

DEBEVOISE & PLIMPTON LLP

919 Third Avenue  
New York, NY 10022  
Tel 212 909 6000  
Fax 212 909 6836  
www.debevoise.com

September 13, 2013

**VIA E-MAIL**

Hans Hoogervorst  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

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

Dear Mr. Hoogervorst:

Debevoise & Plimpton LLP represents a number of clients with reporting obligations under both International Financial Reporting Standards (“IFRS”) and Generally Accepted Accounting Principals (“GAAP”). A group of these clients (the “Client Group”) requested that we submit this letter to the International Accounting Standards Board (the “Board”) on their behalf to provide feedback on Exposure Draft ED/2013/6 (“the proposed standard”). Collectively, the Client Group has assets of U.S.\$25 billion and lease obligations in excess of U.S.\$400 million. The comments noted in this letter reflect the viewpoints of the Client Group only and do not necessarily represent the beliefs of other clients of Debevoise & Plimpton LLP.

The Client Group agrees with the core principle of the proposed standard that a lease should result in the lessee recognizing a liability and related asset. The Client Group also supports the practical initiative of the Board in respect of leases with terms of less than 12 months.

The Client Group recognizes the drafting of the proposed standard required a degree of compromise. However, the Client Group believes that the proposed standard does not improve the quality and comparability of financial reporting and will increase costs, increase complexity, reduce comparability and introduce inconsistencies with principles in other standards. The Client Group also believes that the proposed standard will unnecessarily burden preparers of financial statements while failing to provide the transparency required by users of financial statements. Specifically, the Client Group believes:

- The dual lease model will continue to distort the comparability of financial position and financial performance across different entities. A dual lease model will also provide new opportunities for entities to structure arrangements to achieve preferred outcomes or avoid undesired outcomes, both of which also distort comparability.

- The Board has underestimated the costs and administrative burden associated with lessees' and lessors' on-going re-measurement of lease liabilities as a result of changes in an index. In the Client Group's experience, most property leases typically include annual Consumer Price Index ("CPI") adjustments. The Client Group does not believe that the expected benefits of remeasurement will ever exceed the additional compliance costs inherent in the proposed rules.
- The amortization "plug" derived for leased assets under Type B leases lacks a theoretical basis and is inconsistent with the requirements under other existing standards. It will also lead to significant IT system complexity triggering unnecessary expenditure to upgrade or replace existing systems.
- The lessor and lessee accounting for a Type B lease effectively results in the recognition of the same asset by both parties, lending support to common criticism that accounting standards do not reflect reality.
- The proposed disclosures are voluminous and lack practical application. They do not contemplate a single location in the financial statements that would explain the full picture and provide the links between amounts recognized in the income statement and the statement of cash flows. Such disclosures would partially address the distortions and concerns of the front loaded expense.

The Client Group strongly encourages the Board to:

- remove the concept of a dual lease model;
- treat variable lease payments associated with indexes and rates consistent with all other variable lease payments;
- reduce the voluminous disclosure requirements, and focus instead on enhancing the presentation of disclosure to provide improved transparency; and
- permit an option for prospective application on transition.

If the Board decides to persist with the dual lease model, the Client Group recommends modifying the proposed standard so that:

- one consistent set of principles be used to classify all leases; and
- re-assessments of classification occur when there are changes in lease terms to reduce structuring opportunities.

***An interim solution – enhanced disclosure regarding existing obligations***

As an interim solution, the Client Group believes that the Board should consider enhanced disclosure in relation to existing operating lease obligations. The current requirements of IAS 17 contain an accepted framework for measuring lease obligations, including variable amounts. The Client Group believes that enhanced disclosure associated with the present value of existing lease commitments at an incremental borrowing rate applied to the portfolio as a whole would be a cost-effective outcome, without triggering the need for widespread renegotiation of accounting based covenants.

\* \* \* \* \*

**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 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.***

The Client Group generally agrees 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. However, it expresses concern that service agreements, such as for outsourced manufacturing, may still require separation into a service contract and an embedded lease when this does not reflect the economic substance of the transaction. Where an entity uses equipment in the delivery of a service and does not sell the equipment independently of the service, the entity should not be required to separate the arrangement into components even if other entities provide the service and equipment as separate components. The customer of the entity is contracting for the completed service and the entity's obligation is to deliver the service, not a lease. The Client Group believes that there should not be a day one gain or loss as a result of entering into the service contract when the entity does not separately sell equipment to third parties; this result is inconsistent with the substance of the contractual obligations.

## **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?*

The Client Group agrees with the principle and support the initiative of the Board in requiring a lessee to recognize a liability and an asset in relation to future obligations associated with all lease agreements. This recognition is independent of the expected level of economic benefit that the lessee will consume.

The Client Group also agrees that the measurement of this liability and asset at the commencement of the lease should reflect the expected level of economic benefits the lessee will consume over the term of the lease. The greater the benefit expected to be consumed, the larger the asset and liability recognized at commencement of the lease.

The Client Group disagrees with the requirement that the subsequent measurement of the asset depends on whether the lessee is expected to consume more than an insignificant portion of the economic benefit embedded in the underlying asset. As discussed in greater detail below, the Client Group believes that the proposed requirements with respect to subsequent measurement of the asset, which triggers the recording of a component of the expense, should not be adopted because they are:

- based upon unsupported principles that the proposed standard is introducing; and
- are likely to result in unnecessary complexity and cost and reduced comparability.

The Client Group is of the view that there should not be a dual model for balance sheet and profit and loss presentation. It acknowledges, however, that cash flow presentation should reflect the substance of the lease transaction. Those leases that represent a financing transaction should result in cash flow statement presentation that comprises interest and principal repayment. The Client Group disagrees with the “more than an insignificant portion” threshold being the appropriate trigger for this cash flow statement presentation. The proposed Type A lease cash flow statement presentation is appropriate when the significant risks and rewards in the underlying asset are being transferred. More than an insignificant portion is a dramatically lower threshold than in-substance economically acquiring the underlying asset.

### *Unsupported principles*

Upon recognizing an asset, existing accounting principles under other standards require that the asset be amortized using a systematic basis over its useful life, reflecting a pattern in which the asset’s future economic benefits are expected to be consumed by the entity.

To accept that the amortization of the right of use asset is an amount that is determined by deduction rather than being calculated in a manner consistent with other standards is without accounting foundation and inconsistent with requirements in IAS 16, IAS 38 and the recent Interpretations Committee guidelines.

*Unnecessary complexity – IT limitations*

The Client Group believes that existing asset register software is not capable of calculating the by-deduction amortization amount. The proposed standard will force unnecessary expenditure to upgrade software or acquire and integrate new software. The Client Group believes that such a tax on shareholder wealth is not supported by a superior accounting answer to current requirements or enhanced transparency in financial reporting.

*Reduced comparability*

The Client Group believes that the proposed Type A and Type B lease classifications and the subsequent differences in expense recognition, and income statement and cash flow presentation will unnecessarily result in reduced comparability. If an entity has the right to consume 15% of the future economic benefits in two assets, the income statement and statement of cash flows should present the consumption of these two rights consistently. Reduced comparability will lead to preparers seeking alternative measure of performance to explain their results.

\* \* \* \* \*

*Proposed alternative*

The Client Group believes that the lessee's pattern of consumption of the benefits should be the trigger for measurement of the amortization expense on the right of use asset that has been recognized.

The existing cash flow presentation for operating leases under IAS 17 should be retained unless the lease arrangement transfers substantially all the risks and rewards, at which time the proposed Type A (or existing finance lease) cash flow presentation should be used. This is consistent with the substance of the transaction.

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

***Do you agree that a lessor should apply a different 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?***

The Client Group agrees with the principle that entering a lease results in the recognition of an asset and liability for the lessee, and consequently a new type of asset needs to be recognized by the lessor. It disagrees with the approach contained in the proposed standard.

As illustrated below, the Client Group's disagreement with the requirements of the proposed standard reflects the combination of:

- a conceptual disagreement with the premise that lessee and lessor accounting is not symmetrical, effectively resulting in recognizing the same asset by both parties for a Type B lease;
- unnecessary cost and complexity;
- measurement of the residual asset, which implies the lessor may unwillingly be forced from a cost to a quasi-fair value basis of measurement;
- a conceptual disagreement with the assumption that in a property lease land will have the same useful life as the building; and
- various other computation issues which are explained in more detail below.

Given the pervasive concerns discussed below, the Client Group suggests that further detailed consideration is required to ensure that the standard is as robust and practical as possible and does not result in unnecessary and wasteful increases in costs.

#### *The proposed Type B lease accounting results in duplicate asset recognition*

The Client Group believes that the proposed standard's dual lease classification creates accounting alchemy. A Type B lease classification results in the one physical asset effectively appearing on two balance sheets. While the Client Group acknowledges the theoretical difference between the lessor recognizing the actual asset and the lessee reporting a right of use asset, it believes this outcome is flawed and calls into question the creditability of accounting standards. The Client Group believes that only one party can have the future economic benefits associated with the physical asset.

#### *Unnecessary cost and complexity*

The Client Group believes that the annual remeasurement of the lease receivable for changes in an index or rate is an administrative burden. Similar to the observations in relation to the lessee, the Client Group is of the view that the Board has underestimated the cost and effort required to implement this change.

As a result of the proposed day one profit recognition for all lessors, not just manufacturer lessors, there will understandably be significant pressure on management from auditors to justify the expected variable lease payments that are included in the calculation of the residual asset. Such a calculation will be highly subjective, possibly allowing entities to negotiate contract terms which result in a desired outcome or alternatively, avoid an undesired outcome. The Client Group's experience in the U.S. regulatory environment suggests that start-up organizations may be unable to justify any expectation other than zero for expected variable lease payments, resulting in a day one loss. Similarly, more mature entities that enter into an arrangement with a new customer which contains customer specific variable arrangements are likely to struggle in providing sufficient auditable evidence to support management's expectations.

*A dual lease model will result in inconsistent outcomes*

The Client Group believes that under the proposed dual lease model where the useful life of land is the same as the useful life of a building, there will be situations where a property lease will be classified as Type A. For example, a property lease for the period immediately prior to the landlord redeveloping the site will, by definition, represent a lease for substantially all of the remaining economic life of the building.

The lessor will be required to account for this lease differently from all other leases. This will distort the analysis of the portfolio of investment properties, which may be carried at fair value.

*A dual lease model will inevitably lead to structuring to avoid undesired or to obtain desired outcomes*

As noted above in the comments in relation to lessee accounting, a dual model could inevitably lead to structuring such arrangements to avoid undesired or to obtain desired outcomes. If a dual model is retained, the Client Group believes that there should only be a single test to determine the classification of the lease.

*Initial measurement of the residual asset – an unwilling move from cost to quasi-fair value*

Under existing accounting standards, a lessor may be carrying the leased asset at amortized cost. The initial recognition of the residual asset requires the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term. At the expiry of the lease term, it is unlikely that this value will be the same as the residual value derived under an amortized cost model. Expectations about value at the end of the lease term will need to consider expectations about changes in asset values. The Client Group believes that this requirement introduces a hybrid measurement to the balance sheet that is neither cost nor fair value and there is no conceptual basis for this requirement.

*Various other computational issues*

- *Recovery of expected variable lease payments implies impairment of the residual asset*

The proposed measurement of the leased asset under paragraph 71 includes the present value of the expected variable lease payments. If the present value of the asset has been estimated accurately, this implies that the collection of the expected variable lease payments must result in an impairment of this asset. This is confirmed by the language in paragraph 83 which requires the recognition of a “corresponding expense in profit or loss”. The Client Group disagrees with this proposed requirement. The collection of an expected amount is not an expense but should, consistent with the accounting for the collection of a trade receivable, reduce the carrying amount of the lease receivable. The Client Group believes that the requirement to recognize an expense implies that the day one profit recognized at the commencement of the lease was too high.

- *Why is a lessor prohibited from measuring the Type A lease residual asset at fair value?*

The Client Group believes that it is unclear why a lessee can measure a right of use asset at fair value but the lessor of a Type A lease asset is restricted by the language in paragraphs 82 and 83 to “cost”. If the Board is willing to accept a fair value basis of measurement for the lessee’s right of use asset despite the general prohibition in IAS 38 on fair value accounting for intangibles, then fair value measurement of the residual asset by the lessor should be permitted.

- *Bifurcation of impairment testing is inconsistent with economic reality*

Paragraphs 84 and 85 require separate assessments of recoverability for the lease receivable and the residual asset. Paragraph 87 has a similar approach requiring separate assessment of the recoverability of the lease receivable at early termination of a lease. The Client Group disagrees with this approach because the lease receivable and residual asset are intrinsically linked; they are parts of the one physical asset. It is the underlying physical asset that generates the future cash flows. The Client Group believes that the recoverable amount of this asset should be compared against the aggregate of the existing lease receivable and residual value.

If the lease receivable is impaired, a lessor is likely to enforce its security rights to extinguish the lessee’s right of use. An early termination of the existing lease may provide the lessor with the ability to redeploy the asset in a new lease to a new lessee. That is, the value of the residual asset could increase. With changes in market rentals, it is also possible that the future value of the asset exceeds the sum of the previously recognized lease receivable and residual asset. The Client Group believes that the proposed standard requires separate guidance as to whether the new carrying value could exceed original cost.

- *Specific guidance on income statement presentation of the gain or loss on commencement*

To assist with consistency and comparability, the Client Group believes that further guidance should be included to explain how the amount recognized in paragraph 68(d) should be classified and described in the profit or loss.

- *Cash flow presentation calls into question accrual accounting*

The proposed Type A lease accounting by a lessor requires the classification of cash receipts within operating activities in the statement of cash flows. The proposed language implies that the lessor will not be required to allocate such amounts between interest income and “rental” income. On this basis, the Client Group cannot see the value in the proposed presentation of Type A lease accounting for lessors in the income statement, which requires the separation of amounts between interest income and a gain / loss on the commencement of a lease. The Client Group believes that the proposals will result in greater use of non-GAAP measures of financial performance.

- *Is the residual asset a monetary or non-monetary item?*

The initial measurement of the residual asset suggests that the balance contains elements that are monetary in nature, such as the present value of expected variable lease payments. However, the impairment testing requirements require an evaluation under IAS 36, which is applied to non-monetary assets, and the language in BC 184 only addresses the foreign exchange movements on the lease liabilities and lease receivables. The Client Group questions whether the asset should be remeasured in accordance with IAS 21 if the variable lease payments are denominated in foreign currency.

\* \* \* \* \*

#### *Proposed alternative*

Given the pervasive issues associated with the comments above, the Client Group believes that the basic principles of lessor accounting need to be reassessed.

For simplicity and consistency, the Client Group recommends that the lease receivable should not be re-measured as a result of changes in variable lease payments that depend on an index or rate. All variable lease payments should be recognized in the income statement as earned. Only manufacturer lessors should recognize a day one gain at the commencement of the lease. For all other lessors, the income should be earned over the life of the lease, removing the distinction between Type A and Type B leases. The Client Group believes that this simplified approach does not detract from achieving the underlying goal of the lessee recognizing a liability for the future lease obligation. It also believes that this approach provides consistency across lessors regardless of the relative exposure to retail leases, which typically include turnover rentals, compared to more traditional commercial property leases that include CPI indexation.

**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?*

The Client Group disagrees with the requirement that the classification of a lease should differ depending on whether the underlying asset is property.

The Client Group also disagrees with the need for a lessee to classify a lease using the requirements set out in paragraphs 28-34. The classifications required by these paragraphs reduce comparability and introduce unnecessary complexity in the subsequent measurement of the lease arrangement.

*Comparability requires that all classes of asset should be treated consistently*

The Client Group believes that a distinction in the classification of leases, by either lessee or lessor, depending on whether the asset is property is not supported by any principle. This type of classification reduces the comparability of financial information. An entity that has the right to use 25% of the future benefit of an asset that is legally owned by another entity should present comparable financial information regardless of the type of asset.

*Unnecessary complexity and reduced comparability*

The Client Group believes that the proposed lease classification and subsequent different accounting treatment would result in unnecessary complexity and reduced financial statement comparability. The expected consumption of the economic benefits should only impact the quantification of the lessee's lease liability and right of use asset. The larger the expected consumption of economic benefits, the larger the liability and associated right of use asset recognized at the commencement of the lease. In the extreme, 100% expected consumption should result in the recognition of a right of use asset at the commencement of the lease equivalent to an initial cost of an acquired asset.

The subsequent accounting by the lessee should reflect the consumption of the right of use asset and extinguishment of the liability, neither of which depends on the level of expected benefits to be consumed or the type of asset.

*Classifications expose the standard to manipulation*

The Client Group believes that comparability of financial statements under the existing lease accounting requirements can be distorted by entities structuring the arrangements to achieve a particular lease classification. Such structuring initiatives can also be achieved under the proposed classification requirements.

\* \* \* \* \*

*Proposed alternative*

Should the Board decide to retain the dual classification model, then in the interest of reduced complexity, reduced scope for entities structuring arrangements to achieve desired outcomes of the classification and improved consistency, the Client Group recommends the following amendments to paragraphs 28-34:

- The removal of the distinction based on whether the leased asset is property. Classification should be determined solely with reference to the level of economic benefit expected to be consumed.
- The threshold of “more than insignificant” is too low a threshold to assume that the substance of the transaction is equivalent to the acquisition of the underlying asset. The existing well established principle within IAS 17 of substantially all risks and rewards should be retained as the relevant principle. This avoids the introduction of new, undefined terminology and provides a consistency with the revenue recognition standard.
- The classification thresholds should be consistently assessed against the total economic life of the asset for all types of leases. A lessee should not be burdened with attempting to second guess the lessor’s intention about the remaining useful life of the asset, as required in paragraph 30(a).
- The useful life of land is not and should not be the same as the estimated useful life of the building as required by paragraph 33. The two types of asset are fundamentally different. The existing principle within IAS 17 should be retained.
- Lease classification should be reassessed when there is a change in lease term. The lease term is fundamental to the evaluation of the extent of the transfer of economic benefit. The exercising of an option that was initially assessed as having no significant economic incentive can fundamentally change the classification of the lease as either Type A or Type B.

**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?*

The Client Group agrees with the proposed concepts associated with identifying the lease term, including the requirement for a re-assessment if there is a change in relevant factors.

## **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 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?***

The Client Group supports the initiative of the proposed standard in removing the requirement to remeasure the lease liability for changes in variable lease payments. It disagrees with the proposed measurement requirements for variable lease payments if there is a change in an index or rate used to determine lease payments. The Client Group is of the view that the Board has (i) introduced inconsistency in the measurement of the lease obligation and (ii) underestimated the significant burden that this obligation will place on preparers of financial statements and question the benefit of the incremental precision that would be achieved. The Client Group believes that all variable lease payments should be treated consistently and excluded from the remeasurement of the lease liability.

The Client Group agrees with the proposed requirement that a lessee remeasure the lease payments if there is a change in the lease term or changes in economic incentive to exercise a purchase option. It disagrees, however, with the requirement to remeasure the lease payments due to changes in the expected residual value guarantee unless there is a change in the lease term. The disagreement is based on consistency. The Client Group believes that, except for the lease term and changes in expectations regarding the purchase option, none of the other remeasurements require consideration of changes in expectations.

The Board has proposed in paragraph 44(d) that index and rate adjustments to lease payments are revised using amounts as at the end of the reporting period. The Client Group has questioned whether the Board is proposing that such a remeasurement is required on an interim basis for an entity with quarterly or semi-annual reporting.

### *Introduction of inconsistency with IAS 39 – remeasurement for changes in rate*

A lease arrangement that has a variable interest rate is similar to a floating rate borrowing. At the drawdown of a floating rate borrowing, the fair value is the same as cost (ignoring the impact of transaction costs). Under the existing requirements of IAS 39, there is no requirement for a borrower to remeasure the value of its floating rate financial liability.

It is unclear to the Client Group why a similar principle is not being applied to lease agreements where the payments vary with changes in the interest rate. The Client Group believes that application of this principle would still result in the recognition of the lease liability at inception of the lease and the periodic interest expense over the lease term. It would also provide relief to the preparers of financial statements from the unnecessary balance sheet gross up required at each subsequent reporting date and comparability in measurement with other variable rate financial liabilities.

*Introduction of inconsistency – CPI adjustments compared to market reset*

Leases for real estate often include variable lease payments associated with annual CPI adjustments and periodic adjustments to reset the lease payments to prevailing market rates at the time of reset. Both of these result in variable lease payments over the term of the lease, however, the proposed measurement of the lease liability only includes the adjustment for the CPI index. The substance of both types of adjustments is the same.

*Underestimated cost benefit considerations*

The Client Group believes that a significant portion of property leases include a mechanism that periodically recalibrates the rental expense to reflect market conditions. The Client Group believes that the Board has underestimated the recurring annual effort that is required in relation to annual remeasurement of a lease portfolio as a result of CPI indexation. For every organization, whether it has one or more than one thousand property leases, the entity will be required to:

- remeasure the liabilities by lease for the present values of the remaining cash flows;
- update the effective interest rate schedules needed to be part of the accounting entries;
- upload by individual asset changes in cost in the “right to use” asset register to enable revised individual amortization schedules to be recomputed; and
- consider the deferred tax consequences of the above changes.

All of the above is then subject to audit.

For an entity with more than a small number of leases, control over the right to use assets and lease liabilities will require an IT solution. Internal control considerations require that significant changes in an asset register type module, such as the above where the cost of every asset needs to be revised, should be made initially in a test environment prior to migration to the live database.

To avoid unnecessary discussions with an auditor about whether a pre year-end estimated indexation is materially different from the year-end rate, a year-end index will need to be used. This is typically not available until after year-end, triggering the requirement that this computation can only occur after the year-end date. The Client Group believes that this is not the most appropriate time for such a detailed time consuming calculation. While the Client Group acknowledges that the year-end indexation adjustment would only result in a balance sheet gross up, it notes that auditor materiality discussions are now adversely impacted by the recent U.S. PCAOB instruction that balance sheet reclassification materiality is the same as income statement misstatement materiality.

\* \* \* \* \*

*Proposed alternative*

The Client Group recommends that the Board removes the requirement in paragraph 44(d). The Client Group believes that removing this requirement does not detract from the underlying principle that the proposed standard has achieved. The measurement of the lease liability at the commencement of the lease has already included an estimated impact of the index during the life of the lease as required by paragraph 30(b). As noted above, the discounted change in the balance sheet only involves a gross up, which in periods of relatively stable inflation should not be materially different from the initial expectation.

## Question 7: transition

*Paragraphs C2-C22 state that a lessee and a lessor should recognize 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 that the boards should consider, If yes, what are they and why?*

The Client Group agrees that the Board needs to provide an exemption to a fully retrospective application.

While the Client Group acknowledges the general importance of comparative financial information in a set of financial statements, it questions whether the benefits of the modified retrospective approach exceed the costs. The following examples illustrate their concern and support the alternative recommendation that the proposed standard provides an option for application on a prospective basis.

- *Leases with less than one year until maturity in the comparative period*

At any point in time, most organizations with a portfolio of leases will have a number of leases that expire during the reporting period.

The Client Group questions the value of having to undertake the transition adjustment for a lease that will expire during the comparative period as the income statement is unlikely to be materially misstated and, among a portfolio of leases, the net impact on the balance sheet is also unlikely to be material.

Excluding the transition adjustment for leases that expire, or were terminated, in the comparative period would be consistent with the approach adopted by the Board with the initial application of IFRS 10 and the exposure draft in relation to Revenue.

- *Remeasurement of the comparative period for changes in an underlying index or rate*

Assuming the Board retains the proposed requirements of paragraphs 39(b) and 44(d), a traditional IFRS reporting entity (*i.e.* one comparative period) will be required to amend its right of use asset register three times on the initial application of the standard (*i.e.* at the (i) opening of the comparative balance sheet; (ii) comparative year-end; and (iii) closing year-end). Those entities that present two comparative periods will be required to undertake four amendments. In each situation, for a Type A lease asset, the amended right of use asset register is required to quantify the revised amortization expense.

Furthermore, with the proposed requirement that amortization expense for Type B leases is a plug amount, the Client Group questions the value of having to compute a by-deduction amount twice (or three times) within 12 months.

As described above in the response to your question 6, the Client Group believes that the Board has underestimated the significance of such a task on an on-going basis. To complete this task multiple times in a relatively short period is of questionable value, and is likely to place constraints on other more necessary IT system developments and resources.

- *The use of hindsight*

The transition guidance at paragraph C7(b) permits an entity to use hindsight. It is not clear to the Client Group in the current drafting whether the hindsight election can be made on a lease-by-lease basis or must be made on the portfolio as a whole.

If the entity does not wish to use hindsight, it may be difficult to document and substantiate a position about something that was not consciously considered by management at a past date under the previous accounting standards. Given the significance of the assessment of lease term on the proposed Type A and Type B lease classification, there may also be incentives that would otherwise distort the appropriate accounting answer. The Client Group believes that this is likely to lead to wasted time and effort between preparers and auditors.

*Proposed alternative – prospective application*

Given the significance of the proposed change, and the fundamental distortion in comparability to previously issued financial information, the Client Group submits that a prospective application would mitigate unnecessary costs associated with the modified retrospective approach. A prospective application of a fundamentally new accounting standard was applied by the U.S. FASB on the introduction of FAS 133, avoiding issues such as the application of hindsight.

*Additional transitional considerations*

If a prospective application is not adopted in the final standard, in preparation for the pending change, the Client Group recommends that the Board proactively seek clarification with key regulators, such as the U.S. Securities and Exchange Commission, that it will not require an earlier application of the modified retrospective approach.

In certain jurisdictions, such as the U.S., the annual financial statements are accompanied by documents that contain selected summary financial information for periods earlier than those presented in the financial statements. In general, the retrospective adoption of a new accounting standard needs to be applied to all periods in these selected summary financial information tables. Such a requirement would not apply when the change in accounting is prospective.

## 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 recognized 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?*

The Client Group believes that the proposed disclosure requirements for lessees need further refinement. In the introduction to the proposed standard, the Board notes “The prevalence of leasing, therefore, means that it is important that users of financial statements have a **complete and understandable** (emphasis added) picture of an entity’s leasing activities.” For the reasons noted below, the Client Group believes that the proposed standard does not achieve either the complete or understandable pictures as the proposed disclosures are missing a unifying link.

A user of the financial statements is unable to identify in one location all aspects of the impact of lease accounting. In the spirit of “breaking the boilerplate” and given the significance of the proposed change in accounting, the Client Group strongly encourages the Board to consider disclosure from a holistic perspective. Entities should be encouraged to place all lease-related disclosures in one footnote to assist with breaking the cycle of random disclosure spread through what is now commonly a 100 plus page document.

Even if the existing disclosure was located in one footnote, the proposed lessee disclosure does not permit a user to fully piece together the different elements of the information. A key deficiency in the current proposal is the lack of connection between the income statement expense and where the amounts are presented, and the amounts that appear in the different components of the statement of cash flows. Providing this missing link would also assist a user comparing the impact across entities of:

- the front-loaded expense that occurs under Type A lease arrangements; and
- differences arising from relative Type A v Type B lease concentrations.

In paragraph 65, the proposed standard is amending the existing established disclosure requirements of IFRS 7 paragraphs 39(a) and 39(b) to increase the reporting obligations in relation to the lease liability. The Client Group disagrees with this proposal on two grounds. First, it is not clear why additional incremental disclosure should specifically be required for lease liabilities when the Board has already considered them not to be necessary for other financial liabilities. For most organizations, leases are only a subset of the overall capital structure. Providing this incremental disclosure places undue granularity on one form of financing. Second, the obligation to reconcile the undiscounted cash flows to the recognized lease liability is unnecessary boilerplate disclosure. The Client Group believes that the difference will be ascribed to interest which is a difference that any user could compute. IFRS 7 does not require this disclosure for any other financial liabilities.

In paragraph 65, the proposed standard requires disclosure of the costs that are recognized in the period related to lease payments that are not included in the lease liability. To the extent that such costs are expensed as incurred, the proposed standard does not provide any guidance as to how this cost should be classified within the income statement. It is not clear to the Client Group whether this cost represents interest, amortization, an allocation between the two or some other expense for a Type A lease. The Client Group believes that comparability of financial statements will be distorted without guidance on the classification of this amount. Furthermore, the magnitude of these variable amounts in certain industries (*e.g.* retail and turnover related rental) is likely to be significant.

While paragraph 67 of the proposed standard modifies the requirements of IFRS 7, further IFRS 7 related amendments are required to avoid unintended disclosure obligations that were considered but not included in the proposed standard.

IFRS 7 paragraphs 25 and 26 require disclosure of the fair value of financial assets and financial liabilities compared to their respective carrying amounts. This disclosure obligation is inconsistent with the comments in Basis of Conclusion paragraph 210(b). Given the recognized burdensome costs, the Board should amend the proposed standard to exclude the disclosure requirements of IFRS 7 paragraphs 25 and 26.

IFRS 7 paragraph 40 prescribes disclosure obligations in relation to sensitivity for different types of market risk. For an entity with a portfolio of thousands of leases, the preparation of this disclosure will require assumptions. The nature and sensitivity of the actual outcomes compared to the assumptions brings into question the usefulness of the resulting disclosure and the associated cost of preparation.

**Question 9 (FASB-only): non public entities**

*To strive for a reasonable balance between the costs and benefits of information, the FASB decided to provide the following specified reliefs for nonpublic entities:*

- (a) To permit a nonpublic entity to make an accounting policy election to use a risk-free discount rate to measure the lease liability. If an entity elects to use a risk-free discount rate, that fact should be disclosed.*
- (b) To exempt a nonpublic entity from the requirement to provide a reconciliation of the opening and closing balance of the lease liability.*

*Will these specified reliefs for nonpublic entities help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements? If not, what changes do you propose and why?*

While the Client Group supports the intention to simplify the reporting obligations for nonpublic entities, the Client Group believes that the resulting financial metrics associated with the use of a risk free-rate will disadvantage nonpublic entities that apply this exemption.

Although the use of a risk-free rate may remove an element of subjectivity in the calculation of the lease liability, the resulting lease liability will be higher than a comparable entity that applies either the rate that the lessor charges the lessee or its incremental borrowing rate. A higher financial liability will increase the relative leverage of the nonpublic entity compared to its peer. While this may be fully disclosed within the financial statements, credit statistics often only capture a single metric.

The Client Group agrees with the proposal to exempt a nonpublic entity from providing the reconciliation of opening to closing balances of the lease liability.

The Client Group suggests that for a nonpublic entity there may be other disclosures, such as paragraph 60(c), that should not be required.

**Question 10 (FASB-only): related party leases**

*Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases (for example, to require the lease to be accounted for based on the economic substance of the lease rather than the legally enforceable terms and conditions)? If not, what different recognition and measurement requirements do you propose and why?*

The Client Group supports the view that it is not necessary to provide recognition and measurement requirements for related party leases that are different from those applied for third party leases. The Client Group believes that all leases should be recognized based on the economic substance of the lease rather than the legally enforceable terms and conditions. A move away from recognition of the economic substance of the transaction to legally enforceable terms and conditions threatens the credibility of financial statements by providing entities the opportunity to structure arrangements with terms and conditions which result in a desired accounting treatment. While these opportunities may be addressed in part through additional disclosure, the Client Group believes that at best a user would only be able to estimate the differences in order to compare results between entities.

**Question 11 (FASB-only): related party leases**

*Do you agree that it is not necessary to provide additional disclosures (beyond those required by Topic 850) for related party leases? If not, what additional disclosure requirements would you propose and why?*

The Client Group agrees that it is not necessary to provide additional disclosures beyond those required by Topic 850 for related party leases.

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

*The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.*

*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?*

The Client Group agrees that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of an investment property. Accordingly, it agrees with the proposed amendments to IAS 40.

\* \* \* \* \*

Debevoise & Plimpton LLP appreciates the opportunity to provide feedback on the proposed standard on behalf of the Client Group.

Very truly yours,  
/s/ Steven J. Slutzky  
Steven J. Slutzky