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International Accounting Standards Board
30 Cannon Street
London
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Dear Colleagues:

Exposure Draft 2010/9: *Leases*

We are grateful for the opportunity to comment on Exposure Draft 2010/9 *Leases*. Our responses are set out in the attached appendix. We commend the efforts of the Board and the project staff since publication of the Exposure Draft in engaging with constituents on the challenges raised.

We supported the main proposals of the 2009 Discussion Paper, agreeing that the elimination of the distinction between finance leases and operating leases would improve the quality of financial reporting. We also urged the Board to consider ways of making the new leases accounting standard as practicable as possible while ensuring that the objective of improved financial reporting is met. We are pleased to note that some progress has been made in this respect

Nevertheless, we are unable to support all the Exposure Draft's proposals.

Shell routinely enters into leasing arrangements as lessee because they offer greater operational flexibility than outright asset purchases. Consistent with this, many of these arrangements contain options to extend or terminate the lease early. Because decisions whether or not to exercise such options are taken based on relatively short-term outlooks for the industry, it is rarely possible at the outset of a lease to make a reasonably reliable estimate of the actual lease term. Similar commercial considerations apply to leasing arrangements that contain variable payment elements, such as contingent rentals.

The proposals in the Exposure Draft concerning term options and variable payments such as contingent rentals raise a number of issues that we believe undermine the project's objective of improving financial reporting, which we address in detail in the appendix. In summary:

a) We are not convinced that the definitions of an asset or a liability are met in all cases. This would of course preclude recognition, and the proposals may set precedents or have unintended consequences for other accounting issues. In the case of term options, an obligation arises only when the entity exercises the option or commits itself to exercising the option in some other way to create a constructive obligation. Similarly, variable payments that are contingent on the lessee's usage of the asset become unavoidable only when usage occurs.

b) We appreciate that the Board, together with the FASB, have given significant thought to the question of measurement. We have also considered ways in which lease assets and liabilities could be measured to reflect the presence of term options and variable payments that provide relevant, reliable information. It is our conclusion that such measurements can in most cases only be made using a significant degree of estimation and, inevitably, subjectivity. In addition, the measurement approaches proposed do not reflect expected outcomes and will therefore require frequent reassessment throughout lease terms that will further cloud the picture portrayed. In our view, including these measurements in the recognition of lease assets and liabilities will undermine rather than improve financial reporting because they risk prioritising the presentation of 'accounting form' over economic substance.

c) While in principle we support the Exposure Draft's main objective of recognising lease assets and liabilities, which on its own will require significant implementation efforts, because the measurement and reassessment approaches proposed for term options and variable payments do not reflect expected outcomes – in particular, those used in business planning – the effort of implementing the measurement proposals will be burdensome. In this regard, the costs do not outweigh the benefits because we do not perceive readers of financial statements will be better informed.

We therefore urge the Board to reconsider the measurement proposals in respect of term options and variable payments. Because of the conceptual and practical issues, we feel that the most appropriate approach is to require recognition only when the associated obligations become virtually certain, supported by the enhanced disclosure proposals in the Exposure Draft.

In our response to the 2009 Discussion Paper we highlighted the need to ensure that the distinction between lease and service agreements be better defined in the new leases accounting standard than is currently provided in IFRIC 4 *Determining whether an Arrangement contains a Lease*. The narrow scope of the Interpretation, which we note is largely reproduced in the Exposure Draft, as well as its rules-based approach, will not in our view be adequate in distinguishing between the two types of arrangement. We have attempted to outline the principles that we believe such distinction should be made in the appendix, which we would be happy to discuss with you further.

Finally, we are concerned that the transition proposals, while providing some relief in terms of implementation effort, may not be appropriate in all cases. We have therefore proposed in the appendix an alternative approach that should alleviate concerns about the use of hindsight that would be required if full retrospective application were mandated while also achieving a more representative picture of lessees' financial position.

Please do not hesitate to contact us if you have any questions about our responses.

Yours faithfully,

Paul. A. Morshuis.

Paul Morshuis

Vice President Accounting and Reporting

APPENDIX

The accounting model

The exposure draft proposes a new accounting model for leases in which:

(a) a lessee would recognise an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortise the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.

(b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23–BC27).

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 agree with the essential characteristics of the lessee accounting model that are described here; however, as noted in our responses following, we do have concerns about whether the more detailed proposals concerning lessee accounting are appropriate or practically feasible.

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 have both conceptual and practical concerns with the performance obligation approach.

Firstly, as noted in our response to the Discussion Paper, we have conceptual difficulties with the idea of duplicating assets and creating performance-only liabilities, which underlies the performance obligation approach. BC16 argues that a lease "creates a new asset, the right to receive lease payments, and a new lease liability, representing the obligation to permit the lessee to continue to use the underlying asset during the lease term… [the lessor] does not lose control of the underlying asset." We think this assertion lacks substance, primarily because it fails to recognise the lessor having given up of at least some control over the asset in return for lease payments. Furthermore, in our view, the assertion in BC17 that the "obligation to permit the lessee to use the underlying asset… [results] in an outflow of economic benefits from the lessor", is a tautology; in entering into a lease, the asset is surrendering its ability to use the asset for other purposes during the lease but it does so in order to earn lease rentals. On a conceptual level therefore, the proposals in our view set precedents for other accounting issues and should be further researched (possibly within the scope of the Conceptual Framework project) before being applied here, particularly as we suspect the resulting financial information will confuse rather than inform users.

We also note some practical difficulties with the performance obligation approach.

Shell does not regularly enter into leases as lessor, but is intermediate lessor in a number of sublease arrangements. In all instances, subleases are entered into because the asset in the head lease is not required or has excess capacity that Shell cannot use (for example, office space) and it is uneconomic to break the lease agreement. In commercial terms therefore, we view such arrangements as opportunities to reduce the overall cost of leasing rather than as standalone commercial ventures.

Despite the commercial basis for entering into these arrangements, the Exposure Draft proposes that we would use the performance obligation approach since the 'business model' is not primarily the provision of finance. The accounting that would result does not, in our view, reflect that commercial basis and adds unnecessary complexity to the presentation of the financial effects of such transactions. We believe that the derecognition approach is more appropriate because it reflects that we have surrendered some or all of the rights embodied in the underlying lease asset in return for a reduction in the cost of leasing that asset.

Another practical issue arises when measuring the underlying asset under the performance obligation approach. The Exposure Draft proposes that the original cost be depreciated as if the asset were still entirely under the lessor's control, subject to impairment. That depreciation charge represents only a notional cost because it lacks commercial substance, while there may be practical difficulties with assessing the appropriate recoverable amount while the asset is being leased.

We also do not consider that the derecognition approach proposed addresses all the issues associated with lessor accounting, principally because it involves the re-measurement of the residual asset when this may not be practicable.

On balance, we are not convinced there is a compelling case for wholesale changes to the accounting for leases by lessors, and we urge the boards to reconsider this element of the project.

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?

Our preference is for a single accounting model that is applied to all leases, which should ensure that a clear, consistent and comparable picture is provided to users. It would also make application of any new lease accounting standard as manageable as possible.

In principle therefore, we are not convinced of the need for a concession in respect of short-term leases, as defined. However, we doubt the concession will have much impact on lessees because under IAS 39 financial assets and liabilities due within one year are generally not discounted in practice because of the immaterial effect of discounting. Because of its limited impact, we are not opposed to the proposal. We do feel it should be an option, because in some cases the cost of applying the concession – in distinguishing between short-term and other leases – will outweigh the benefits.

Definition of a lease

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

Question 4 (a)

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

Notwithstanding the concerns we have about the application of the boundary between leases and other agreements (addressed in questions 4(b) and (c)), we agree that leases are appropriately defined in the Exposure Draft.

Question 4 (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?

In our view, the distinction made in the Exposure Draft between leases and in-substance purchases and sales is unhelpful because it complicates the accounting and disclosures, both from a user information perspective and in the application of the new leases requirements.

Most users currently regard lease liabilities (whether recognised or not) as an element of financing that is not dissimilar from conventional borrowings. The argument put forward in the Exposure Draft that an in-substance purchase/sale is a financed acquisition implies that the liability arising under the right-of-use model is always something substantially different, a distinction that has more to do with the nature of the asset than the liability.

As noted above, we prefer a single accounting model that is applied to all leases, which in our view ensures a clear, consistent and comparable picture is provided to users and makes application of any new lease accounting requirements as manageable as possible. In order to achieve this, the definition of a leased asset may need to be reconsidered.

Question 4 (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?

In our response to the Discussion Paper, we highlighted the practical difficulties arising when applying IFRIC 4 *Determining Whether an Arrangement Contains a Lease* and urged the boards to develop clearer principles for determining between a lease and service contract. We are therefore disappointed to see that the Exposure Draft contains almost identical guidance to that in IFRIC 4.

The main issue with IFRIC 4 arises in determining whether or not a contract conveys the right to use an asset. Under IFRIC 4 (and the Exposure Draft), the right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

(a) The entity has the ability or right to operate the asset or direct others to operate the asset in a manner that it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(b) The entity has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(c) The entity will obtain all but an insignificant amount of the output or other utility of the asset during the term of the lease, and the price that the entity will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output. If the price that the entity will pay is contractually fixed per unit of output or at the current market price as of the time of delivery of the output, then the entity is paying for a product or service rather than paying for the right to use the underlying asset.

The issues arising are as follows:

(a) Criteria (a) and (b) set low thresholds in respect of the benefits obtained from the asset. It is therefore possible to obtain 20% of the benefits and have a lease when the purchaser:

    (i) Operates the asset directly, or is able to direct others how to operate the asset. IFRIC 4:BC30 elaborates on this: ‘for example, a purchaser’s ability to operate the asset may be evidenced by its ability to hire, fire or replace the operator of the asset or its ability to specify significant operating policies and procedures in the arrangement (as opposed to a right to monitor the supplier’s activities) with the supplier having no ability to change such policies and procedures. It is not stated if the purchaser has to be able to direct the seller for all of the time the asset is in use or only when it is in use on behalf of the purchaser. However, it would be unlikely that a seller would agree to adopt the purchaser’s operating policies and procedures either temporarily (when the asset is being used for the benefit of the purchaser) if the purchaser is only obtaining a minor amount of the asset’s output. It is also worth noting that the guidance in BC30 is not replicated in the Exposure Draft.

    (ii) Has the ability or right to control physical access to the underlying asset. Again, the question arises of whether access can be restricted only when the asset is in use for the benefit of the purchaser.

(b) Criterion (b) can result in different accounting depending on where the asset is located. For example, a generator that is located on the purchaser's premises could give rise to a lease while a generator located adjacent to the purchaser's premises would not.

(c) Criterion (c) assumes that if the purchaser is not paying a market price for each unit of output then part of the amount paid represents a contribution to the seller's investment in the asset and therefore gives rise to a lease. This ignores whether or not the purchaser controls the use of or access to the asset (as in criteria (a) and (b)). A purchaser could therefore obtain a substantial amount of the output – say 75% – pay a non-market price for the output and, so long as it does not control the use of or access to the asset, no lease arises.

The disconnects in these criteria between operational arrangements, pricing and the flow of benefits from the underlying asset make IFRIC 4 complex to apply and can result in inconsistencies in the accounting. With respect to criteria (a) and (b), most arrangements that result in leases are currently determined to be operating leases, which have the same accounting as executory contracts and as a result, their application has tended to be less important.

Given the proposal to recognise all lease arrangements, there is a clear need for a principles-based approach to distinguishing between lease and executory contracts. We see an opportunity to achieve this without opening the whole question of what constitutes a lease by applying two principles:

(a) A lease arises if there is a determinable relationship between the operating of the asset and the pricing of the asset's output (we think this principle underlies IFRIC 4, however it is obvious); and

(b) The accounting for this relationship should be consistent with the principles applied to other assets, i.e. it should be based on control.

We therefore propose alternative guidance, which have attempted to articulate as follows:

A contract conveys the right to use an asset if:

(a) the purchaser controls the flow of the majority (i.e. more than half) of the output or other utility of the asset for its own benefit, either by:

(i) operating the asset directly; or

(ii) being able to control the timing or delivery of the asset's output; and

(b) the price that the entity will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery.

We appreciate that this is an issue that could lead to lengthy discussions on the dividing line between lease and other arrangements, however we feel it is imperative that it be addressed in order for a new lease accounting standard to be operational. It is our hope that the alternative approach suggested above offers a pragmatic solution to the issue.

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?

The Discussion Paper proposed retaining the scope exclusions currently in place, because the topics excluded are dealt with elsewhere. In the context of the oil and gas industry, licences to explore for and exploit minerals and hydrocarbons are already the subject of a broader scope project on extractive activities. The proposal in the Discussion Paper therefore seemed to us to be sensible.

The Exposure Draft proposes also to exclude leases of intangible assets from the scope of the new lease accounting standard. In our view, this is a retrograde proposal because without guidance on how such transactions should be accounted for, it will inevitably lead to divergence in accounting practice. The Basis for Conclusions explains that the exclusion achieves convergence with US GAAP, which is undoubtedly desirable but when the quality of financial reporting under IFRS suffers as a result, it is unsupportable.

We therefore urge the IASB to reconsider this proposal. We see no reason why the new lease accounting proposals could not be applied to intangible assets (other than those already scoped out by IAS 17), however, if there are indeed issues that affect leases of intangible but not tangible assets, the IASB should fulfil the mandate set out in the Discussion Paper and address those issues rather than avoid them for the sake of expediency.

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?

We are generally more inclined to the IASB’s view, with some qualifications:

(a) We do not agree there is a need for two lessor accounting models/approaches and we believe the derecognition model proposed has greater decision-utility; consequently, we also do not agree that there should be two approaches to splitting or otherwise combined lease-service contracts.

(b) We have considered the proposals in the Exposure Draft *Revenue from Contracts with Customers* separately. In the context of this Exposure Draft, we feel IAS 18 already adequately addresses distinguishable service elements of combined lease-service contracts and that additional guidance is therefore unnecessary.

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?

As noted in our response to question 4(b), we think the proposed requirement to treat separately leases and so-called in-substance purchases and sales will complicate the application of the new lease accounting standard without improving the quality of financial reporting. The proposal here is a logical consequence of that proposal, i.e. it is a further complication that arises in attempting to consistently apply the proposed treatment of in-substance purchases and sales.

We are concerned that this proposal could give rise further complications in practice, for example, where a contract contains an option to extend or purchase the asset. If the lessee expects to extend the lease, the extension period is included in the measurement of the lease asset and liability, but if the lessee expects to exercise the purchase option, the option is only recognised when it is exercised. Conceptually, it is difficult to see why purchase options should be treated differently to extension options.

As described in our responses to questions 8 and 9, we favour a consistent approach to the measurement of options and variable terms. We therefore recommend including the measurement of purchase options on the same basis.

Measurement

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

(a) assumes the longest possible term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).

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

(c) is updated when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments, including expected payments under term option penalties and residual value guarantees, since the previous reporting period (paragraphs 17, 39, 56 and BC132–BC135).

Question 8: Lease term

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

We supported the proposal in the Discussion Paper to measure lease assets and liabilities reflecting the most likely lease term, because we shared the boards' concern that, without such a requirement, financial statements might understate lease obligations and provide opportunity to structure lease arrangements to achieve a desired accounting result.

However, our subsequent research leads us to conclude that the proposal to include additional lease terms in the measurement of lease assets and liabilities will probably not provide better financial reporting information. We therefore concur with the Alternative View. We also note the concerns of some constituents that extension options do not meet the definition of a liability until the lessee has committed to them. We share these concerns, which may have as yet unforeseen conceptual implications for other assets and liabilities.

The inclusion of extension options in lease agreements is driven by economic factors. In Shell's case, lease rates for assets such as exploration equipment and shipping are heavily dependent upon market conditions and outlooks, including projected oil prices, and therefore such options provide additional operating flexibility. In other words, it is more desirable to pay a premium to the lessor for the option to extend rather than be locked in to a lease term when the contract might become onerous. In our assessment, were lease assets and liabilities to be measured based on the minimum lease term or the term that is reasonably certain to occur, this would be unlikely to result in the structuring of lease agreements because such structuring would be economically prohibitive.

Finally, we are seriously concerned about the reliability of financial information that contains judgements about future decisions. In many cases, it will not be possible for us to provide an auditable assessment of the probability of exercising an extension option because such decisions cannot be made until quite close to the exercise date. This is because firm business plans do not cover extended future periods and, as noted above, extension decisions depend also upon market conditions and outlooks. For this reason, not only do we consider the approach proposed in the Exposure Draft to be impracticable in the majority of instances, we also believe that the proposal in the Discussion Paper will not achieve improved financial reporting. This is because the assessments required will be inherently imprecise, heavily subjective and, because they will inevitably require frequent revision, will lead to less transparency (more "noise") in financial statements.

We therefore propose that extension options only be included in the measurement of lease assets and liabilities when their exercise is reasonably certain or are committed to, either legally or constructively.

Currently, there are minimal specific disclosure requirements concerning extension options. Our view is that the disclosure proposals in the Exposure Draft provide sufficient information about the nature and potential financial effect of extension options so that users have a view of the resources and associated obligations available to the reporting entity.

Were the boards to require some measure of recognition of extension options, our assessment is that the most appropriate basis for measuring term options is the most likely lease term rather than the longest lease term that is more likely than not to occur. The principal reason for this conclusion is relatively simple: since it is the term that has the highest probability of occurring, it is a more accurate reflection of the expected outcome of the arrangement, including the cash flows that are expected to occur.

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?

Contingent rentals linked to a rate or index

We support the proposals in respect of contingent rentals that depend on a rate or an index. Measurements based on readily available forward (or prevailing) rates or indices should result in useful information and are relatively straightforward to monitor for the purposes of reassessment.

We do note, however, that some contingent rentals that are dependent upon rates or indices would clash with the embedded derivatives requirements of IAS 39:10-13 and IFRS 9:4.3. Currently, a contingent rental that is based on a rate or index that is not closely related to the host rental contract (for example, based on commodity prices (IAS 39:AG33(f) and IFRS 9:B4.3.8(f)) constitutes an embedded derivative that is required to be recognised separately at its fair value.

The boards will need to address this overlap, either by excluding such contingent rentals from the scope of the new lease accounting standard or by amending IAS 39/IFRS 9 to exclude such embedded derivatives from its scope. Our preference is for the former approach, which would more readily facilitate economic hedging (i.e. without applying hedge accounting) because both the embedded derivative and the hedging instrument would be measured on the same basis.

Other contingent rentals, term option penalties and residual value guarantees

In our view, other contingent rentals (i.e. those that are based on usage), term option penalties and residual value guarantees cannot justifiably be recognised before they are incurred or otherwise committed to.

We note the concerns of some constituents that contingent rentals connected with usage do not meet the definition of a liability until the lessee has committed itself to them by using the asset. We share these concerns, which may have as yet unforeseen conceptual implications for other assets and liabilities.

Furthermore, we cannot support the use of weighted average expected outcomes as the basis for their measurement. The proposed approach has two significant disadvantages:

(a) Because it is an averaging technique, it will only reflect actual results when applied over many homogenous instances and/or over many periods. This assumes, of course, that it is possible to objectively determine the probabilities for each reasonably potential outcome, which we doubt. At any given reporting date, for a single lease, a measurement based on artificial premises that are possibly not used for internal decision making purposes, will inevitably result in unreliable estimates.

(b) Because the weighted average expected outcome approach will result in the measurement of a single lease asset and liability that are not reflective of the actual expected outcome, the measurements will need almost perpetual reassessment. This will add an unjustifiably high administrative burden to the application of the requirements without providing relevant or reliable financial information.

We therefore propose that contingent rentals connected with usage as well as term option penalties and residual value guarantees be recognised as incurred.

Currently, there are minimal specific disclosure requirements concerning contingent rentals. Our view is that the disclosure proposals in the Exposure Draft provide sufficient information about the nature and potential financial effect of contingent rentals and other variable terms so that users have a view of the resources and associated obligations available to the reporting entity.

If, however, the boards were to proceed with requiring the recognition in advance of estimates of contingent rentals and other variable terms, in our view, the only viable approaches to dealing with these variable terms are:

(a) Measurement based on management's view of the expected result, in other words, the most likely outcome. We share the boards' view that it is difficult to identify a point on a range of potential outcomes, but if a value must be reflected in the measurement of lease assets and liabilities, then the mostly likely outcome will be more relevant and reliable because:

    (i) It has a far greater chance of reflecting actual outcomes; and

    (ii) It is likely to be easier to determine. This is because such estimates will be based on management's budgets, which are subject to a greater degree of scrutiny and therefore variances from those expectations will be better understood.

(b) If, for some reason, management is unable to determine an expected outcome with a reasonable degree of reliability, the only alternative is to exclude it from the measurement of lease assets and liabilities. In our view, financial statements that include "guesstimates" fail the user in terms of relevance and reliability.

In terms of drafting, we also struggled with the term "term option penalties" which, unlike "contingent rentals" and "residual value guarantees", is not defined in the Exposure Draft. It is not clear to us precisely what the term means, and we assumes it refers to situations where the lessee pays a penalty if it terminates the lease early or fails to extend it. We would recommend including a definition or, better still, using a broader term that captures any non-standard payment, fixed or otherwise, that the lessee might be required to pay the lessor in connection with a lease arrangement, other than contingent rentals and residual value guarantees.

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?

In principle, we agree with the proposal. It is clear that a mechanism for reassessing the amounts included in the measurement of lease assets and liabilities is needed to ensure that their carrying amounts continue to reflect expectations about lease terms and variable terms. We also agree with the proposal in paragraph 57 not to change the rate at which lease payments are discounted except in limited circumstances.

However, we believe the boards have under-estimated both the effort that reassessment will require and its impact on the clarity of the reporting for leases. This is because the proposals for the measurement of initial recognition of lease assets and liabilities, addressed in questions 8 and 9, are based on hypothetical valuation models rather than management's expectations; their carrying amounts will inevitably require more frequent revision than the Board envisages, if only to reflect the actual lease payments made. For example, if a lessee estimates that the most likely amount of contingent rental is X but is required to recognise an amount, based on a weighted average probability that does not follow a normal distribution, of Y, when the lessee pays the contingent rental of X (or, indeed, another amount), a mismatch in the accounting will arise.

In addition, the requirement to reflect remeasurements will confuse rather than clarify financial reporting, particularly in the case of contingent rentals, which will need to be separated between those that have retrospective effect and those that are prospective.

Therefore, although we agree with the reassessment proposals, we think they highlight the weaknesses in the measurement proposals and, in the interests of clear and relevant financial reporting, we urge the boards to reconsider these proposals.

Sale and leaseback

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

Question 11

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

We think the two-model approach to lessor accounting proposed in the Exposure Draft creates unnecessary complexity in the accounting for sale and leaseback transactions, and some inconsistencies in the underlying principles. In particular:

(a) The Exposure Draft rejects the option of applying the derecognition approach to the leaseback leg while permitting it under normal circumstances. This is inconsistent.

(b) The conditions listed in B31 that preclude the treatment of a purchase or a sale are different from those in paragraph 8, which we think has no conceptual justification.

Because we support only the use of the derecognition approach in respect of lessor accounting, we therefore disagree with the boards' rejection of the derecognition approach in accounting for the leaseback leg.

Presentation

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

Question 12: Statement of financial position

(a) **Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?**

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

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

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

In general, we agree with the proposals to separately present the balances relating to lease assets and liabilities, however, it is not clear to us how the proposals are intended to interact with the requirements in IAS 1:54, which stipulates minimum line items to be included in the balance sheet.

As noted in our responses to questions 13 and 14, we favour a consistent approach to primary statement presentation. In our view, separate presentation on the face of the balance sheet of lease assets and liabilities should follow the requirements of IAS 1:55, which would permit the requisite information to be presented in the notes. This flexibility takes into account the different degrees of emphasis leasing activities have on reporting entities.

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?

In general, we agree with the proposals to present separately the income effects of leasing arrangements.

As noted in our responses to questions 12 and 14, we favour a consistent approach to primary statement presentation. In our view, separate presentation on the face of the income statement (statement of comprehensive income) of the income effects of leasing arrangements should follow the requirements of IAS 1:85, which would permit the requisite information to be presented in the notes, for both lessees and lessors. This flexibility takes into account the different degrees of emphasis leasing activities have on reporting entities.

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 see no special need to separately present cash flows relating to leases, which are anyway proposed to be disclosed in the notes. Instead, we feel IAS 7 should continue to apply in respect of capital amounts paid, depreciation and interest.

Disclosure

Question 15

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

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

(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows

(paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

Generally, the proposed disclosure requirements appear consistent with the proposals for lease accounting. However, we do consider the proposal in paragraph 77 to disclose a reconciliation of lease liabilities, particularly by class of underlying asset, to be excessive. This is because, even though lease liabilities are to be accounting for similarly to financial liabilities carried at amortised cost, there is no requirement in IFRS 7 to provide this disclosure. We therefore suggest that this proposal is superfluous and that it be excluded from a new lease accounting standard.

Transition

Question 16

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

(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 the proposed approach has the advantage over full retrospective application in that it is both easier to apply and eliminates the need to go back to inception and guess what assumptions would have been made at the time about likely lease terms and contingent rentals. We also agree with the boards' rejection of a full prospective approach to transition, because this would mean leases would be accounted for under two models, in some cases for many years.

However, we also share the concerns raised in the Alternative View about the financial impacts the proposed approach will have. This arises from the different subsequent measurement approaches to lease assets (usually depreciated on a straight-line basis) and lease liabilities (at amortised cost), which will mean that, almost always, the carrying amount of the lease liability will be higher than the net book value of the lease asset. Therefore, the recognition at transition of the lease asset and lease liability, which will be at the present value of the lease liability, will increase the depreciable amount of the lease asset.

We favour an alternative approach that eliminates this anomaly, as follows:

(a) As at the date of transition, the entity makes the necessary assessments regarding likely lease term and variable terms as if the transition date were the date of inception for all leases, except simple finance leases (which will continue as currently);

(b) The entity then backdates those assessments to actual inception to arrive at what the transition date lease asset and liability carrying amounts would have been had the new requirements been effective; and

(c) The balance sheet at transition is restated to include the new/revised lease assets and liabilities, together with a corresponding adjustment to retained earnings.

Although this approach is slightly more complex than the approach proposed in the Exposure Draft, in our view the benefits will outweigh the costs in many cases, and we therefore recommend the boards allow it as an alternative to the approach proposed in the Exposure Draft.

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 welcome the steps the boards have taken in modifying the proposals of the Discussion Paper aimed at ensuring that the administrative burden and cost connected with implementation of the new lease accounting standard are not disproportionate to the benefits of improved financial reporting.

The following summarises further improvements we think could be made to achieve this aim, all of which are covered in more detail elsewhere in this response letter. They are simplifications mostly, which we feel would have a beneficial rather than detrimental impact on the quality of financial information by making it more readily understood.

(a) Consider retaining the current lessor accounting requirements, pending more research on how pressing is the need for reform in this area (refer also to our response to question 2).

(b) Remove the distinction between leases and in-substance purchases/sales (refer also to our response to question 4(b)).

(c) Improve the guidance on determining whether an agreement is or contains a lease contract (refer also to our response to question 4(c)).

(d) Measure lease assets and liabilities by reference to the minimum lease term or the term that is reasonably certain to occur rather than the longest lease term that is more likely than not to occur.

This will also ease the burden associated with reassessment (refer also to our responses to questions 8 and 10).

(e) Recognise contingent rentals and other variable payments that are connected with usage when they are incurred rather than including an estimate of their weighted average expected outcome in the measurement of lease assets and liabilities. This will also ease the burden associated with reassessment (refer also to our responses to questions 9 and 10).

(f) With respect to presentation, (i) do not require separate presentation of lease assets and liabilities on the face of the balance sheet unless they meet the IAS 1 criteria for separate presentation; and (ii) retain the current approach to presentation of cash flows arising from interest and capital payments that are currently applied to finance lease liabilities (refer also to our responses to questions 12 and 14).

(g) Drop the proposal to require disclosure of a reconciliation of lease liabilities (refer also to our response to question 15).

Other comments

Question 18

Do you have any other comments on the proposals?

We would like to raise four areas that we think require clarification in the new lease accounting standard.

(a) Reassessment: The restriction in IFRIC 4:10-11 on the reassessment of whether an arrangement is or contains a lease agreement does not appear in the Exposure Draft. In our view, this is useful guidance that should be included in the new lease accounting standard; we therefore recommend that the boards consider this.

(b) Incremental borrowing rate: The Exposure Draft does not specify whether for the incremental borrowing rate should be assessed from the perspective of the reporting entity in the case of a group (i.e. the parent) or that of the individual leasing entity. This is also not specified in IAS 17. In practice, opinions differ on whether the concept of the group as a single entity that underlies IAS 27 is applied in this instance. We therefore recommend the boards address this by providing guidance on how the incremental borrowing rate should be determined in consolidated financial statements. In our view, the guidance would be most helpful if it acknowledged circumstances where the individual leasing entity's borrowing rate is affected as a consequence of its relationship with the rest of the group. For example, a subsidiary established solely for the purposes of leasing an asset might not have the practical ability to raise borrowings of its own and is capable only of entering into the lease arrangement thanks to specified or implied backing. Similarly, the rate offered a subsidiary might also be affected by specified or implied backing by the group. Under these circumstances, we are of the view that the incremental borrowing rate could be applied at a level higher than the individual leasing entity, perhaps based on rates charged internally by the group's treasury function.

(c) Unit of account: The Exposure Draft does not specify the unit of account that should be applied in assessing lease agreements or recognising lease assets and liabilities. This means also that the guidance in IFRIC 4:3, that the unit of account guidance in IASs 16 and 38 be applied, has not been carried over to the draft standard. An important aspect to the implementation of the new lease accounting standard will be the level at which the standard is applied, for example, in an agreement that covers a number of individual assets. Consequently, we recommend the boards include the IFRIC 4 guidance in the new lease accounting standard.

(d) Eligibility for capitalisation in the cost of another asset. It is not clear to us whether the costs classified in the Exposure Draft as interest expense and depreciation can be capitalised as part of the cost of another asset:

(i) IAS 16:48 permits the depreciation charge on an item of property, plant and equipment to be included in the cost of another asset; however, the Exposure Draft is silent on this.

(ii) IAS 16:22 permits the capitalisation of borrowing costs; however, Appendix C to the Exposure Draft proposes deleting paragraph 6(d) from IAS 23 rather than updating it to include interest expenses on lease assets.

(iii) IAS 16:16(b) requires the capitalisation of directly attributable costs, which currently would include operating lease rentals for assets used in the construction of an item of property, plant and equipment.

The current treatment is clear: whether leased under an operating or a finance lease, the expenses relating to those leases are capitalised if they are directly connected with the construction of property, plant and equipment. The Exposure Draft, together with the consequential amendments listed in Appendix C, seems to be taking a different approach, but we cannot be sure. Our view is that the changes proposed to lease accounting should not affect the capitalisation principle in IAS 16 (the same applies also to IAS 38, of course). We therefore recommend the boards clarify this in the new lease accounting standard.