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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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13 December 2010

Dear Sir David

Exposure Draft: Leases

We welcome the opportunity to comment on the joint IASB and FASB Exposure Draft (ED) on Leases and support the IASB in its efforts to improve Lease accounting and publish a globally accepted standard.

Our responses to the questions raised in the Exposure Draft are set out in the Appendix to this letter.

Whilst we are generally supportive of the move towards a principles based standard, and congratulate the IASB on its work so far, we are concerned that the application of the ED to lease extension periods would result in a departure from the conceptual framework. We consider that the recognition of lease extension options as lease assets in lessors', and lease liabilities in lessees' financial statements do not meet the conceptual framework definition of an asset or liability because they are options, and therefore there is no present obligation, on the part of the lessee, and no right to receive income on the part of the lessor.

We have a secondary concern surrounding the quantification of the lease term, as we consider the decision making process for a lessee or lessor with a significant number of leases will be unduly onerous and therefore we urge the IASB to conduct further research to ensure these concerns have been fully explored. Further comments on this area are included in our response to questions 8 and 17.

We also consider that the IASB has not put forward a convincing argument for the recognition of a net lease asset or liability within the statement of financial position for a lessor applying the performance obligation approach. We consider that it is inappropriate to offset the lease asset and liability and suggest that if there is a strong argument for recognising the asset and liability then there is a strong argument to present them separately within assets and liabilities. Further comments on this area are included in our response to question 12(b).

If you wish to discuss anything further please do not hesitate to contact me.

Yours sincerely

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Encs – Appendix A

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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?

Response:

a) We agree with the Boards that a lessee should recognise a right-of-use asset and a liability to make lease payments. The recognition of the right-of-use asset and liability reflect the business reality that the entity controls the use of an asset for a period of time, and also that it has an unavoidable obligation to pay for the use of that asset over the length of the contract term and will therefore provide useful information and allow financially similar transactions to be accounted for in a similar manner. We consider that the proposal for the asset and liability approach is largely consistent with the IASB Conceptual Framework, noting our reservations about the measurement of the lease term within the answer to question 8, and will lead to an improvement to the current model whilst limiting structuring opportunities which currently exist between on and off balance sheet lease assets and liabilities.

b) We agree with the proposal as this will provide relevant and useful information to users of the financial statements.

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?

Response:

a) We recognise that lessors have different business models that can fit into the hybrid model proposed by the Boards and therefore agree that a sensible distinction can made in line with how the business is managed. As a result we support the IASB model as it reflects the business model of lessors, and so should provide useful information to users. However, we caution that the dividing line will not be distinct and may be difficult to apply in practice and is likely to lead to structuring opportunities for lessors, which was one of the situations the Standard set out to avoid. However, we feel an element of management judgement cannot be avoided in the preparation of financial statements and therefore agree with the Boards' proposals for the performance obligation approach and derecognition approach for lessors.

b) We agree with the proposal as this will provide relevant and useful information to users of the financial statements.

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?

Response:

Whilst we consider that it is important that short term leases are recognised where they are material individually or in aggregate, we agree with the proposed simplifications where the treatment would not be significantly different due to the short lease term. However we would encourage the Board to revisit the wording of paragraphs 64 and 65 to ensure they are consistent with the rationale in BC46 which suggests the reason the assets and liabilities can be dealt with in a simplified fashion is that the short lease period "may make the assets and liabilities arising from those leases insignificant". This rationale is understandable and if developed into paragraphs 64 and 65 would avoid the preparer simply "cherry picking" those leases to which they do not wish to apply the standard on an arbitrary basis. We therefore consider that if the intention is that the preparer should only apply the simplification to those leases where a significant difference in accounting outcome is unlikely due to the short lease term then the standard should make this clear.

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?

Response:

a) We agree that a lease is defined appropriately.
b) We agree that the criteria in paragraphs B9 and B10 are suitable to distinguish a lease from a contract that represents a purchase or a sale, however as noted in our response to question 11, we consider that the criteria in B31 are also indicative of a purchase/sale situation and could be added to this section.
c) We are concerned that the distinction between leases and service contracts will be difficult to apply in practice. We consider that further guidance is required in addition paragraphs B2 to B4. Our principle concern is that entities may structure leases as service contracts in order to obtain a specific accounting treatment. Rather than include specific criteria surrounding the provision of a specified asset, we consider the criteria should look at the business rationale for entering into the agreement.

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?

Response:
The argument advanced by the IASB has not convinced us that there is a conceptual reason for the scope exclusions for intangible assets. Furthermore IAS 17 included some intangibles within its scope and so to have a blanket exclusion may have unwanted side effects and is a clear deterioration from the current position. We therefore urge the IASB to give further consideration to the treatment of intangible assets prior to the finalisation of this standard in order that the new standard is an improvement to IAS 17 in all areas.

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?

Response:
We believe that where service components are distinct these should be separated out and accounted for under the revenue proposals. Where there are non-distinct service components we believe that both lessors and lessees should identify the predominant component and treat the whole contract accordingly. This would accord with the business rationale for entering into the contract and would provide a practical approach that depends on the entity's perception of the overall economic substance of a contract, and minimises complexity by allowing lessors and lessees to avoid attempting to separately ascribe values to 'non-distinct' services, which by their nature cannot be separated.

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?

Response:
We agree with the view that a purchase option is a means of terminating the lease therefore such options should only be accounted for when they are exercised. We agree that the exercise price of a purchase option is not a lease payment and should not be included in the measurement of the lease.

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?

Response:
Whilst we understand that this is a difficult area we support the alternative view expressed by Stephen Cooper. We consider that amounts payable or receivable under extension periods do not meet the definition of a liability or an asset under the conceptual framework and as a result they should not be recognised in the financial statements. Paragraph 61 of the framework makes it clear that a distinction needs to be made between a present obligation and a future commitment. We consider that this is fundamental to the understanding of the financial statements and the recognition of uncommitted liabilities would overstate the liabilities of a lessee.

We hold the view that for a lessee, until the decision to extend the lease has been taken and the contract has been entered into (i.e. commitment), there is no obligation to pay cash, and so no liability should be recognised. If this were to be enacted then recognising the longest likely lease term will result in dissimilar leases being accounted for in the same way (e.g. a 20 year lease could be accounted for in the same way as a 5 year lease with an option to extend for another 15 years).

Investors should have confidence that only the entity's unavoidable obligations are provided for in the financial statements at the year end, rather than being complicated by the expected outcomes of a decision that can change with the business cycle and therefore add to the volatility of reported balance sheet items, and hence on covenants surrounding debt and equity. An investor should know which cash flows are committed and which are subject to future decisions.

Recognising the longest likely lease term is equally difficult to justify conceptually from the lessor's point of view, since they do not have any control over whether the lease is going to be extended, and so would effectively be recognising a contingent asset. To recognise a receivable suggests that the key risk is credit risk, whereas there is an asset or business risk as Mr Cooper points out in his opposing view.

We therefore consider that information about secondary lease terms and options to extend leases are better dealt with from a disclosure perspective to allow the users to decide whether they attribute any value to that asset or liability.

We anticipate that the decision process for preparers with multiple operating leases will be overly onerous. At present, preparers with operating leases record the length of the contractual term and the amount payable under each lease. The new standard would require significant management input into the expected lease term for every lease with very little added clarity to the financial statements. We consider the costs of this would outweigh the benefits of this requirement.

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?

Response:
Whilst our concerns over the recognition of lease extension options are shown in our response to question 8, we consider the topic of lease payments during the contractual term to be a measurement issue. We therefore consider that the financial statements should accurately reflect the measurement of the contingent rentals and expected payments under term option penalties and residual value guarantees arising under a lease. We are comfortable that such options can be reliably measured using an expected outcome technique as this should reflect the most accurate measurement of the cash flows under the contractual terms of the lease.

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?

Response:
We consider that it is important that the financial statements at each reporting date reliably and accurately measure the lease assets and liabilities over the term of a lease. Therefore we consider that lessees and lessors should ideally remeasure assets and liabilities at each reporting date. However, we are satisfied that requiring remeasurement only where there is an indication of a significant change is a pragmatic and appropriate approach as it is considerably less burdensome than requiring a periodic reassessment of all lease contracts. We suggest that consideration is given to define the term "significant" in this context to assist preparers in determining how this threshold differs from the concept of materiality.

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?

Response:
We agree with the criteria for classification as a sale and leaseback transaction. We believe that the information in paragraph B31 is also relevant to distinguish between a lease and a purchase or sale and therefore it may be appropriate to include, or at least cross refer to, this criteria within paragraphs B9 and B10.

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?

Response:

(a) We agree with the proposed presentation in the statement of financial position for lessees. We believe this will result in transparent and decision useful information within the lessee's financial statements.

(b) We disagree with the proposal that lessors applying the performance obligation approach should present a net lease asset or liability on the face of the statement of financial position. We have concerns that this is inconsistent with IAS 1 and do not consider that the IASB have put forward a convincing counter argument to rebut the presumption that to offset "detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows."[1] We have concerns that this has been proposed to alleviate the perception that under this approach the underlying asset is somehow double-counted. We consider that if this is the case, then the model requires further minor modification to avoid this perception.

(c) We agree with the proposed presentation in the statement of financial position for lessors applying the derecognition approach.

(d) We agree that lessors should distinguish assets and liabilities relating to a sublease in the statement of financial position if these balances are material.

[1] *IAS 1 paragraph 33*

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?

Response:
We agree that lessees and lessors should present lease income and expense separately from other income and expense in profit or loss. We believe it is useful for the impact of leasing transactions to be clearly disclosed on the face of the statement of comprehensive income.