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Financial Accounting Standards Board
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Reference: IASB File Reference ED/2013/6, Response to Exposure Draft *Leases*
FASB File Reference No. 2013-270, Response to Proposed Accounting
Standards Update *Leases (Topic 842)*

Dear members of the Boards:

Duff & Phelps appreciates FASB's and IASB's efforts to improve the accounting for leases and we appreciate the opportunity to provide comments on the above referenced Exposure Draft and proposed ASU.

Our valuation advice, particularly with regards to financial reporting, is sought by hundreds of global clients annually as we work with them in developing pragmatic solutions for applying fair value techniques that are acceptable to the public accounting community.

We would be pleased to further discuss our comments with the Boards and staff. Please direct any questions to either of us via the contact information set forth below.

Sincerely,



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IASB/FASB

September 13, 2013

Response to IASB Exposure Draft

Leases and FASB Proposed ASU

Leases (Topic 842)

General Observations

We are pleased to provide comment on the IASB and FASB proposals on leases. We agree with the Boards' conclusion that leases are a source of financing for many entities and we support the efforts to reflect their economic effects in the statement of financial position. As noted in our comment letter to the original exposure draft in 2010, we agree with the "right-of-use" asset concept and the treatment of the related liability. The recognition of the liability is consistent with corporate finance theory, which views lease expenses as financing expenses.

We note that many of the concerns raised in our 2010 comment letter have been addressed by the 2013 proposals. However, we have the following key observations and areas of concern, many of which focus on the subjectivity that will be involved in applying the proposed requirements. Our responses to the specific questions asked are in the next section.

Additional Guidance for the Impairment of a Residual Asset is Needed

It is unclear from the proposals how to apply the impairment requirements in IAS 36 *Impairment of Assets* and ASC 360 *Property, Plant and Equipment* to the residual asset of a lessor. For example:

- How should lessors reflect a decline in the expected fair value of the underlying asset at the end of a lease when applying the impairment guidance for residual assets?
- From a practical perspective, how is the lessor to determine the condition of the underlying asset during the lease term in order to estimate its fair value?
- What cash flows should be used in estimating value in use in IAS 36 or the undiscounted cash flows in ASC 360? Or is the residual asset meant to reflect today's estimate of the expected value at the end of the lease?

Because the carrying value of a residual asset increases over time with the unwinding of the discount rate, it seems that it could be more likely that the residual asset would be impaired.

The Meaning of an Impairment of a Right-of-Use Asset is Questionable

We note that the impairment guidance does not describe its application to a lessee's right-of-use asset. Although such assets under capital/finance leases today are periodically tested for impairment, the impairment triggers are written in the context of the underlying asset, not of the right-of-use asset.

In our view, the right-of-use asset should be adjusted for the reassessment and remeasurement of the lease liability, but not for impairment. From the lessee's perspective, it is not relevant how the market or fair value of the underlying asset compares with the carrying amount of the right-of-use asset as long as the leased asset provides the utility needed and is expected to continue to do so over the lease term. Given the link between the right-of-use asset and the lease liability, we

are unsure what a write-down of the right-of-use asset means (that is, what information it conveys to users of a lessee's financial statements).

Even if a lessee is no longer using a leased asset, the lessee still is obligated under the terms of the lease to make the lease payments and it still has the *right to use* that leased asset. The value of the right-of-use asset stems from that right, not from changes in the value of the underlying asset. If the lessee is no longer using the leased asset but is still making lease payments to the lessor, that fact should be disclosed along with why the lessee has found itself in that situation. We think this is different from the situation when an entity uses debt to finance the purchase of an asset. In such a case, unlike in a lease, the entity has the rights associated with owning the underlying asset, and an owned asset has value regardless of how its purchase was financed. Because the right-of-use asset and the lease liability are inextricably linked, we believe that as long as the lessee has the lease liability, the lessee should not recognize changes in the value of the right-of-use asset unless the terms of the lease contract change (also see our response to Question 12 below) or the lease liability has been reassessed and remeasured.

If the final standard does require that a right-of-use asset be tested for impairment, we think the Boards should include guidance on potential indicators that a right-of-use asset may be impaired. Such guidance could include the following (adapted from the indicators in IAS 36):

- Evidence is available of obsolescence or physical damage of the asset.
- Significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used, such as:
 - the asset has become idle;
 - the entity has plans to discontinue or restructure the operation to which the asset belongs; or
 - the useful life of the asset is less than the lease term.
- Evidence is available that indicates that the economic performance of the asset is, or will be, worse than expected. For example, if the cash needs for operating or maintaining the asset are expected to be significantly higher than those originally budgeted.

Furthermore, any impairment guidance should address the situation when the lessee subleases the asset to a third party, particularly when the rent under the sublease is not at a market rate. Today the value of the liability would be reduced by the income received from the third party sublessee. How should the existence of the sublease affect the value of the right-of-use asset? Would one adjust the right-of-use asset by the same amount as the reduction of the liability?

Some Terminology Used May be Confusing

There is a risk that by referring to the costs associated with the lease payments as “interest expense” and “amortization expense”, users of financial statements could potentially misclassify both of these in their cash flow forecasts and other analyses because those are not terms normally used to describe the components of free cash flow (which comprises cash flow available to all capital providers). Today when operating leases are capitalized, users of financial statements refer to the “depreciation” of the leased asset. That depreciation encompasses the consumption of the asset’s utility over the lease term. Although we prefer the term “depreciation” to “amortization”, we understand that from an accounting perspective the right-of-use asset is an intangible asset and therefore is subject to “amortization”.

From a financial statement analysis perspective, “interest expense” is treated as a financing cost and “amortization expense” is currently understood to represent amortization of intangible assets and is a non-cash charge. Both are typically excluded from net profit/earnings in arriving at operating income and ultimately free cash flow. Under the lease proposals, both would be relevant cash expenses related to a lessee’s leasing activities and depending on a user’s view of the split between Type A and Type B leases, may be reflected in an operating cash flow forecast.

We suggest requiring lessee entities to label these items in a way that makes it understandable and clear that these expenses relate to cash costs associated with leasing activities. For example, the Boards could use the terms “interest cost related to lease payments” and “amortization of right-of-use asset related to lease payments”. At a very minimum, amortization related to the right-of-use asset should be distinguished from the amortization of other intangible assets because their nature is very different. Determining the appropriate terminology should be undertaken through consultation with users of lessees’ financial statements.

Responses to Specific Questions

Question 1: Identifying a Lease

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 (IASB)/842-10-15-2–15-16 (FASB) 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.

Response: We generally agree with the proposed definition of a lease.

We also think that the final requirements should make it clear how a lease contract differs from an executory contract. It seems that some lease contracts could meet the definition of an executory contract under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (a contract under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent) and without explicit mention of their differences, some entities may be able to use or avoid lease accounting by analogy. We think it is important that entities engaged in leasing activities cannot avoid recognition of a lease liability by asserting that the lease contract is an executory contract and therefore not recognized in the financial statements.

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?

Response: We agree with the proposed dual model approach, subject to our response to Question 4 below regarding the split. However, we believe that there is little difference economically between purchasing an asset using debt financing and leasing that asset (there is, however, a difference between purchasing an asset with cash and leasing that asset—both in terms of the business risk and the cash flow pattern), regardless of the type of asset being leased. However, it is important to identify to what the cash flow relates—for example, for leases there is a cost to consume the utility of the asset and a cost to finance that consumption over the lease term. Therefore, when estimating free cash flow the portion related to consumption must be separate from the portion related to financing. Such a split ensures that the free cash flow reflects the cash flows available to all capital providers. Accordingly, we think that for financial statement presentation purposes it is not necessary to separate Type A leases from Type B leases in the financial statements (as long as the split between consumption and financing is evident),

although such a distinction should be provided in the note disclosures to provide information about the economic characteristics of the assets that are leased.

From a valuation perspective an important factor to consider is the cash flow impact of the leasing activity, even beyond the contractual lease term. For example, if an entity enters into a lease contract to use a heavy equipment vehicle for two years out of its ten year life, the important information from a cash flow perspective is the following:

- Will the entity need that vehicle for only those two years or will it need to renew the lease or enter into another lease for a similar vehicle (and if the latter will it need to do so continuously given the entity's business model)?
- What are the periodic lease payments during the lease term?
- At the end of the lease term, if the entity will need to renew the lease or enter into another lease what are those lease payments likely to be?

The valuation of a lessee will reflect the expected cash flows resulting from the leasing activity, regardless of the terms of the entity's current leases or what the accounting requirements allow an entity to present in its financial statements. For this reason, we think that a lessee should be required also to disclose the expenses that are not captured in the proposals, such as the amount of short-term lease payments and variable lease payments that do not depend on an index or rate. Even if such lease payments do not qualify for recognition as a lease liability, users of financial statements would be able to understand whether there are any, and if so the magnitude of, "unaccounted for" lease payments.

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?

Response: We agree with the proposals. We think it is appropriate that a lessor's recognition and derecognition of an asset should depend on whether the lessee is consuming its utility during the lease term. Also please see our response to Question 2.

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 (IASB)/842-10-25-5–25-8 (FASB), which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

Response: We think the important factor is not whether the underlying asset is property, although we agree that property may more consistently exhibit the characteristics attempting to be captured in that classification. We think that the criteria for distinguishing between finance leases and operating leases in paragraphs 10 and 11 of IAS 17 reflect an appropriate principle and implicitly consider "the lessee's expected consumption of the economic benefits embedded in the underlying asset". We suggest that rather than introducing new concepts that are not well understood, the principle in IAS 17 be altered to refer explicitly to the expected consumption of the underlying asset. Such a change might be better than introducing a property versus non-property split that may be adhered to more strictly in practice than the Boards intend.

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?

Response: We agree with the proposals on lease term. The proposed guidance is much more principles-based than the probability assessment proposed in the 2010 exposure draft. We think that the factors listed in paragraph B5 provide sufficient guidance for determining whether there is significant economic incentive to exercise or not to exercise an option in the lease contract. We also agree with the proposals on the reassessment of the lease term.

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?

Response: We do not agree with including in the measurement only those variable lease payments that depend on an index or a rate or that are in-substance fixed payments. We agree with the view stated in paragraph BC150 that the lessee's

obligation to make and the lessor's right to receive variable lease payments exists at the lease commencement date. Therefore, it is the measurement that is uncertain, not the existence of the asset or liability that is uncertain. We think that variable lease payments form part of the lease liability and that there is the risk that entities will structure lease contracts to avoid particular types of variable lease payments to minimize that liability.

Although we understand the concerns raised by some that it would be difficult to estimate the variable lease payments reliably, the challenges involved in estimating them are no different from those encountered when measuring for example the fair value of contingent consideration and in-process research and development assets in a business combination, contingent liabilities in IAS 37, or applying the proposed expected loss model for financial assets carried at amortized cost. Furthermore, we note that the lessor is expected to measure the residual asset by estimating the "present value of the amount the lessor expects to derive from the underlying asset at the end of the lease term". For very long leases, the uncertainty around that estimate can be significant.

From a practical point of view we recognize that such measurement challenges would be amplified by the volume of leases in place for some entities and acknowledge that there are some industries (e.g. retail) in which variable lease payments are more common, requiring significant rigor to estimate and calling into question the measurements. However, regardless of the number of leases in the portfolio, we think that users of financial statements also need information about those leases that have a significant variable lease payment component even when those payments do not depend on an index or a rate. In our experience, the process of negotiating a lease contract involves assessing all possible lease payments that the lessee could be required to make, and those payments are reflected in the entity's budgets. To the extent the lessor can make the estimate of the amount it expects to receive for the purpose of measuring the residual asset, we think that the lessee also could make an estimate of what it expects to pay. Therefore, we think it is appropriate that the proposals require disclosure of information about variable lease payments and we suggest including, in addition to paragraph 60(a)(ii), a requirement to disclose at least the minimum amount that the lessee could be required to pay under the lease.

Question 7: Transition

Paragraphs C2–C22 (IASB)/842-10-65-1(b)–(h) and (k)–(y) (FASB) state that a lessee and a lessor would 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 the boards should consider? If yes, what are they and why?

Response: We agree with the proposals, although we think that because the leases standard will result in a significant change from current accounting for most lessees, lessee entities (in particular, those that are publicly-traded or listed) should also be required to disclose quantitatively the impact that the initial application of the new requirements is expected to have on their financial statements. We understand that some lessees provide detailed cash flow, discount rate and foreign currency information to their credit rating agency so that the agency can get an accurate picture of the entity's total leverage. Such entities will have the information necessary to quantify the impact of the new leasing standard. Furthermore, today many investors and analysts adjust an entity's total leverage by capitalizing operating leases. If the information in a lessee's note disclosure allows investors and analysts to make such adjustments, it seems that the entity itself should be able to quantify the impact. Therefore, we think that the hurdle for publicly-traded or listed entities stating that the impact is not known or reasonably estimable should be high.

We acknowledge that such an approach might seem to introduce the new requirements as of the new standard's issue date rather than its effective date. However, as noted above, many investors, fixed income and equity analysts, and credit rating agencies already include this information in their assessment of an entity's total leverage. We would expect such a practice to continue until the standard's effective date. In our view, it would be better for the entity to provide the information itself in the meantime in order to remove any uncertainty about the magnitude of the change.

Question 8: Disclosure

Paragraphs 58–67 and 98–109 (IASB)/842-10-50-1, 842-20-50-1–50-10 and 842-30-50-1–50-13 (FASB) 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?

Response: We agree with the proposals and think they are a significant improvement over the information disclosed about leases today, particularly because the proposals require more information about the nature of an entity's leases and reconciliations of opening and closing balances of the right-of-use asset and lease liability. However, we think that lessors should be required to disclose the amount of assets reported on the statement of financial position that are the subject of Type B leases so that users of financial statements can clearly see which assets are currently in the possession of and being used by the lessor and which are not. Also see our suggestions regarding disclosure in our responses to Question 2, Question 6 and Question 7.

Question 9: Nonpublic Entities (FASB only)

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?

Response: We agree from a practical perspective that a nonpublic entity should be able to make an election to use a risk-free rate in the measurement of the lease liability. However, we note that the proposals already provide relief to allow a lessee to use its incremental borrowing rate if the rate implicit in the lease is not known. Presumably a nonpublic entity lessee that borrows money to finance its operations will know its incremental borrowing rate. Since one of the objectives of the proposals is to ensure that users of an entity's financial statements have an

accurate picture of the entity's leverage, the use of a risk-free discount rate will misstate that picture, making the entity appear more leveraged than it actually is. However, many nonprofit entities do not borrow money and therefore will not have an incremental borrowing rate. For those entities, we believe it is appropriate for them to be able to make an election to use a risk-free rate.

We do not agree with not requiring nonpublic entities to provide a reconciliation of the opening and closing balance of the lease liability. The reconciliation gives users of the entity's financial statements information about leases entered into and terminated and how the components of the lease liability value have changed period to period. Such information is necessary for understanding an entity's leasing activities and the extent to which those activities form part of its business model. At a minimum, a nonpublic entity should be required to provide a qualitative disclosure of the information.

Question 10: Related Party Leases (FASB only)

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?

Response: We agree with the proposal.

Question 11: Related Party Leases (FASB only)

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?

Response: We agree as long as users of financial statements would have information about the existence of the related party relationship and other information required by paragraph 850-10-50-1 even if the amounts involved are eliminated in the preparation of consolidated or combined financial statements.

Question 12: Consequential Amendments to IAS 40 (IASB only)

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?

Response: We do not agree with the proposal. Although we think that the treatment of a leased investment property should not differ from the treatment of a purchased investment property, there are several difficulties that would need to be overcome.

If the right-of-use asset is subsequently measured at fair value, we think it would be inappropriate to measure it initially in accordance with IFRS X *Leases*. Initially measuring the right-of-use asset at fair value would be more consistent with the requirement to measure purchased investment property at its cost (which is likely to be its fair value upon acquisition). Otherwise, the first subsequent period's gain or loss could be significant because of the measurement differences between IFRS 13 *Fair Value Measurement* and IFRS X (e.g., the discount rate used, the existence and potential magnitude of variable payments, the existence of renewal or termination options even if there is not currently a significant economic incentive to exercise them and other factors).

Furthermore, it is unlikely that the right to use the asset could be transferred to a market participant in a fair value measurement without also transferring the lease liability. We are not sure if this is what the IASB intends. This is very different from the situation when an entity transfers an asset that it owns and that is has purchased with debt. In that situation, the debt and the asset are separable. In the situation envisaged by the proposals, the right-of-use asset and the lease liability are inextricably linked and a market participant could only (and would only be willing to) buy the right-of-use asset if it could take possession of and use the underlying leased asset, and it would only have the right to use the leased asset if it assumed the obligation under the lease liability.

The requirement to measure investment property right-of-use assets at fair value has implications for the relationship between the asset and the measurement of the related lease liability. The right-of-use asset exists only because the lease liability exists. Its value stems entirely from the fact that the lessee has a contractual obligation to make lease payments. The value of the right-of-use asset could only be higher than the present value of the remaining lease payments at any given time because of the capitalization of the initial direct costs. We are concerned that disconnecting the measurement of the right-of-use asset from that of the lease liability could potentially result in increased profits and equity if the fair value of the right-of-use asset increases while the lease liability decreases with no economic explanation for such an occurrence. It also removes the symmetry between lessee and lessor measurement.

Please note that our response to this question applies equally to the ability of an entity to use the revaluation model in IAS 16 *Property, Plant and Equipment*. Our concerns about impairment are discussed in the section on "General Observations".