standard. If this is not done, there will be divergence in the way other IFRSs are applied to those items. For example, if IAS 16 applies, there will be different interpretations of what the cost of the purchased asset should be – the present value of the payments or fair value, as mentioned above, or perhaps some other value.

The ED specifies for the remaining leases in the current IAS 17 finance-lease category one approach (right of use) for lessees and two approaches (performance obligation or partial derecognition) for lessors. The single approach for the lessee and the hybrid approach on the lessor side are also retained for the entire rental category, including short-term rentals.

While we recognise that there is conceptual merit in the use of the right-of-use model for the lessee, we think that its extension to short-term rentals is not appropriate. It provides information of poor value, as it makes no distinction between rentals of items which represent no long-term commitment (short-term leases or leases cancellable at short notice, typically three to six months) and which are used to provide flexibility, and rentals of assets for a longer committed term. It also makes no distinction in the long-term rentals between rentals of assets which are fundamental to the lessee’s business and over which the lessee does need to maintain close management control, and those which are ancillary (but still necessary) to the activities but which the lessee can outsource in order to maintain flexibility.

We do not accept the argument that all rentals have to be captured on the balance sheet to prevent lessees from structuring their transactions in such a way as to avoid capitalisation. In our view this is not a valid argument as in practice lessors do not readily agree to let such assets as factories, warehouses, retail stores and other infrastructure assets for such a short period as one year as this would expose them to the risk of being left at short notice with investments which are not generating revenue.

We think that use of this right-of-use model by the lessee has some logical implications for the lessor, in that it precludes the use of the performance model by the lessor. Recognition of the lessee’s right of use for the whole of the term along with the corresponding liability implies that the lessee has an unconditional right and obligation, and that the lessor has therefore delivered the whole of what was promised for the lease term. It therefore appears inconsistent to recognise at the same time the lessor’s obligation to deliver to the lessee as though nothing has been delivered. However, the
lessee does have an unconditional right to the payments that result from having satisfied that obligation to provide the asset.

Distinguishing between the two approaches relies on guidance which is not limpidly clear and will require much judgment and inevitably be arbitrary in many cases. We think that the proposals will be difficult to apply on the lessee side and will lead to divergent interpretation and application.

In order to avoid the complexity of having to distinguish between two approaches for the lessee, we would recommend the use of a single, partial derecognition approach with the retention on the balance sheet of a residual asset representing the risks and benefits that the lessee retains.

We think that the performance obligation has a number of flaws and should be abandoned. Although we believe the partial derecognition approach is superior, we are not sure that the ED’s proposal is completely satisfactory as yet and think it needs further refinement. We would urge the IASB to take the time necessary to produce a consistent standard of high quality for both lessees and lessors rather than to focus on the arbitrary deadline of the end of June 2011. The models should be thoroughly field-tested to ensure that they are robust, durable and practical before they are introduced.

The final category of lease listed above, services, involves the use of equipment but the real purpose of the entity’s entering into such a contract is to obtain service or a product, not to obtain control of an asset. The difficulty here is to identify the cut-off point in a range between a lease where the right of use should be recognised from a service where only the obligation for service received should be recognised. This category could cover photocopiers with a maintenance service, a completely outsourced reproduction service, the use of a liveried fleet of supplier-maintained delivery vehicles or the sub-contracting of deliveries to a supplier-owned and –operated fleet of vehicles bearing the entity’s colours. We think that all of these could be categorised as services, but much depends upon the interpretation of the ED’s definition of a lease and the guidance in B2 to B4.

Question 3: Short-term leases

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

(a) at the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).
(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).

(See also paragraphs BC41–BC46.)

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 think that the major effort for a lessee is to gather the information about the future lease payments. The effect of discounting over a period of twelve months or less will generally be negligible and would probably be ignored on grounds of lack of materiality anyway. We think that the option given for lessees will therefore actually provide very little relief, if any at all.

In contrast, the option proposed to lessors does represent a real simplification. We agree with this proposal and recommend that the Board provides the same approach to lessees for two reasons: we see no conceptual grounds for differing approaches in respect of short-term leases between the lessees and the lessors, and we are not convinced that the grossing-up of the lessees' balance sheets in this way will provide useful information to users, whose principal concern with current accounting seems to be in respect of those of the entity's core assets which do not appear on the balance sheet because they are currently classified as operating leases.

Furthermore, where the lessee has the ability to cancel a rental of any length of term at very short notice (3-6 months) with no penalty, the recognition of a liability by the lessee or receivable by the lessor misrepresents the risks on both sides. Such arrangements mean that in effect there is no commitment to the rental and we think that these should be either scoped out of the future IFRS or included in scope with the requirement to show these on an accruals basis.

We think that the best and most practical approach to achieving comparability in the accounting for short-term leases for both lessees and lessors is to mandate the use of the "simplified", that is, accruals-accounting, approach for all. Providing an election for the "simplified" approach on a lease-by-lease basis to either lessees or lessors does not appears to be the best way to achieve comparability or a reduction in complexity. If the Board wishes, however, to continue with this proposal, it could, in our view, enhance clarity and comparability if it were to offer this as an accounting policy election for all such leases rather than on a lease-by-lease basis.
Definition of a lease

Question 4

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

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

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

(a) As mentioned in our response to Question 2 above, the scope of the ED relies to a large extent upon the definition of a lease. The proposed definition incorporates the essence of IFRIC 4 Determining whether an Arrangement contains a Lease but with the substitution of the word “specified” for the word “specific” used in that Interpretation.

Given the importance of the term “specified asset” to the definition of a lease and hence to the scope of the standard, we find it strange that there is no reference to paragraphs B1 to B4 in the body of the standard or in Appendix A.

This change of word from “specific” to “specified” is unfortunate as it has resulted in paragraphs B2 and, particularly, B3 being rather confusing. We think it would be helpful to revert to the word “specific” in the definition of a lease, or perhaps, even better, use a new term such as “designated asset” and then to define this term clearly. We find the following parts of these paragraphs B2 and B3 particularly unhelpful: “An asset is implicitly ‘specified’ if it is ....or (b) if a lessor can substitute another asset for the underlying asset but rarely does so in practice”, and “A contract that permits an entity to substitute a similar asset for the specified asset...does not contain a lease because the underlying asset is not specified, even if the contract explicitly identifies a specified asset”.

We think that the ability of the supplier to replace the asset easily and continue the provision of the service almost seamlessly could be a useful indicator as to whether the asset is specific (and therefore subject to a lease) or fungible (and therefore possibly part of a service contract).

We think that this area of the guidance is very confusing and needs to be completely redrafted to make consistent application possible. Before embarking on this, it is essential, in our view, that the Board first decides upon, and clearly articulates, the principle behind the future standard, that is, what are the types of arrangement which it is intended to capture in the scope of the ED.

(b) We do not think that the criteria included in paragraphs B9 and B10 are fully consistent with the wording of the scoping paragraph 8(a). The latter specifies “transferring control and all but a trivial amount of risks and benefits associated,”
implying that both criteria are independent but of equal standing and that both have to be met. However, paragraph B10 deals only with control as the criterion, and does not clearly express what the relevance of risks and benefits is to the identification of a purchase or sale transaction or provide guidance as to how to assess what a “trivial amount” of risks and benefits would be.

The notion of the control of the use of, or the control of the output of, the underlying asset is also used in the definition of the right of use, and it therefore seems that the future standard should clearly distinguish between the “control of the underlying asset” used to identify a purchase/sale transaction and control in the context of the right of use.

As a sale transaction would generally fall within the scope of the future revenue recognition standard, we think it is important that the criteria used to determine the boundary between the two future standards are fully consistent. We are not sure that this is the case at present, as the revenue accounting proposals are based on the transfer of control with no consideration of risks and benefits.

(c) As discussed above, we do not find the guidance in paragraphs B1 to B4 to be sufficiently clear in distinguishing lease contracts from service contracts.

Finally, we recognise that the correct identification of the type of arrangement that an individual contract could represent is not simple. We think that this task could be facilitated and the standard could be enhanced by the inclusion of a decision tree to guide entities through the various definitions and criteria involved.

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 note that the exclusion of intangible assets has been broadened to exclude all intangible assets from the scope of the leasing ED. It is unclear to us from the Basis for Conclusions why this has been done, and we can see no conceptual basis for this. If the Board intends to exclude all intangible assets, then we think guidance is needed in the revenue recognition standard to ensure that all arrangements including intangible assets are clearly covered. We think it is also important for it to be clear what the distinction is between rights-of-use assets and exclusive licence agreements and which standard applies to the accounting for these - the leases standard or the revenue recognition standard.
As a further aspect of the issue of scope, we think that the frontier between the leases standard and those arrangements covered by IFRIC 12 also needs to be clearly defined, as the accounting for similar assets could be very different depending upon the scope in which they fall.

Finally, as discussed in our responses to Questions 1, 2 and 7 we think that the lease contracts referred to in paragraph 8 as purchases or sales contracts should not be scoped out of the leasing standard as it is the leasing standard which provides the guidance necessary to identify these as such. Instead, in order to enhance clarity, we think that the leasing standard should provide clear guidance on how these contracts should be accounted for during the different stages of their economic lives.

**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?

In our view, the lessee should determine whether the contract is predominantly a contract for services or a lease and account for the whole arrangement on the basis of the predominant element. We see no useful information in accounting for an executory contract for services as a lease if the lease is only an incidental part of that arrangement. To do this, the entity should develop criteria for distinguishing service contracts from leases based upon its own business model and apply them consistently.

We think that the lessor will usually have information available to it to enable it to separate the service component from the lease component and should account for these separately.
Again, as suggested in our response to Question 4, a decision tree may help practitioners to arrive at the correct conclusions about the arrangements they are dealing with.

Question 7: Purchase options

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

We agree that the full effect on the statement of financial position or cash flow should be recognised only when the purchase option is exercised. We think that the ED is lacking in application guidance about the detail of the accounting for the exercise of the purchase option, and how to deal with the situation where a lease which has been treated as a purchase because of a bargain purchase option would no longer qualify as such because a change in economic conditions means that the contractual price is no longer a bargain price.

In order to ensure the highest degree of consistency and comparability between entities, the accounting for all in-substance purchases or finance leases should be scoped into the standard and the accounting for these specified in the lease standard.

In common with all options, the option itself should in principle be accounted for if it can be measured reliably and if would be material. However, we think that this will in most cases be impossible to do, and it would be a pragmatic solution just to disclose the options rather than to try to account for them.

Measurement

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

We agree with the alternative view of Mr. S. Cooper: renewal or cancellation options provide the lessee with the flexibility to reduce its exposure to risks and this should be reflected in accounting which differs from that of an entity which is firmly committed to a longer period.
In addition, the exercise of a renewal option is at the discretion of the lessee’s management. We do not think that a renewal option represents an obligating event, as the management does have a realistic alternative to renewal up to the time it irrevocably commits itself to renewal. It is thus a future commitment rather than a present obligation, as discussed in paragraph 61 of the Framework. As IAS 37.18 states, financial statements deal with the situation at the end of the reporting period, not with the possible position in the future. Indeed, under IAS 37 even a decision that the management has already taken to exercise may not be sufficient on its own for a liability to be recognised.

The lessor has no control over the amounts to be received during the period of the extension until the lessee exercises its option to renew. It is therefore difficult to see how these could qualify as assets until renewal is confirmed. Accounting for these as an asset before is in our view inappropriate.

We therefore do not agree with the inclusion of optional periods in the lease term until the options are exercised. However, such options do represent a material right, as described in the proposed revenue recognition standard, and we think that they could be dealt with using the approach of that proposed standard.

We think that the current definition of the lease term included in IAS 17 is still the most appropriate and useful requirement and should be carried over into the future standard. Where lease-term options exists and are not included in the measurement, their existence and nature should be disclosed.

If the Board were to continue with its proposal to include optional periods in the lease term, we would recommend that the “most likely” lease period be used for the lease term. We think that this provides more useful information than a measurement based on the “longest possible term that is more likely than not to occur”. We would recommend that the views of users be canvassed in order to confirm what information is the most useful to them.

**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?*

In a similar vein to our response on the lease term above, we do not think that an obligation for payments based on elements which are under the control of the lessee and depend on a future decision by its management can qualify as liabilities to be
recognised. This would include rentals which are contingent on future usage or performance of the asset. Such contingent items should be accounted for only when they have been incurred or payment is probable.

However, we agree that payments which are dependent on an element totally outside the control of the management, such as a retail prices or commodity price index, would qualify as unconditional obligations and should be included in the measurement of the obligation for lease payments, provided that they can be reliably estimated. A residual value guarantee is of a similar nature.

Consistently with our response to Question 8, when contingencies and variable elements are not included in the measurement, disclosure should be provided about their existence and nature.

We think that the "most likely" amount, rather than the probability-weighted average, provides the most useful information about future cash flows. The requirement for the use of the expected outcome will be a source of a significant burden for preparers and opaqueness for users.

Finally, although we do not agree with its use in this proposed standard, we find it curious that the notion of expected outcome, which is fundamental to the ED as it stands, is not included in the Defined Terms in Appendix A but rather buried in the text, for example, in paragraphs 52 and B21.

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 think that mandatory remeasurement on a periodic basis would be very onerous and therefore agree that this should not be required. We think that further guidance should be provided about how to put into practice the requirement to reassess "if facts and circumstances indicate that there would be a significant change in the liability". The extent of the effort required to search for the facts and circumstances could vary significantly according to the interpretation of this requirement. It may be useful therefore to provide some indicators as to when reassessment could be required, as are provided for impairment. Suitable indicators could be the actual exercise of options to renew, extend or terminate a lease.

In addition, much of the change in the lease liability would be generated by the ED’s inclusion of variable lease terms and payments in its measurement requirements. As indicated above, we do not agree with the proposals to include the effect of renewal options and certain contingent rentals in the measurement of the lease payables and
receivables. Under our preferred approach, and under a “most likely amount” approach, we would therefore expect the necessity to reassess to occur infrequently for most arrangements.

In the context of a reassessment of contingent rentals in the derecognition model, we do not understand why the whole of the effect of the change is taken to the result of the period. We think that some, if not all, of the effect of a change in the contingent rentals would also affect the value of the residual asset. The residual asset should therefore be remeasured to take this into account.

Sale and leaseback

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

We agree with the use of the general criteria of B9 and B10 for the identification of a sale or purchase in identifying a sale and leaseback transaction. However, we note that paragraph B31 contains a number of additional indicators which could be more restrictive than those of B9 – B10 and result in transactions not qualifying as a sale or purchase. It would be helpful if the Board were to indicate whether these should be considered only in the case of a sale and leaseback or whether they should also be considered in all potential sales and purchases.

We do not understand why only the performance obligation approach can be used by the transferee for the subsequeunt lease. We would expect the derecognition approach to be available to be used if the conditions of paragraphs 28 and 29 are satisfied. This needs to be better explained in the Basis for Conclusions.

We think that it would be very useful to provide an example of the accounting for a sale and lease-back in Appendix B.

Presentation

Question 12: Statement of financial position

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)?

Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?
(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

As a general comment, in our view, the requirements to present many elements related to leases separately from similar elements which are not related to leases could result in a great deal of clutter in the balance sheet and other financial statements. We think that the ED should provide principles for the classification in the financial statements but that the management of the entity should be required to exercise its judgement in deciding upon whether to present lease items separately from the equivalent non-lease items. The required detail should be presented in the notes if it is not presented upon the face of the financial statements. The management should take into account its business model, materiality and the requirement for clarity and comparability in making its decision. The principles of current IAS 1 and the Financial Statement Presentation (FSP) project should be reflected in the requirements for lease presentation.

(a) As stated above, presentation of the detail on the face of the balance sheet or in the notes should be determined by the lessee's management using the principles outlined in paragraphs 25 – 26 of the ED.

(b) We are not in favour of the performance obligation model for lessors. We do not agree with the gross-to-net presentation and see this cluttered presentation as one of the consequences of this model. The difficulty of applying a sensible impairment test to this model is a further consequence (see our response to Question 18 on the matter of the impairment test in the performance obligation model).

(c) We agree with the principles for presentation of the elements of the derecognition approach in the balance sheet, subject to the general comments expressed above.

(d) See our comments on the subject of clarity and management judgement above.
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?

As discussed above, we think that the management of the entity should be required to exercise its judgement on how the income and expense should be presented in the context of its business model. The principles of IAS 1 and the FSP project should provide guidance for lease presentation.

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?

As discussed above, we think that the management of the entity should be required to exercise its judgement on how the cash flows should be presented in the context of its business model.

We think that there are cases where it would be more appropriate for a lessee to present the cash flows in respect of leases in the operating activities section of the cash flow statement. This would be the case for short-term leases (if these have to be dealt with according to paragraph 64 of the ED) and where, for example, leases are used for the purpose of maintaining flexibility rather than as a means of financing assets.

The principles of IAS 7 should be applied to lease cash flows.

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 BC166–BC183)? Why or why not? If not, how would you amend the objectives and why?

No, we do not agree with the whole of the disclosure requirements.

We agree with the objectives and principles laid out in paragraphs 70 to 72.

However, the disclosures suggested in paragraphs 73 to 86 are voluminous and in our view may not be appropriate for all lessees or lessors. Management should be required to use its judgement in determining the level of detail to be provided in the disclosures. The principles of paragraphs 70 to 72 should be applied in making this determination.

The reference to the requirements of paragraphs 31 to 42 of IFRS 7 could potentially result in very onerous separate disclosures solely in respect of leases in addition to those required for financial instruments in general. We think that the requirement in respect of leases should be restricted to cases where these items are material compared to the other financial instruments. In addition, clear principles should be established to give preparers guidance in deciding upon the disclosures to provide.

Finally, as discussed in our responses to Questions 8 and 9, the existence and nature of options and contingent elements should be disclosed where these are not included in the measurement of the lease asset or liability.

Transition

Question 16

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

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

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

(a) In general terms we are in favour of retrospective application but we think significant transition relief is needed for preparers. As discussed above we would recommend further simplifications to the accounting for short-term leases for lessees. For finance leases recognised under IAS 17, it would be helpful for the starting-point for the amounts to be recognised to be the carrying amounts of assets and liabilities currently in the balance sheet, adjusted for the impact of incremental changes due to any new guidance on lease terms and contingent items
that the Board finally introduces. We think this would minimise the effect of the changes in respect of existing leases on future periods.

(b) Yes, we agree that full retrospective application of lease accounting requirements should be permitted.

(c) From a preparer’s perspective, the length of the transition period is essential. The development and implementation of new IT systems cannot be completed within a short period of time.

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?*

We do not agree that the benefits of the proposals would outweigh the costs.

Our discussions with users indicate that, while they think it is appropriate for more of what are today treated as operating leases to appear on the balance sheet, this will not provide them with all the information they require. The primary information they require is the detail of commitments, cash flows and timings, and the variable and contingent elements. Furthermore, the primary cash flow information they require is that relating to the minimum commitment to the lease, and not probability-weighted expected outcomes. They use this information as input into their models to enable them to perform simulations of the effect of the leases on the entity’s financial situation. The raw accounting data arising from recognition and measurement are of less use to them as these provide a single point-of-time view as calculated by the entity. Indeed, the users appear to us to be indifferent to the accounting approach used and will require detailed disclosure whatever the accounting approach.

Given that we think that the proposed approach to lessee accounting will be onerous for entities to prepare and apparently of little informational value to users, we think that the benefits will not outweigh the costs. A simpler approach to lessee accounting would be helpful.

On the lessor’s side, the proposals introduce a completely new set of approaches to replace an existing model which is well established and understood. The new proposals will involve significant implementation costs for both preparers and users, not only because of the change in the models but also because of the inherent complexity of having two models.

We therefore recommend that the Board revise the proposals in the ED, both for lessees and lessors, with the aim of simplifying the accounting models and thereby enhancing the usefulness of the information provided to users while reducing the costs for both users and preparers.
Other comments

Question 18

Do you have any other comments on the proposals?

Integration of IFRIC 4 Determining whether an Arrangement contains a Lease

We think that the following useful guidance of IFRIC 4 should also be integrated into the future standard

(a) Paragraph IFRIC 4.3 in respect of the unit of account; and
(b) Paragraphs IFRIC 4.10 and 11 in respect of the reassessment of whether arrangements are leases.

Impairment

The guidance given in paragraph 41 under the performance obligation approach for lessors is insufficient as it deals only with the impairment test on the right to receive lease payments and therefore does not take into account the underlying asset and the inter-action of these two assets with the lease liability. In the absence of specific guidance in the proposed standard, IAS 36 would require the underlying asset to be reviewed for impairment, and it is not clear how this should be carried out when there are assets and liabilities giving rise to a net lease asset or liability.

This problem was identified by the Board and indeed the Board's debates highlighted the difficulty of performing the impairment review in the context of the performance obligation approach. It is disappointing, therefore, that this appears to have been ignored in the ED. In our view, this represents a serious flaw in the ED, and is one of the reasons that lead us to think that the performance obligation approach for lessors should be abandoned.

The nature of the right-of-use asset

The principal approach of the ED appears to be to consider the right-of-use asset to be an intangible asset and to require the application IAS 38 to its amortisation and revaluation. It also allows a lessee to measure the right-of-use asset in accordance with the fair value model of IAS 40 Investment Property. At the same time it requires the asset to be presented as if it were a tangible asset. We think this will cause confusion and think it would be better to treat the right-of-use asset according to the nature of the underlying asset throughout.

Relationship to the exposure draft “Revenue from contracts with customers”

In the exposure draft “Revenue from contracts with customers” an entity shall recognise revenue when it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service. On the other hand, the exposure draft
"Leases" does not apply to a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity. This means that in the exposure draft "Revenue from contracts with customers" the transfer of control is sufficient, whereas in the exposure draft "Leases" risks and rewards have to be considered too.

We are concerned about the apparent inconsistency between the control concept proposed in the ED Revenue on Contracts with Customers and the risk and rewards approach proposed in the ED Leases. Therefore we recommend harmonising the scope of both standards.

Discount rate

The specification of the discount rate to be used to determine the present value of the lease payments for the lessee is confusing. Paragraph 12 appears to require the use of the rate the lessor charges the lessee or, if that cannot be readily determined, the lessee's incremental discount rate (although paragraph 12 actually expresses this in a counter-intuitive way). Paragraph B11 states that the discount rate to be used is the lessee's incremental discount rate if that can be reliably determined. These two paragraphs are contradictory and it is therefore unclear which is the discount rate that takes priority.

The ED should make it clear whether the choice of discount rate is an accounting policy choice, and if not, what the hierarchy of mandatory discount rates to be used is.

Costs related to leases eligible to be included in the cost of a constructed asset

IFRIC 1 paragraph 8 prohibits the capitalisation of the periodic unwinding of the discount on decommissioning and similar liabilities. We think that where a leased asset is used to construct another asset, it is correct to capitalise the depreciation of the right-of-use asset and the interest expense on the liability to make lease payments as a directly attributable cost of that asset. If the Board agrees with this, it would be helpful to specify this in the leases standard for the avoidance of doubt.