

December 15, 2010

International Accounting Standards Board First Floor 30 Cannon Street London, United Kingdom EC4M 6XH

Re: Exposure Draft ED/2010/09 Leases

Dear Board Members,

The Liquor Control Board of Ontario ("LCBO") appreciates the opportunity to respond to the Exposure Draft ("ED") on Leases. We also would like to thank the Board for giving the LCBO the opportunity to present at the IASB outreach working groups on Leases.

#### **Background on LCBO**

The LCBO is a \$4.3 billion arm's length agency of the provincial government whom are exempt from income taxes. We operate principally as a retail organization with over 600 stores across Ontario, specializing in the responsible retailing of beverage alcohol. We are also one of the world's largest single purchasers of beverage alcohol.

# **Overview on Exposure Draft**

We conceptually agree with the Board that entities apply a right-of-use model to account for leases. However, we have significant concerns over the practicality of applying the ED in its current form. Our main concerns are as follows;



- We disagree with the Board's proposal to include lease renewal options within the measurement of right-of-use assets and lease liabilities if they are "more likely than not to occur". We believe that renewal options should only be included if they are "reasonably certain to occur".
- We disagree with the Board that contingent rentals should be included within the measurement of a right-of-use asset and lease liability.
- We disagree with the Board on the level of extensive disclosures which are required to be included in the notes to the financial statements.

Overall, we strongly believe that the implementation costs and the ongoing maintenance required to comply with the ED far outweigh any proposed benefits to the users. Please find herein, our detailed responses to the questions in the ED.

Should you have any questions or concerns please do not hesitate to contact either Michael Massoud, IFRS Financial Analyst (<u>michael.massoud@lcbo.com</u>, phone 1-416-365-5791) or Carol Lyons, Controller (<u>carol.lyons@lcbo.com</u>, phone 1-416-365-5742).

Sincerely yours,

**LCBO** 



#### APPENDIX 1 – DETAILED RESPONSES TO EXPOSURE DRAFT ON LEASES

## **OUESTION#1: LESSEES**

A) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

We agree that a lessee should recognize a right-of-use asset and a lease liability for their lease rental payments for which a contractual obligation exists.

We believe that the ED does not provide a practical approach to measure the right-of-use asset and lease liability. More specifically, in regards to lease options to renew ("options") and lease payments, the ED requires entities to make significant judgments which are prone to significant uncertainties. See our responses in Questions 8 to 10.

The application would result in the recognition of significant right-of-use assets which embed significant unsupportable uncertainties. The recognition of lease liabilities under the ED would result in the recognition of significantly uncertain liabilities.

Overall, under the current model of the ED, we strongly believe that the costs greatly outweigh any benefits derived from the ED.

B) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?



We agree that using the amortized cost method to account for the right-of-use asset is appropriate and that the right-of-use asset should be amortized over a period of time during which an entity will obtain a benefit from the right-of-use asset. This is consistent with accounting for property, plant & equipment (IAS 16) and intangible assets (IAS 38).

We do agree that interest should be recognized on the liability using the effective interest rate method, whereby any difference between the lease rental payment and the interest on the liability represents the principal repayment.

## **OUESTION#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?

Not applicable as we are a retail business by nature and are primarily impacted by any guidance which impacts lessees and not lessors. Therefore, we have no comment on this issue.

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?

Not applicable as we are a retail business by nature and are primarily impacted by any guidance which impacts lessees and not lessors. Therefore, we have no comment on this issue.



## 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 recognize 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 recognize assets and liabilities arising from a short-term lease in profit or loss, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other guidance and would recognize 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 thank the Board for attempting to simplify this process by not requiring preparers to discount short term leases. However, we believe that the relief provided by this is minimal.

We believe the main issue is that it is extremely difficult to track and account for a large number of short term leases. The main issue revolves around



identifying and estimating the "lease term" for short-term leases, particularly leases which are month-to-month in nature that do not contain a contractual end date.

We recommend that the Board allow preparers to expense any costs associated with short term leases that have a contractual end date of less than 12 months in order to achieve the simplification objective.

Overall, we believe that the costs required to apply the ED far outweigh any benefit which will be derived by the users in applying this standard to short term leases.

# **QUESTION#4: DEFINITION OF LEASE**

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

We feel that the definition of a lease is properly defined within the ED, however we believe the Board needs to provide further guidance surrounding the measurement of a lease.

We also strongly believe that the definition of a lease should be based on the legal & contractual obligations. See our response to Question 8.

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

We do not see any issue surrounding this question.



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

We believe the ED should provide further guidance to assist entities in determining whether an arrangement is within the scope of the ED. Under the current IFRIC 4 standard, entities were not concerned over whether an arrangement should be accounted for as an "operating lease" under the current IAS 17 or IFRIC 4 as both standards would result in the same expense charges. However under the ED, this will not be the case and we will therefore need clear guidance to determine if arrangements would be classified as a service contract or lease agreement.

#### **OUESTION#5: SCOPE EXCLUSIONS**

The exposure draft proposes that a lessee or a lessor should apply the proposed guidance 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 guidance? Why or why not? If not, what alternative scope would you propose and why?

We agree with the scope exclusions within the ED. Furthermore, we cannot conceptually provide an alternative recommendation to limit the types of leases which should be accounted for as finance leases. Leases which are categorized as core operating assets (i.e. building leases) and non-core operating leases (i.e. printer fleet) should conceptually be similarly treated.



However, given the large volume of non-core assets that are leased by entities, preparers of financial statements would be required to separately track and account for insignificant non-core assets under the ED. This will result in entities incurring significant costs to account for these leases. These costs would far outweigh the benefits to the user.

# 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 lessee should apply the lease accounting requirements to the combined contract.
- a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
- a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?



We believe the contracts that contain both a lease component and service component should be separated and accounted for based on the nature of the costs. The component of the transaction which relates to the lease should be accounted for as a lease transaction and the component of the transaction related to service should be expensed as incurred.

This issue is very common within real estate lease transactions. Under the ED, there is very little guidance around what qualifies as a distinct service component thereby certain costs which should be accounted for as a service component could be included within the right-of-use asset & lease liability inconsistently between financial statement preparers.

In current real estate practice the definition of 'executory costs' can vary significantly. In certain lease contracts 'executory costs' include insurance, maintenance and property taxes. In other lease contracts, the definition is expanded to include costs such as common area maintenance, utilities, landscaping and snow removal.

If these costs are determined to not be distinct service components and thereby included within the measurement of the right-of-use asset and lease liability, this would seem to be an inconsistent practice of accounting for these transactions assuming an entity had purchased the asset, as the entity would traditionally not capitalize these costs within the asset.

In addition, if these costs are determined to be distinct service components and thereby excluded from the measurement of the right-of-use asset and lease liability, this would require entities to separate these costs out of the lease rental payment for each lease. In practice, this task would not be feasible to accurately perform as lessors are generally not legally required to disclose this information unless stipulated to do so within the contract.



## **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 with the ED on this question.

## **QUESTION#8: LEASE TERM**

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

We do not agree with the definition of a lease term as the longest possible term more likely than not to occur, taking into account the effect of any options to extend. We believe that by including renewal options which are "more likely than not to occur" would result in a lease liability for which an entity does not have a contractual or constructive obligation to make any future lease payments, thereby these options would not meet the current definition of a liability.



Furthermore, we have significant issues with regards to an entity's ability to reliably estimate and measure the probability of exercising renewal options which may or may not occur in the foreseeable future.

In practice, particularly in real estate transactions, lessees are not economically tied to renew an option at the end of a lease term, but have an option for the "right of first refusal" to exercise an option at the end of a lease term. In most real estate transactions, lessees are given the choice, to exercise an option based on the market price and are not given any economic incentives by the lessors to exercise an option in the form of (1) a penalty to not renew or (2) a lessors incentive to renew.

Lease terms should only include the renewal options if they are "reasonably certain to occur". Our definition of "reasonably certain to occur" would include the contractual lease term for which the lessee has a legal liability plus any options to extend based on the existence of a significant economic incentive to renew (i.e. significant capital investment in the lease or a bargain renewal lease rate) or a penalty for non-renewal.

For example, within the ED example, an entity whom is a retailers may have a lease that has a non-cancellable 10-year term, an option to renew for 5 years at the end of 10 years and an option to renew for an additional 5 years at the end of 15 years. The entity determines the probability for each term as (a) 40 per cent probability of 10-year term; (b) 30 per cent probability of 15-year term; and (c) 30 per cent probability of 20-year term. As the term will be at least 10 years, there is a 60 per cent chance that the term will be longer than 15 years, but only a 30 per cent chance that the term will be for 20 years. Therefore, there is a 60 per cent chance that the term will be 15 years, which is the longest possible term more likely than not to occur. Therefore, the lease term is for 15 years.



Lease	Lease Term	Probability	Cumulative Probability
Current term	Lease term only 10 years	40%	100%
Option#1	Lease term will be extended to 15 years	30%	60%
Option#2	Lease term will be extended 20 years	30%	30%

However, under our proposed lease term definition assume that under the same lease an entity made a significant capital investment for improvements which are expected to provide a useful life of 10 years. At the end of the non-cancellable 10 year term, management will determine if its right-of-use asset is providing an adequate return based on several factors such as profitability of the location, market growth of the area, population, etc. If the factors for extending the right-of-use asset are positive at the end of the lease term, the entity will exercise the option, if they are not positive the entity will not exercise the option. The entity is unable to reasonably determine these variables at the inception of the lease. Thereby, under the proposed lease term definition, the lease term would be 10 years.

We propose that the lease term under the ED should be defined the same way lease terms are defined under the current IAS 17 standard. This will allow entities to better reflect the present obligation of the lease term and is much more practical for entities to determine. Overall, we do not believe that lease liabilities based on payments that may not occur based on management's decisions in the distant future should be included as a right-of-use asset or obligation on the balance sheet.

Finally, we do not agree with the Board's assumption that the reason for the proposed approach to include optional lease periods in the definition of a lease term is to avoid structuring opportunities. We believe that structuring opportunities can still be created under the definition of a lease term under the



ED. We believe that the Board should be more concerned about the resultant liabilities.

# **QUESTION#9: LEASE PAYMENTS**

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why? Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

We do not agree with the idea of including contingent rental in the measurement of right-of-use assets and lease liabilities. In several situations, contingent rentals are based on future events occurring, for instance rent based on future sales. We do not believe these contingent rentals should be included in the lease liability as they do not meet the definition of a liability with a present obligation based on past transactions or events.

## **OUESTION#10: REASSESSMENT**

Do you agree that lessees and lessors should re-measure 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 conceptually agree that under the ED entities should be required to reassess the right-of-use assets and lease liabilities after inception of the lease. However, given that under the ED entities will need to make significant assumptions in determining the lease term and lease payments (see our issues on these topics in Question 8 & 9 respectively), the reassessment process will prove to create significant practical and operational issues whereby entities will be required to incur significant costs to perform the reassessments. These costs will greatly outweigh any benefits associated with the ED.

In order to meet the simplification objective of the standard we propose to adjust the lease term & lease payment measurement requirements as discussed in Questions 8 & 9.

Finally, we propose that the reassessment of the leases should occur on an annual basis rather then at each reporting period. Several organizations have 3 month reporting periods; thereby the practicality of reassessing leases at each reporting period is not feasible.

## QUESTION#11: SALE & LEASEBACK

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 have no comment on the criteria for the classification of a sale & leaseback transaction.



# <u>QUESTION#12: STATEMENT OF FINANCIAL POSITION - FOR THE LESSEE</u>

(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?

**Liabilities** – We agree that lessees should present lease liabilities separately from other financial liabilities.

**Right-of-use-asset** – We agree that the nature of the right-of-use assets is similar to other assets included within property, plant & equipment.

# QUESTION#13: STATEMENT OF COMPREHENSIVE INCOME - FOR THE LESSEE

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

We agree with the ED on the presentation of lease expenses for lessees. We believe that disclosure of expenses that relate to leases in the notes to the financial statements would be sufficient.

## **OUESTION#14: STATEMENT OF CASH FLOW – FOR THE LESSEE**



Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

We agree with the ED on the presentation within the statement of cash flows.

## **OUESTION#15: DISCLOSURE- FOR THE LESSEE**

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

- (a) identifies and explains the amounts recognized in the financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

We believe that lessees in principle should use a modified version of the current finance lease disclosure requirement. We believe that lessees should disclose the qualitative and quantitative elements of a lease.

We believe that under the ED entities would be required to consume extensive resources in order prepare disclosures that would provide little benefit to users. For instance, we do not believe that a sensitivity analysis should be included within the ED, as this would be a difficult process with no direct benefit to the users of the financial statements.

Furthermore, if our modifications as discussed in Questions 8 to 10 are included within the ED, we believe that the required disclosures would be more feasible and practical to apply.

## **QUESTION#16: TRANSITION**



(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?

We agree with the simplified retrospective approach to applying the ED. However, we also believe entities should be able to choose whether they wish to apply the standard using (1) the simplified retrospective approach or (2) the full retrospective approach as required under IAS 8.

# QUESTION#17: BENEFITS & COSTS

Paragraphs BC200-BC205 set out the Boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the Boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

We believe that the benefits of the ED do not outweigh the costs. We have significant concerns around the cost and burden on preparers to apply all the requirements of the ED, especially with regard to difficulties of determining the lease term using optional renewals, lease payments and the extensive disclosures which would be required. All these additional variables will require preparers of financial statements to commit extensive costs, time to implement, training, and ongoing management of the ED.

**System considerations** – Entities will need to re-engineer their current processes around the capturing and reporting of lease data. At a minimum, entities will be required to incur significant costs to upgrade systems, hire additional resources and retrain staff in implementing and maintaining compliance with the requirements of the ED, while providing little to no benefits for users.



## **OUESTION#18: OTHER**

**Discount rate at inception** — Under the ED, preparers will be required to discount future lease payments using the same discount rate as at the standard transition date, or lease inception date. We believe that given interest rates are at historically unusual low levels, this will consequently result in entities presenting their lease liabilities at inflated levels over the remaining lease term with no ability to change the discount rate based on future interest rate conditions. We believe that these inflated lease liabilities will present additional operating and financial difficulties for those entities seeking any new financing or adhering to existing debt covenants ratios.

**Leasehold Incentives** – In real estate transactions, it is common practice that a lessor gives a cash payment (tenant allowance) or a grace period to the lessee at the commencement of a lease agreement. In practice, lessees have accounted for the transactions as a deferred liability on the balance sheet and drawn down this liability over the lease term against rent against. In reviewing the ED, there is no guidance on how lessees should account for these transactions upon implementation of the ED. Should the tenant allowance be accounted for as an increase in the lease liability whereby an effective interest expense is charged, or should the tenant allowance continue to be accounted for in the same manner as under the current existing standard? We require further guidance from the Board on this issue.

**Overall Guidance** – We are asking the Board to provide further example guidance tailored to the needs and requirements of lessees within the new standard.