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International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

Dear Colleagues:

## **Exposure Draft 2013/6: *Leases***

We are grateful for the opportunity to comment on Exposure Draft 2013/6 *Leases*.

We welcome the progress that the Board has made in developing a new leases standard and we support many of the key proposals.

Shell routinely enters into leasing arrangements as lessee because they offer greater operational flexibility than outright asset purchases. We therefore especially welcome the refinements made to the proposed requirements since the 2010 Exposure Draft in respect of the initial recognition of lease extension options and variable payments, which we consider strike a good balance between good quality financial reporting and the cost of producing it.

We do, however, feel that there is some progress yet to be made on the issue of reassessment. In many instances, reassessment will not be necessary because none of the assumptions made at initial recognition has changed; nonetheless, preparers will be required to demonstrate that this is not the case. Where remeasurement is found to be required, the accounting requirements are complex and may not noticeably improve the quality of the financial information. On balance, our view is that the initial recognition requirements proposed are sufficiently robust as to render reassessment unnecessary.

Several new proposals appear in this Exposure Draft, which we acknowledge represent the Board's efforts at reconciling the varying views of its constituents. While we recognise that the move away from straight-line expense recognition of what are currently operating leases may require some adaptation, we are neither convinced that two accounting models are therefore required nor that the proposal for Type B lease accounting model is the appropriate answer. Furthermore, the introduction of two accounting models will

significantly increase the implementation effort, requiring two systems to deal with the different accounting processes. We therefore strongly urge the Board to reconsider this proposal.

Another new proposal concerns the guidance on determining whether or not a contract is or contains a lease. We welcome the Board's response to the call to refine the narrow-scope, rules-based guidance that is currently provided in IFRIC 4 *Determining whether an Arrangement contains a Lease* and we believe that the control and risks/rewards model proposed is appropriate. Our expectation was that nearly all contracts currently classified as leases would continue to be treated as such. However, our research indicates that the proposed criteria will result in significantly fewer contracts being classified as leases – including some that are accounted for as finance leases. We also find that some of the proposed guidance is vague, such that there is a real risk of diverse accounting treatments emerging.

We therefore urge the Board to strengthen the proposals to make them more robust.

Our detailed responses to the questions raised by the Board accompany this letter. In addition, we have included a number of observations on other matters not specifically raised.

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

## Scope

### Question 1: identifying a lease

*Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.*

In principle, we agree with the proposed definition of a lease and we welcome the attempts to improve on the current guidance in IFRIC 4 *Determining Whether an Arrangement Contains a Lease* on how to determine whether a contract is or contains a lease. In our view, if the new leases standard is going to be successful in improving financial reporting, the distinction between a lease and a service contract needs to be both robust and workable. Our experience has been that IFRIC 4 is often difficult to apply in practice and does not always result in determinations that make sense.

The proposed guidance in paragraphs 6-19 is, in our view, an improvement on the IFRIC 4 requirements. We also think it is appropriate to analogise the control and risk/rewards model that underlies IFRS 10 *Consolidated Financial Statements*.

We are, however, concerned that in some aspects the proposed guidance falls short of its objective of ensuring all contracts that rely on the use of an asset are properly and consistently accounted for.

The proposals differ from current requirements because, in addition to fulfilment of the contract depending on the use of an identified asset, they require the customer to have the ability to direct the asset's use and derive the benefits from that use if the contract is to be deemed to be a lease. Under IFRIC 4 the ability to operate or direct the use of an identified asset while obtaining the output would result in a lease but is not a necessary condition. Therefore, contracts where the customer does not have this ability but which are currently leases under IFRIC 4:9(b) because of the control of physical access or IFRIC 4:9(c) because of the payment structure would not be classified as leases under the new standard. These changes have the effect of shifting the boundary between lease and service contracts such that fewer agreements will be classified as leases, including contracts that are currently classified as finance leases. In our view, this will make for less transparency than under the current regime: operating leases are at least required to be disclosed; under the proposals, a contract that is not classified as a lease is not disclosed at all. We fear this could lead to distrust in the completeness (conceptually speaking) of amounts recognised in the balance sheet and suspicion about what other lease-like commitments companies have which are not disclosed.

Having reviewed our own leasing arrangements, we also conclude that the proposed guidance on determining whether or not the customer has the ability to direct the use of the asset fails to take into account the broad "grey area" that many asset-with-services contracts occupy, particularly those where decisions about use are often shared by the customer and supplier or are to a great extent pre-determined, for example, by industry standards. These arrangements fall within the scope of IAS 17 largely because of the criterion in IFRIC 4:9(c) and to a lesser extent IFRIC 4:9(b), and their classification as leases is, we feel, appropriate. However, the proposals as drafted leave us with little solid guidance on how the boards intended these contracts to be accounted for; this will undoubtedly lead to unwanted divergence in practice as constituents reach – justifiably – differing conclusions.

Despite these concerns, we continue to believe that the control and risks/rewards model in IFRS 10 is the most appropriate framework for defining a lease. We would urge the boards to explore the potential to extend the analogy further, particularly in the following aspects:

- (a) IFRS 10:B20 provides the guidance that an investor would not ordinarily expose itself to large variability of returns without having rights to be able to control that variability. While the same presumption would not necessarily apply to all lease contracts, the fact that the customer obtains

substantially all the benefits from the output of an asset could be cast in the guidance as a presumption that the customer has the rights to direct the asset's use, unless it can be demonstrated that in fact the supplier directs the asset's use.

- (b) IFRS 10:B47-50 describe situations where an investor holding less than a majority of the voting rights nevertheless controls the investee if it has a presently exercisable option to obtain a controlling interest. This is an example of where the investor has the ability to direct the investee but chooses – for the time being – not to exercise that power. This is perhaps comparable to situations where the customer does not direct all the uses of an asset (for example because most decisions are taken in collaboration with the supplier, which has perhaps specialist expertise in the use of the asset); however, the customer can ultimately require the supplier to use the asset in a particular way within technical, safety and legal confines.

For the reasons stated above, we cannot support the proposals for determining whether or not a contract is or contains a lease. We therefore urge the boards to consider strengthening the guidance to ensure it achieves the overall objective of the project.

## **The accounting model**

### **Question 2: lessee accounting**

*Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?*

We agree with the proposal to allow the option to exclude short-term leases from the scope of lease accounting. We believe it is a practical expedient that will not have a detrimental effect on the quality of financial reporting.

We do not agree with the proposal to introduce the Type B lease accounting model, for two reasons.

Firstly, we are concerned by the conceptual flaws of this model. The introduction of a new methodology for the measurement of assets may have unintended consequences (particularly with respect to impairment testing) and create precedents that have as yet not been thoroughly researched. We note also that the Board recently affirmed the principle in IAS 16 that the method for depreciation or amortisation should reflect the expected pattern of consumption of the future economic benefits embodied in the asset. The Type B model would appear to conflict directly with that principle and we wonder how the Board will resolve this.

Secondly, we fear that the introduction of two accounting models will bring unnecessary complexity to the accounting for, and reporting of, leases. The implementation of the leases standard is likely to require significant investment in updating accounting systems; the imposition of two lease accounting models will effectively require preparers to invest in two accounting systems: one for each model. They will also nullify the benefits of eliminating the current distinction between operating and finance leases by replacing them with the need to determine the distinction between two new types of leases. All of this will involve significant additional cost and time, both at implementation and on an ongoing basis. In addition, we believe the quality of financial reporting will be adversely affected by the complexity of presenting two types of lease in financial statements, the income and cash flow statements in particular.

We note the significant efforts undertaken by the boards in attempting to meet the concerns of constituents who favour a “straight-line” approach to lease accounting, particularly with respect to property leases. However, we do not feel the concerns are of such significance that they merit this additional complexity and cost. The Type A model has the advantage of being largely familiar to all constituents and should, in our

view, be retained as the only model for leases other than the short-term leases that the Exposure Draft proposes to scope out.

### **Question 3: lessor accounting**

*Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?*

Our position is that lessor accounting is not in need of reform. We continue to favour the de-recognition model that is currently applied in respect of finance leases as the only appropriate approach for future leases.

### **Question 4: classification of leases**

*Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28–34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?*

For the reasons stated in our responses to questions 2 and 3, we do not agree with the proposal.

## **Measurement**

### **Question 5: lease term**

*Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?*

We consider the proposals concerning measurement at initial recognition to be much improved when compared with previous proposals. In our view, the requirements strike the right balance between ensuring that lease options and variable payments are properly reflected in the measurement of lease assets and liabilities and making them operational across a wide range of possible scenarios. Consequently, we support these proposals.

We would however recommend that the guidance on determining the appropriate incremental borrowing rate to be applied in discounting lease assets and liabilities includes an explicit statement that the rate applied should be based on the incremental borrowing cost the lessee would incur if it were to borrow: (a) a similar amount, (b) in the same currency, and (c) for a similar period of time. For example, if an entity entered into a five-year lease valued at USD 10 million, it should base the discount rate on the interest rate it would incur in issuing additional borrowings of a similar amount in the same currency for a similar period of time. This may seem an obvious point, but we feel such guidance would ensure that inconsistencies do not arise in the measurement of lease assets and liabilities. It would be especially relevant to entities holding leases of different sizes, maturities or in different currencies from its outstanding debt.

Notwithstanding the above, we would also welcome further guidance that permitted the use of a portfolio approach to the determination of the appropriate discount rate where an entity holds various more or less comparable leases, such that a single discount rate may be applied to all new leases, with that discount rate updated periodically to reflect market- and entity-specific changes.

We find the reassessment proposals overly burdensome when weighed against any likely benefits in terms of financial information. We are sympathetic with the objective of making sure that lease assets and liabilities reflect current views (i.e. as at the reporting date) of the remaining lease term, which may have changed since initial recognition. Nonetheless, the proposals in paragraphs 27, 43, 44 (a) and (b) and 45 (a) and (b) will require regular reviews of lease contracts to ensure the original assessments have not changed and, if they have, to remeasure and account for the resulting changes. They will impose significant additional administration, even if remeasurement is not required.

Consequently, our preferred approach would be not to require reassessment.

For situations where a lease is extended beyond the previously expected term (i.e. the term used at initial recognition), we would propose that the extension should result in the recognition of a new lease asset and liability at that date.

For situations where a lease is expected to end sooner than originally expected (because the significant economic incentive to extend is no longer present), we would propose that the asset and liability be de-recognised at the date on which the lease is terminated.

### **Question 6: variable lease payments**

*Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?*

Consistent with our views on lease terms, we feel that the proposals concerning measurement at initial recognition are sufficiently robust and workable that subsequent reassessment would be redundant: the cost of ascertaining whether remeasurement is required, measuring it and accounting for it would far outweigh the incremental refinements to the carrying amounts of lease assets and liabilities.

In particular, we are concerned by the proposals to reassess the discount rate applied, a practice that is not currently applied to other financial assets and liabilities that are carried at amortised cost using the effective interest rate, for example debt. In our view, most users will consider lease liabilities to be equivalent to financial liabilities and it is therefore desirable that the two items are measured and presented consistently.

### **Transition**

#### **Question 7: transition**

*Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why? Are there any additional transition issues the boards should consider? If yes, what are they and why?*

We favour the flexibility of being able to apply the new leases standard using either a modified retrospective approach or a full retrospective approach, and therefore we agree with the proposals. We also believe the specified reliefs in paragraph C7 will be helpful to many preparers in alleviating the considerable burden that implementing the new standard will place on them.

Regardless of the boards' final decisions concerning transition, it is clear that implementation of the new leases standard will require considerable effort on the part of preparers such as Shell. In addition to ascertaining the transition accounting adjustments required in the year of implementation and for

comparative periods, preparers will need to bed down the new requirements in their financial reporting and management accounting systems, reassess and adjust controls procedures and communicate the changes internally and externally. We therefore take this opportunity to urge the boards to set an effective date that allows sufficient time for these activities to be carried out.

At the detailed level, we think there is scope to make transition less onerous and would suggest the following to be taken into consideration by the boards:

- (a) Paragraph C8(a) specifies that the lease liability be measured as at the transition date (the beginning of the earliest comparative period) but using the discount rate applicable as at the effective date. We think this is unhelpful because it will mean that preparers are unable to fully prepare for implementing the new standard until the standard becomes “live”. If the discount rate applicable as at the transition date were used to measure transition date liabilities, this would enable preparers to confirm in good time the transition adjustments required and to test their systems prior to the effective date. It would also eliminate financial reporting “noise” at transition caused by changes in discount rates between the transition and effective dates at what will undoubtedly be a busy time.
- (b) Paragraph C3 makes clear that the new leases standard should be applied to leases that are still operative at the transition date, rather than leases that are operative at the effective date. This means that leases that end prior to the date the new leases standard becomes effective will nonetheless need to be accounted for under that new standard. The logic for this is obvious; however, it does result in putting additional pressure on the time needed to implement the new standard because the effective date is, practically speaking, the transition date. We would suggest either dropping the requirement to account for leases that end prior to the effective date or ensuring that preparers have sufficient time to properly implement the new standard.
- (c) As an alternative, the boards might also consider not requiring the restatement of comparative periods as a means of shortening the time between publication of the standard and its effective date without placing undue strain on companies preparing for transition.

We also draw attention to the assumption in paragraph C10 that all finance leases under IAS 17 will remain within the scope of the new leases standard. As our response to Question 1 explains, this may not always be the case. To avoid confusion, we would recommend revisiting the wording of this paragraph.

## **Disclosure**

### **Question 8: disclosure**

*Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?*

Generally, the proposed disclosure requirements appear commensurate with the proposals for lease accounting. However, we do consider the proposal in paragraph 64 to disclose a reconciliation of lease liabilities and the proposal in paragraph 67 to disclose annual maturity information to be excessive. This is because, even though lease liabilities are to be accounted for similarly to financial liabilities carried at amortised cost, there is no requirement in IFRS 7 to provide these disclosures. We therefore contend that these proposals are superfluous and recommend that they be excluded from a new lease accounting standard.

## **IAS 40 Investment Property**

### **Question 12 (IASB-only): Consequential amendments to IAS 40**

*Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?*

We agree with the IASB's proposal.

### **Other matters**

We would like to take this opportunity to address certain other matters that are not specifically referred to in the questions posed in the Exposure Draft.

#### *Financial statement presentation*

We agree with the proposals (in paragraphs 54-55) concerning the presentation of lessees' lease assets and liabilities. We believe it is right that the decision to present those assets and liabilities on the face of the balance sheet or in the notes should be guided by IAS 1 Presentation of Financial Statements. In our view, the same approach should be applied to presentation in the statements of comprehensive income and cash flows; we therefore consider the requirements in paragraphs 56 and 57 to present these items in the statements themselves rather than the notes to be unnecessarily prescriptive.

#### *Interaction with IFRS 11 Joint Arrangements*

Companies in the oil and gas industry frequently enter into joint arrangements that use leased assets, the associated costs of which are either shared among the partners or recharged by one partner to the other partners according to their share in the arrangement. Many such leases are operating leases and do not present any significant accounting issues. The proposed definition of a lease and the revised accounting model could, in our view, lead to unintended consequences because the Exposure Draft assumes there to be only one customer, i.e. a single entity. Where several partners jointly lease an asset or share in the lease, the proposed definition would result in no lease being accounted for because none of the partners directs the use and benefits from all of the asset's output.

Our recommendation would be to clarify in the leases standard that in the context of a joint arrangement, the partners to the arrangement should be considered the "customer" for the purposes of determining whether a contract is or contains a lease.

#### *Consequential amendment to IFRS 3 Business Combinations*

The consequential amendment to IFRS 3 *Business Combinations* in respect of the acquiree's leased asset (B45E) requires a two-step approach of first establishing the present value of the remaining lease payments and then adjusting that value for favourable or unfavourable terms and other relevant market-related intangible assets. The Basis for Conclusions does not explain why this approach is proposed. It appears that the proposed approach attempts to measure the leased asset at its fair value. If this is the case, we think it would be more helpful if the amendment instead permitted a one-step approach that requires measuring the leased asset at its fair value. If the boards had other intentions, we think it would help constituents to properly apply the guidance if they explained what they expect the difference between the leased asset's fair value and the two-step measurement to be.

#### *Consequential amendment to IFRS 13 Fair Value Measurement*

The consequential amendment to IFRS 13 *Fair Value Measurement* deletes the scope exclusion from that standard for leases. The Basis for Conclusions does not explain why this deletion is considered appropriate.

IFRS 13:BC22 explains: “The IASB concluded that applying the requirements in IFRS 13 might significantly change the classification of leases and the timing of recognising gains or losses for sale and leaseback transactions.”

The main reason IFRS 13 might have significantly affected lease classification is that IAS 17 requires the lessee to compare minimum lease payments with the asset’s “fair value” in order to determine whether the lease is a finance or an operating lease. In such circumstances, the appropriate measure of fair value is the asset’s purchase price; it is this value that best informs an entity’s decision to buy or lease the asset in question. However, IFRS 13’s notional exit price principle is incompatible because it would require the lessee to derive its resale value, potentially in a different market from that in which it would buy the asset. It is therefore sensible that leases were excluded from the scope of IFRS 13.

Although lease classification under the ED differs in purpose from that under IAS 17, the conflict remains. In order to determine whether a lease is a Type A or Type B lease (paras 29-30), the lessee must ascertain the asset’s fair value. In our view, the appropriate measure of that value is the entry (purchase) price, not its exit price. We therefore suggest the boards add guidance in the ED to confirm that the “fair value” is based on the lessee’s entry price.