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9 September, 2013

Dear Chairmen,

### **Comments on ED/2013/6 LEASE**

1. Thank you for the opportunity to comment on the second exposure draft, Leases ED/2013/6.
2. The new exposure draft is a significant improvement on the first exposure draft, ED/2010/9, and reflects a number of important simplifications. The ED also acknowledges for the first time that leases cover a wide spectrum of transactions, some of which are not necessarily of a financing nature, and accords them a straight-line expense pattern. I support this view, but I believe the Boards may have chosen the wrong dividing line.
3. I also believe that there is a lot the Boards could do reduce complexity by encouraging the use of practical shortcuts, estimates and approximations and by adopting a much less prescriptive tone in the text of the standard. The standard should emphasise the objectives it is trying to achieve in measurement and disclosure, and allow some flexibility so that reporters can make reasonable endeavours to achieve them without excessive cost.

### **Respondent information**

4. Before I retired in 2011, I was a director in PwC's Banking & Capital Markets Division in London. My career with PwC and its predecessor firms spanned over thirty-nine years, of which some thirty years were spent specialising in providing auditing and advisory services to the leasing industry. I was author of "Leasing In the UK", first published by Euromoney in 1992, and the principal author of four subsequent PwC editions published through Tolley's (1998-2002). During my career I acted as a technical advisor on a large number of complex leasing transactions; forensic investigations of failed leasing companies; and litigation matters involving lease accounting. And over the course of my career I have spoken at over 100 conferences and training courses on leasing. Before I retired, I was Chairman of the firm's global Leasing Industry Accounting Group, and was recognised as one of the firm's leading global experts in lease accounting.

5. I also acted on certain external committees on lease accounting. I was a member of the Finance & Leasing Associations Working Party that introduced the UK SORP on lessor accounting; and I served on the ICAEW's sub-committee on the review of IAS 17. Throughout my career I have followed lease accounting developments with a keen interest and since retiring have continued to track the Boards' progress.

### **The Boards' Leases project**

6. The anomalies of off-balance sheet finance have long been known. In 1996, Warren McGregor, the principal author of the special report "Accounting for Leases: A New Approach", wrote:

"Under the approach set out in this Paper, assets and liabilities under non-cancellable operating leases could be accounted for *using the principles established in current lease accounting standards for the recognition of assets and liabilities under finance leases*. The amounts recognised would reflect the period for which the resources are controlled and the related obligations undertaken."

\*My italics have been added for emphasis.
7. Unfortunately, it took the Boards another ten years before they put lease accounting formally onto their agendas, and then another six years of project development to get to where the Boards are today. Notwithstanding the need for proper due process, the progress on the Lease project has been extremely slow and at times frustrating.
8. The principal problem that has plagued the Leases project is that despite the consensus for recognising operating lease liabilities on balance sheet, there has been little consensus among analysts, user groups and preparers as to how best to achieve this. And the devil has always been in the detail of measurement.
9. In my view, there have been two major impediments to the project's progress. The first was the initial Boards' views that all leases had the same economic consequences and required the same accounting treatment. This view was largely a reaction against the existing risks and rewards approach, which was seen as flawed. The second was the attempt to measure complex aspects of lease transactions, such as contingent rentals and lease renewals, rather than rely on the existing measurement bases used for finance leases. As a result, the proposals in the Boards' discussion Paper (2009), and subsequent ED/2010/9 were overly complex and would have proven impractical to implement.
10. In its latest exposure draft, ED/2013/6, the Boards acknowledge that some leases are non-financing in nature. This marks a significant change in the Boards' thinking. Furthermore, the treatment of contingent rent and renewals have changed to a simpler basis closer to that applied for finance leases under existing practice. Both changes are welcome.

## **Lessee accounting – the profit and loss impact effects of lease capitalisation**

11. I believe the Boards are right to distinguish between leases that are financing of the underlying asset and those that are not. But in my view a more meaningful and practical distinction would be to use the well-known finance/operating lease criteria, rather than a new criteria based on consumption.
12. When the Boards debated this issue, one of the matters they considered was the lessee's expense under the 'whole asset approach' of lease accounting. Under this approach, the level of lessee's charge for interest and depreciation depends on the extent to which the underlying asset's value is consumed during the lease term. So if no consumption of value is expected during the lease term, the whole of the rental would reflect the lessor's return on the lease – that is, a straight-line pattern. Although the Boards rejected the whole life asset approach, they were clearly influenced about the nature of the lessee's economic expense to find a reason to exempt operating leases of real estate from the front-end loading effects of lease capitalisation. And so the Boards defined Type B leases to allow what effectively amounts to annuity depreciation, in all but name, for operating leases of real estate.
13. It was also very clear from the Boards' discussions that the board members were not minded to extend the same treatment to long term operating leases of equipment, as they believed most of them to be financing in nature. The proposals, therefore, set a much more stringent threshold for leases of plant and equipment leases to qualify as Type B leases than the threshold for real estate. For a real estate lease to qualify as a Type B lease, the lease need only qualify as an operating lease. For a lease of plant and equipment to qualify as a Type B lease, the lease must consume no more than an insignificant proportion of the underlying (measured in terms of lease term to asset life, or present value of rents to the fair value of the underlying).
14. I can understand the Boards' reason for wanting to treat real estate leases differently from other assets due to their investment nature. But from the point of view of good standard setting, it seems illogical to set different thresholds for different asset classes, without any real economic justification. In BC 62, the Board sets out its reasons:

“...if a lessee was to classify all leases that are operating leases as Type B leases, a lessee would be likely to present a single expense for a 20-year lease of a vessel or an aircraft rather than presenting amortization and interest on the transaction.”
15. Firstly, the example is a poor one; a 20-year lease of an aircraft would almost certainly be classified as a finance lease under IAS17; the vessel may indeed be marginal depending on its type. But there are even more perverse examples that can be shown to have the opposite effect. Compare a seven-year lease of a ship with a twenty-year lease of a building; both with an asset life of say fifty years. The lease term is for 14% of the life of the ship and 40% of the life of the building; but the lease of the building would qualify as a type B lease, the lease of the ship would probably not.

16. Even taking the Boards' example of a 20-year operating lease of a vessel, I am not convinced that the depreciation and interest expense is any more relevant in reflecting the true economic cost of using the asset, than the rental expense, because the depreciation and interest expense would not be comparable to that of an equivalent owned asset. (The only methodology that would provide this comparability of depreciation and interest expense is the 'whole life' approach, which the Boards have firmly rejected.) By contrast, the disclosure of the rental and analysis of lease liability provides analysts with the raw data to perform whatever calculations they wish.
17. One of the biggest problems with the Boards' Type A/B approach is that although it is based on a principle (consumption of value), the accounting treatment is rule-based using ad hoc rules for different asset types that the Boards think will produce the right effects most of the time. One of the main criticisms of FAS13 is that it is not a principles-based standard: the accounting rules were given priority over the principle underlying them. The Boards are in danger of making the same mistake again.

#### **Are all leases financing in nature?**

18. Of course, some Board members have persistently argued that all leases contain a financing element, because it may be possible to pre-pay (or in other cases defease) the rents at an amount less than the full amount of the outstanding future rent. This argument ignores the fact that the discount rate used for calculating the pre-payment or defeasing the rent would be at a substantially lower rate than the rate that the lessor priced into the lease in order to maintain the lessor's expected return. As a consequence, any pre-payment of a lease would fundamentally change the economics of the transaction. For example, why would a lessee enter into a transaction at a lessor's rate of say 8.5% and then prepay the rent obligations at say 5%? The ability to pre-pay a liability is, therefore, not by itself a sufficient test of whether a liability is financing in nature.

#### **Looking again at IAS 17 classification criteria for non-financing leases**

19. If 'prepayment' and 'consumption of value' are not necessarily useful tests of whether a transaction is financing or not, what is? One answer might be to look more closely at the existing risks and rewards framework, which worked reasonably well under IAS17, and is well understood. The principal criticisms of the risks and rewards approach mainly relate to the application of FAS13 under US GAAP, where some companies exploited the mechanical application of the standard. The same problems did not arise to anything like the same degree under IAS17, where the overarching principle was to reflect the substance of a lease transaction. A starting point for looking at whether a transaction is a financing or not could be to look again at the existing IAS 17 definitions and, if necessary, tweak them.
20. Under IAS17, finance leases are quite clearly financing in nature since they are near substitutes for other types of asset finance used to acquire the underlying; the lessor's return is largely in the nature of a financing return; and the principal risks the lessor bears are credit risk.

21. The nature of returns in operating leases are more difficult to analyse; the expected returns are usually larger than finance leases, and the actual returns are more variable; and the risks extend beyond credit to forms of asset risk. At one extreme, the interest element of the pricing of a daily hire contract would be insignificant and the contractual arrangements looks more like service contract than a financing. At the other extreme, some lease contracts may include very little in the way of additional services, but include fixed purchase options that effectively cap the lessor's expected return at a rate similar to that of some unsecured lending rates. Nevertheless, if a line is to be drawn between financing and non-financing arrangements, the existing line between finance lease and operating lease seems the most natural place to draw it.
22. If the boards are looking for a reason to treat operating leases and obligations differently from other tangible assets and their financings, there is one unique feature that makes them different. They are a single contractual package where the rights to use the asset are limited to a period of time, and obligations to pay rent are closely bound together. Furthermore, where the terms of the lease, or business practice, permit early termination, the settlement of the obligation will be invariably be on a net basis, taking into account the lessor's remaining investment and his expected proceeds from the sale of the asset. They are therefore fundamentally different from other forms of finance, which are independent of the assets they finance.
23. If the objective of the leases standard is to measure the rights and obligations under a lease contract in a relevant and unbiased manner, it seems illogical to measure the liability and the asset using different bases. In fact, using different bases implies the lease contract has a negative effect on the business: a view that is potentially misleading.
24. In the feedback to ED/2010/9, some analysts expressed concern about how replacing rental with depreciation and interest charges would impact the income statement. At least some analysts, therefore, believe that the operating rental expense was more relevant than the interest and depreciation expense. I support this view. The best measure of the economic cost for the using the underlying asset is simply the periodic rental expense. At the inception of a lease the periodic rent is the economic cost of using an asset for the required term determined by a market transaction. Why ignore this?
25. Using the existing finance/operating lease distinction for leases, and treating all operating leases in the same way as Type B leases, would have a number of important advantages:
  - It would achieve the principal goal of including all lease liabilities on balance sheet.
  - It would be simple to apply as companies already classify leases on this basis.
  - It would lead to a profit and loss charge consistent with current practice, and therefore would avoid large restatements of equity and associated problems of capital adequacy.
  - It may be less problematic for debt covenants, because the impact of GAAP changes on balance sheet and income ratios would be easily identifiable and adjustable.
  - It may avoid some analysts' need to recast the income statement to get back to the original rental charge.

- It may be possible to measure some operating lease classes on a portfolio basis (see below) thus saving considerable amounts of preparation time.

### **The need to reduce complexity by using practical shortcuts**

26. My main concern with the ED's proposals is that, despite extensive outreach, the Boards may have failed to fully appreciate the size of the problem facing some companies that would have to account for large volumes of relatively small value operating leases. BC 342 simply states: "Lessees that have less sophisticated systems in place to manage and track leases are expected to incur more significant costs than lessees with sophisticated systems." From my research, many companies do not even know how many operating leases they have as they are often lost in the cost centres of individual expense budgets. Leaseurope's data suggest that the average size of a lease transaction by their associations members is only 28,000 euros. Many operating leases include such small ticket items such as: cars, vans, fork lift trucks, laptops, photocopiers, IT and telephone equipment, short-leases of property etc. Basically, there are lots of operating leases and capturing this data is going to be problematic. Even trying to determine just how material the effects of these leases are will prove difficult without performing an exercise to quantify them. And once quantified, there is little point in not reporting them.
27. In addition, further complexity would arise because many of these leases are subject to frequent changes during the term of the lease. For example, in car leases the rentals may be reset at service intervals to reflect changes in anticipated mileage, leases may be subject to 'informal extensions', or the lease term may be defined in terms of mileage rather than time. In IT leases, large numbers of assets may be leased on a pool basis, with upgrades/replacements occurring during the life of the master contract. Accounting on an individual lease basis is going to be difficult. The large numbers problem also arises with real estate. In the case of one retailer I spoke to, they had over 10,000 operating leases of small retail outlets, all of which were relatively short term and constantly churning.
28. If the Boards are prepared to extend the treatment of type B leases to all operating leases and not just real estate, I think there are ways of dealing with the practical issue of measuring these potentially large volumes of operating leases. Companies already have processes and procedures for gathering details of operating lease obligations by their maturity for year-end reporting purposes under current standards; and they could extend this information into smaller time bands. The main problems associated with capitalising these leases, then stem from the missing information relating to the historical discount rates applicable to individual leases, and the complexity of calculating net book values. If the standard were to permit the user to elect, on an asset category basis, to use current borrowing rates to measure their operating lease obligations, the calculations of lease liability and net book value for large volumes of leases could be performed on a portfolio basis.

29. For example, if a retailer elected to use current rates for all of its categories of asset, except say its real estate leases, the process would simplify down to the following:
- Continue to measure and report finance lease assets and obligations as under existing lease accounting standards. (There is no reason to change the accounting of these leases.)
  - Measure and report real estate operating lease liabilities using historical rates on an individual lease basis.
  - Measure and report plant and equipment operating leases liabilities on a portfolio basis using current borrowing rates based on the average maturity of lease payments for each major asset class.
  - Measure operating lease assets at the same amount as the relevant lease liability +/- the prepayment/(accrual) or rent.
  - Disclose the average rates used for each category.
30. I would add that I am not advocating the general use of current borrowing rates across all asset categories, as historical rates are still the most relevant for larger ticket leases, but for large volumes of leases it may be the only practical basis.
31. The cost/benefit advantages of measuring large volumes of operating lease liabilities and assets on a portfolio basis could be substantial. However, portfolio measurement is only possible when lease assets are measured on the same basis as lease obligations +/- prepayments and accruals; and when current rates are used. Both changes would require a modification to the ED's proposals.

### **Sale and leasebacks**

32. As currently drafted it would seem that the presence of a fair market re-purchase option would invalidate sale and lease back accounting. This may well have an effect of invalidating sales treatment on a large number of existing sale and leaseback real estate transactions in the UK and require significant re-statements. The same is not true in the US, which has long had draconian rules on 'continuing involvement'. In my view there is little benefit to be achieved by re-opening existing sale and leasebacks on transition. The simplest solution would be to treat the leaseback as any other lease.
33. Another problem in the UK is the use of very long (999 year) lease and leasebacks that are intended to have the same commercial effect as a sale and leaseback. Again, under the proposals sale and leaseback accounting would fail. To avoid unnecessary complexity I would suggest not re-opening existing transactions and to deal with the leaseback as any other lease.
34. With the regard to the treatment of new sale and leaseback transactions, I don't believe a fair market repurchase option is sufficient reason to invalidate sales treatment unless there are commercial factors to force exercise.

## Lessor accounting

35. Generally, the issue of lessor accounting is of less concern than lessee accounting. If, as I suggest, lessee's expense is based on the current finance lease/operating lease distinction then there would be little reason to mess with lessor accounting at all. It is not broken. One solution could be to simply retain current measurement criteria and enhance disclosure, particularly of residual values, along the lines recommended in the UK SORP on lease accounting. However, having carried out a detailed examination of lessor accounting I suspect that the Boards will require change, if only to make lessor accounting consistent with the revenue recognition project and re-write the standard into a modern idiom.
36. The two methods of lessor accounting, the derecognition approach and the straight-line revenue recognition approach, described in the exposure draft are both reasonable methods of accounting for certain types of leases or lease businesses. The question arises as to whether the Type A and Type B definitions best classify these leases into their most appropriate methods.
37. The types of leases falling into the Type A categorisation would cover:
- Most leases of equipment from:
    - Banks and finance businesses
    - Manufacturers' sales finance businesses
    - Specialist asset management - cars
    - Specialist management – IT/Telecom/photocopier
    - Specialist operating leases transport - rail/shipping/aircraft
  - Finance leases of real estate

The types of leases falling into Type B

- Operating leases of real estate
  - Very short term hire from
    - Specialist short term hire companies (daily car hire)
    - Some very short leases of ships, aircraft, railcars
38. In my view, this does not represent the best split between these methods as it requires a number of specialist service companies to use the derecognition method. In these circumstances, the amounts described as lease receivables in the balance sheet may well be subject to significant on-going performance risks. Consequently, the lease receivables may turn out to be unenforceable in the event of the lessor or the lessor's agents breaches its contractual service obligations under the leases. While such issues may only prove important on the failure of the leasing company, as experience has shown, users of accounts may well have a strong argument for questioning the veracity of the description as a receivable that is contingent on future service performance. In my view, such leases are more in the nature of Type B leases. Furthermore, leases with multiple revenue streams

and frequent changes to lease terms might be better suited to the straight-line methodology in order to avoid unnecessary complexity.

40. The problem with the EDs approach is the classification between Type A and Type B leases is based on what the Boards think that works for lessee accounting. It is not one that has designed from the point of view of the lessor's business model. A more sensible approach from a lessor perspective is to classify leases based on the lessor's business model. In my view the Type A derecognition approach should **only** be used where:
- there are no substantive service elements or on-going performance risk, and
  - residual amounts at the end of the leases are based on realistic market estimates of what the lessor expects to realise from sale.

41. All other leases (those with significant service elements, or those which have assets that the lessor expects to be re-let after the lease term to other lessees) should be straight-lined. This effectively splits lessor accounting into two models: a financing model and asset services model.

- Most leases of equipment from:
  - Banks and finance businesses
  - Manufacturers' sales finance businesses (without performance risk)
- Finance leases of real estate

The types of leases falling into Type B

- Operating leases of real estate
- Specialist leasing (performance risk or multiple re-hiring)
  - Manufacturer (with performance risk)
  - Specialist asset management - cars
  - Specialist management – IT/Telecom/photocopier
  - Specialist operating leases transport - rail/shipping/aircraft
- Very short term hire from
  - Specialist short term hire companies (daily car hire)
  - Some very short leases of ships, aircraft, railcars

### **Tone of the standard**

42. Many companies with large volumes of leases will experience difficulties in applying the new standard. The Boards should acknowledge this and expect companies to make reasonable endeavours to achieve the standards objectives without unnecessarily excessive costs. For example many populations of leases follow a pareto distribution with say 20% of the population accounting for 80% of the value. The volume of large leases may be relatively easy to measure on an accurate basis. However, the cost of performing all the measurement and re-measurement calculation on the large number of smaller items in the way prescribed in the standard may well prove costly.

43. Unfortunately, the prescriptive tone of the drafting of the standard leaves little or no room for companies to ignore those requirement when the population sizes may well be material. Consequently, there is a danger that companies will need to spend disproportional costs of relatively minor matters just to comply with the letter of the standard.

### **Conclusion**

44. Overall, I believe the new ED is a significant improvement over its predecessor and reflects the extensive outreach process and willingness of the Boards to consult. The principal criticism the Boards still face is that of complexity and whether the costs of implementation justify the benefits. The Boards have made some concessions in the interests of eliminating complexity, but I believe they could go further. I hope my suggestions to reduce complexity prove helpful.

Yours sincerely

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## Appendix 1

### Answers to the questions for respondents

#### Question 1: Identifying a lease.

*Do you agree with the proposed requirements in paragraphs 6-19 for how an entity would determine whether a contract contains a lease?*

In my view, this is probably one of the most difficult aspects of standard since it defines the borderline between leases and service contracts. The issue is a very complex one and one where I know the Boards and their staff have consulted extensively. In my view, the Boards have just about got the balance right. The exposure draft is a significant improvement on IFRIC 4.

#### Question 2: Lessee accounting

*Do you agree that the recognition, measurement and presentation of expense 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 proportion of the economic benefits embedded in the underlying asset?*

I believe it should differ for different types of leases; but not based on the criteria proposed in the ED. My arguments are set out in the main body of the letter in paragraphs 11-25. My view is that the existing finance/operating lease distinction, although not perfect, is well understood; and that a straight-line expense for an operating lease is more meaningful than an arbitrary split between interest and depreciation.

If the Boards did not want to go so far as this, it might be worth considering whether operating leases with significant service elements should be treated as Type B. This would at least avoid the Boards fears concerning purely financing arrangements of large ticket assets on long leases.

#### Question 3: lessor accounting

*Do you agree that the lessor should apply a different accounting approach to different leases, depending on whether the lease is expected to consume more than an insignificant proportion of economic benefits embedded in the underlying asset.*

I don't believe that the analyses between Type A and Type B leases is meaningful from a lessor's business perspective. I accept that most real estate leases should fall into the B category. But I do not think it is wise to require all other leases to fall into the de-recognition method. The de-recognition method is in my view only relevant when there are no significant performance risks, no significant other service streams, and the lessor anticipates disposing of the residual value at the end of the lease (unless it is extended by the lessee). These are businesses that price the rental using a finance model of the contracted cash flows and the expected residual. All other leases should be subject to straight-line method of revenue recognition as they are closer to a services model.

#### **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.*

No. Real estate leases need only meet the current classification of operating leases to qualify as Type B, whereas equipment leases have to meet an insignificant portion of asset life or insignificant PV to fair value. A twenty-year lease of a property is treated as a non-financing, but a seven-year lease of a ship is a financing even though both may have the same asset life. This does not make sense even if you accept that part of the building may be land.

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

*Do you agree with the proposals for the lease term including the reassessment of the lease term if there is a change in relevant factors?*

Yes.

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

*Do you agree with the proposal on the measurement of variable lease payments, including reassessment if there is a change in the index or rate used to determine lease payments.*

Variable lease payments can occur under the terms of a contract in a number of ways:

(a) **Market revision** – These leases are common in UK real estate sector where the rents are adjusted (say every five years) to a market comparison of comparable properties. Sometimes the revisions are upward only. In my view these revisions are neither due to an index or a rate. Clearly they are a revision of rentals that require re-measurement. Although they do not seem to fall into any of four the categories of paragraph 44 of the ED. Clearly the ED should be amended to take account of this.

(b) **Indexes** (RPI or CPI) – Here the rents are revised but based on market index. I agree with the proposals in the draft ED.

(c) **Interest variable leases** – In the UK, the interest variation for each period may well be based on a schedule of the lessor's notional post tax cash flows set out in the financial schedule to the lease. However this is not all ways the case; the contract may simply refer the cash flows without the lessee seeing them. Consequently the lessee may only know the interest variation at the end of the interest period. The common practice is to record the liability at the original rates and accrue the rental adjustments to profit and loss as they arise. This mimics the same effect as an interest variable loan. The requirements of the ED would seem to require the lessee to revise future payments (paragraph 44d) even if he doesn't know what they are, and re-measure at the new interest rate (45c). This has broadly the same effect, but discloses the gross liability at the new interest rate rather than the old one.

(d) **Tax variable leases** – It is common in the UK to have tax variation clauses in lease that require the revision of lease payments to maintain the lessors expected post-tax rate of return in the event of a change in the rate of tax, rate of capital allowances or tax law and practice. Paragraph 44 simply does not anticipate changes in rent other than those prescribed under the four captions. The text should be amended.

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

*Paragraphs C2-C22 state that a lessee and 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?*

Broadly I agree. But again the tone of the text should recognise the need for reasonable approximations and estimates. As indicated in my paragraphs 32-34 I believe there is little point in re-opening sales and leaseback treatment if the original treatment was to treat the initial transaction as a sale.

Note that if the Boards were to concede that all operating leases were treated in the same way as suggested for type B, and did not re-open sale and leaseback accounting, the potential impact on companies' reserves would be minimal.

#### **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 undisclosed lease payments; reconciliation of amounts recognised in the statement of financial position; and narrative disclosure about leases (including information about variable lease payments and options). Do you agree with those proposals?*

I agree with the spirit of paragraphs 58-59 and 98-99. The detailed paragraphs provide a list of those things that may be relevant in the circumstances. However, I am not convinced that all the information is necessarily always relevant or for that matter practicable to obtain. The reconciliations in particular may prove troublesome. Again, the prescriptive way in which these paragraphs have been drafted will most likely lead to excessive and meaningless boiler-plate type disclosures simply for compliance sake.

What however is missing from the lessor disclosure is any meaningful analysis of lessor's residual values and residual value exposure. Most lessor's re-assess residual values on a quarterly or half years basis, based on the market evidence available. This is necessary because IAS 16 deals with changes in estimates of RV and IAS 36 deals with impairment of fixed assets. The EDs proposals are unnecessarily complex and confused both in the measurement of residual values (which can include adjustments for future contingent income, unrealised profits, as well as discount) and in re-measurement (where the proposals only seem to consider impairment). Accordingly, there is no simple comparison of accounting numbers (before discount) against market benchmarks.

#### **Questions 9, 10, & 11: FASB only**

No comment.

**Question 12 Consequential amendments to IAS40**

*Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased asset meets the definition of investment property?*

Yes.

## Appendix 2

### Further comment on points of detail

1. The measurement basis of renewals and contingent rent under the new ED is now in line with the measurement basis of finance leases under the current standards. The one matter that remains different is the treatment of residual guarantees. In my view the full amount of the residual guarantee should be included in the lease liability, as under existing practice. I appreciate that the Boards have debated this point. I just disagree with their conclusion.
2. Paragraph 72 implies that a lessor would reflect an expectation of variable lease payments in his determination of the lease rate. In over 30 years of experience in dealing with leases I have yet to see any lessor evaluate his expected rate on this basis.
3. Paragraphs 84 and 85 are overly complex. Under existing standards finance leases are treated for impairment under IAS39 and operating leases under IAS36, but in each cases as one asset. Choose one standard or the other but not both.
4. Paragraph 91(b) If a lessor is in business to provide finance; the lessor should not be recognising a profit on commencement.