



15 December 2010

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Your ref: ED/2010/9

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Sir David

ED/2010/9 Leases

ICAEW is pleased to respond to your request for comments on the exposure draft *Leases*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ED/2010/9 *LEASES*

Memorandum of comment submitted in December 2010 by ICAEW, in response to the IASB's Exposure Draft *Leases* published in August 2010.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft *Leases* published by the IASB.

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

MAJOR POINTS

Overall assessment

4. We welcome the publication of the exposure draft and the development of a new approach to lease accounting. The existing approach has been widely criticised. The current distinction between finance leases and operating leases is a bright line that is vulnerable to structuring. We welcome the proposals to replace it. Moreover, there is evidence that users of financial statements that disclose significant operating lease commitments are adjusting to capitalise the commitments to obtain a proper assessment of gearing, but in ways which may not produce sufficiently accurate or comparable results.
5. However, while we agree with the principles underlying the proposals, we feel that further work is needed if the proposals are to be operational in practice. We have particular concerns over the proposals relating to the lease term, contingent rentals and remeasurement as they involve departures from the Conceptual Framework definitions of assets and liabilities and introduce too much artificial volatility in earnings. We are also concerned that the proposed hybrid model for lessors will be difficult to apply in practice and does not address concerns about comparability. We propose in this letter a number of solutions in each of these areas, which we believe will enhance the benefits for users and, in many cases, also reduce the cost and complexity for preparers.
6. We have considerable sympathy for the alternative view put forward by Stephen Cooper and although specific comments on his views were not requested we refer to them throughout this letter where we believe they offer a better alternative to what the boards are proposing. In particular we agree that the risks of over-leverage are just as significant as the risks of under-leverage that is shown under existing IAS 17 *Leases*.

Costs and benefits

7. While we acknowledge that the boards have considered the costs and benefits of the proposals, we are concerned about their wider effect on businesses, such as the potentially significant impact on metrics, key performance indicators, employee remuneration, bank covenants, regulatory capital, taxation, audit costs etc. In addition, consideration should be given to the possibly high cost of changing systems and processes to accommodate the proposed requirements, not just on initial adoption but on an ongoing basis.
8. Many leases are sold and priced with the knowledge that a particular tax treatment will apply. The boards' proposal to amend the accounting in the way that it does (particularly the removal

of the distinction between finance leases and operating leases classification) requires that, in certain territories (such as the UK), tax legislation be changed and this can only proceed on a particular legislative timetable. The proposed timing of the application of the standard, and any permitted early adoption, will cause significant transitional difficulties if the tax treatment operates on any existing lease in a different way to previously, with consequent difficulties for tax accounting. This is likely to lead to confusion in the industry, or unexpected losses for one party or another. Early adoption is also likely to be impractical as lessors will have significant problems in writing and pricing new leases until tax legislation is in place.

9. The potential impact for regulated institutions also needs to be considered. For example, consideration needs to be given to how the lessee's right-of-use asset will be treated for regulatory capital purposes. While we appreciate that this is primarily a regulatory matter, clarification as to the nature of the asset (ie, is it tangible or intangible?) would be helpful, both for this and debt covenant purposes.
10. Given the fundamental concerns raised above and the additional work we believe is needed before the boards can finalise their proposals, we have concluded that a June 2011 deadline for completing this project unlikely to prove feasible. We believe a delay would be more than worthwhile if it results in a more robust standard and encourage the boards to reconsider their timetable. As noted above, we propose in this letter a number of solutions to the concerns we identify, which we believe would enhance the benefits for users and, in many cases, also reduce the cost and complexity for preparers. We also believe that plenty of time needs to be allowed before a new standard becomes effective in order to give reporting entities, tax authorities and other interested parties the opportunity to prepare properly. We will return to this subject when we respond to the boards' consultation on effective dates, but given the current significant economic situation, in which the private sector is being looked to to lead a recovery, we would prefer the final standard to have a much longer implementation period than the norm.

Needs of users

11. IAS 17 has often been criticised as failing to meet the needs of users and quite rightly one of the stated aims of this project is to provide users with a complete and understandable picture of an entity's leasing activities. However, we are concerned that the proposals fall short of achieving this objective and may not always provide useful information to users of the financial statements.
12. We urge the boards to undertake more research in this area and to refine their proposed approach accordingly. This should include, but not be limited to, determining what users think should be recognised in the financial statements and what they are happy to see disclosed in the notes so that the right balance can be reflected in the final standard.

SMEs

13. We are concerned that the proposals in the ED would impose disproportionate costs on SMEs if any new leasing standard affects the updating of the IFRS for SMEs. We urge the IASB to develop a simplified model for SMEs that recognises their limited resources and the realistic needs of users. Some of the suggestions we make in this letter regarding lease term, contingent rentals and remeasurement of lease obligations would go a long way towards achieving this, without requiring a special treatments for SMEs.

Distinguishing a lease, a sale and a service arrangement

14. The boards should recognise that, having deleted one bright line, they may well be introducing or placing more pressure on others, in particular the distinctions between leases and service contracts, and leases and sale and purchase agreements.
15. We are concerned that the boundary between leases and contracts that represent a purchase or sale is not clearly enough defined. Moreover, the proposed guidance on when a sale should

be recognised is inconsistent with the revenue recognition proposals contained in the boards' recently-issued exposure draft. We would urge the boards to provide more clarity in this area to ensure consistency and to limit structuring opportunities. In our view the definition of a sale provided in the revenue recognition proposals should also be used throughout any new leases standard, including in the guidance on sale and leaseback transactions.

16. We have similar concerns regarding the boundary between leases and service contracts. We are not convinced that the criteria, which have effectively been carried forward from IFRIC 4 *Determining Whether an Arrangement Contains a Lease*, provide a clear enough distinction, meaning classification may remain difficult to determine in practice. Again, failure to provide more clarity in this area will lead to inconsistencies and structuring opportunities. Furthermore, we believe that the boards should take this opportunity to improve on what is currently contained within IFRIC 4 and address issues that are known to cause diversity in practice.

The right-of-use model

17. We agree with the introduction of the 'right-of-use' model for both lessees and lessors. We accept the boards' analysis of assets and liabilities for simple leases. However, for more complex leases we question whether the assets and liabilities that would be recognised under the proposals are consistent with the definitions in the Conceptual Framework.
18. For lessors we support the introduction of the derecognition model, which in our view is a logical reflection of the lessee's right-of-use. However, we disagree with the requirement not to remeasure the residual asset. We do not support the proposed hybrid model for lessors and oppose the introduction of the performance obligation model.

Lease extensions, contingent rentals and remeasurements

19. We do not agree that the lease term should be recognised on the basis of the longest possible term that is more likely than not to occur. We believe that payments that would become due if an option were to be exercised should only be recognised where the definition of a liability is met in the case of lessees and the definition of an asset is met in the case of lessors. As with other options in financial accounting, we believe lease term extension options do not represent obligations for a lessee and should not be accounted for as if they were already exercised. We believe that optional extension periods should be included in the determination of lease term (and therefore in the measurement of the right-of-use asset and obligation to pay rentals) only where there is no genuine commercial possibility that the option will not be exercised - that is, structuring of the contractual terms as an option was non-substantive.
20. Consistent with our views regarding lease extension options, we believe that contingent rentals should be only be included in the measurement of assets and liabilities arising from a lease where they represent unavoidable obligations for the lessee. Some contingent rentals, such as those based on usage of the leased asset, are avoidable and only where the contingency is crystallised (in this case, the asset is used) does the lessee have an obligation to make lease payments. In effect, the lessee has an option to 'acquire' more of the leased asset and we believe the accounting should be consistent with the model we propose for extension options as described above. It follows that where the lessee is not able to control or avoid the lease payments (such as where payments vary with an underlying index) that they should be included in the measurement of lease assets and liabilities. Where contingent payments are included in the measurement, we believe it should be based on management's best estimate of the expected cash flows associated with the lease provided they can be measured with reasonable certainty. This would not necessarily be based on assigning probabilities to alternative outcomes in the manner suggested in the exposure draft.
21. If the boards were to proceed with their proposals on lease extensions and contingent rentals, we feel that the requirement to perform a reassessment at each balance sheet date would be very onerous. Therefore, we support the proposal that reassessment should only be required

in the limited circumstances where there is a significant change. In addition, we urge the boards to consider allowing reassessments to be undertaken on a portfolio basis.

Short-term leases

22. While we support some simplification for short-term leases, we do not believe that the proposed model for lessees is the best solution as the burden of identifying and tracking a large number of leases will still be very onerous even if discounting payments under those leases is not required. We would instead propose that the existing requirements of IAS 17 relating to operating leases should be applied to short-term leases, as is proposed for lessors.

Transitional arrangements

23. We agree that mandatory full retrospective application would be too onerous in many cases and therefore agree that some simplified transitional arrangements are necessary. However, we do not consider that what the boards are proposing is a suitable solution and share the concerns raised in the alternative view. We believe other transitional provisions should be considered. We agree with the alternative view in paragraphs AV9 and AV10.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

Question 1(a)

Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

24. We agree that there a number of problems with IAS 17 as set out in the introduction to the exposure draft. Therefore we support the development of a new approach to lessee accounting.
25. We accept that the right-of-use model establishes a pragmatic approach to lessee accounting. For simple leases, the rights and obligations arising clearly meet the definitions of assets and liabilities included in the Conceptual Framework. However, we are not convinced that the definitions of assets and liabilities are met for elements of more complex lease arrangements and we have raised a number of concerns about certain aspects of the model in our responses that follow, particularly to questions 8 (lease term), 9 (lease payments) and 10 (reassessment) below.

Question 1 (b)

Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

26. We agree that where the right-of-use model is applied, a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments.
27. While we agree that this approach is consistent with the right-of-use model, we do have concerns about some of the practical implications of replacing rental expense for leases currently classified as operating leases with a combination of amortisation and interest expense. Our concerns are that users of financial statements may not properly understand the impact on the profile of expenses, the impact on metrics and the impact on banking covenants. The lack of a proper impact assessment of the wider effect of these proposals on businesses is a concern we return to in our response to question 17 below.
28. We would recommend that the boards consider additional disclosures, especially on transition, to explain the impact of this change.

Question 2(a)

Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

29. We do not agree with the proposed hybrid model for lessors. Allowing two alternative approaches replicates a number of the problems inherent in IAS 17, such as lack of comparability and the scope for structuring opportunities. It is also inconsistent with requiring a single approach for lessees.
30. We support a single approach for all leases based on the derecognition model. We believe that this approach is a logical reflection of the lessee's right-of-use. However, we believe that improvements could be made to the model proposed by the boards and our thoughts on this are discussed further in our response to question 2(b) below.
31. We do not support the use of the performance obligation approach in any circumstances. We are particularly concerned that the performance obligation approach creates for the lessor an asset to receive rentals while at the same time retaining the leased asset in property, plant and equipment. We do not believe that these assets are distinct, and in our view this leads to double counting of cash flow potential of a single asset. Moreover, the effect is that the same asset is capitalised by both lessee and lessor.

Question 2 (b)

Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

32. As noted above, we support the use of the derecognition model for all leases. We broadly agree with the boards' proposals for the recognition of assets, liabilities, income and expenses under this model.
33. However, we disagree with the prohibition on remeasuring the residual asset. We support the alternative view; the initial amount recognised should be accreted to reflect the time value of money. Failing to do so understates the profitability of the lessor during the lease term and creates an artificial one-off gain when the asset is sold at the end of the lease term. We acknowledge that the residual asset is not a monetary asset, but believe that the nature of the asset changes over time. For example, a residual asset at the inception of a five year lease represents a right to obtain property in five years' time. One year later, it is a right to obtain property in four years' time, which is arguably a different asset, but is certainly an asset with a different value. In view of this direct linkage to the passage of time, we believe the time value of money ought to be reflected, as it currently is implicitly in the measurement of the net investment in a lease under IAS 17.
34. Moreover, we would also include an option to fair value the residual asset through other comprehensive income where an entity adopts such a policy for similar items of property, plant and equipment. This would allow lessors to apply a consistent approach for assets that they hold to use within their business and those which they lease to others. Although we do not believe that many entities would take up this option, we believe that it should be made available for those who wish to do so, such as UK government bodies that are currently required to revalue in this way.

Question 3

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

35. We do not believe that short-term leases as defined in the exposure draft are inherently different from other leases and therefore in theory we believe that they should be accounted for in the same way. This would be consistent with the aim of having a single model for all leases. However, from a pragmatic point of view we have concerns that doing so would impose a heavy burden on some businesses and therefore we accept that a simplified approach is appropriate for short-term leases.
36. The proposed simplified approach would require lessees to gross up their statements of financial position to include lease assets and liabilities with rentals presumably recognised on an accruals basis. In our view, this offers little relief in practice, particularly for entities with large numbers of short-term leases for whom the burden of identifying and tracking these leases will still be very onerous regardless of whether the payments under those leases are discounted or not. Therefore, while we support some simplification for short-term leases, we do not believe that the proposed model is an adequate solution. We would instead propose that the existing requirements of IAS 17 relating to operating leases should be applied to those leases with a maximum possible lease term at commencement of twelve months, as is proposed for lessors.
37. We acknowledge that this proposal may result in assets and liabilities not being recognised on the lessee's statement of financial position. However, we feel that the costs of complying with the boards' proposed requirements will far outweigh the benefits to users, which could be just as well served through disclosure. For example, there could be disclosure of the annual expense relating to short-term leases, which would give users information about the magnitude of such leases without the lessee incurring substantial cost and effort to estimate the remaining rental payments due.
38. The boards' proposals allow lessors and lessees to apply the simplified approach on a lease-by-lease basis. We are concerned that such an approach would lead to a lack of comparability and could be open to manipulation. We would therefore recommend that where an entity elects to apply the simplified approach it should be required to do so for all short-term leases of a similar nature.

Question 4 (a)

Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

39. The definition of a lease is largely carried forward unchanged from IAS 17 and we have no major concerns about the definition itself.
40. However, more clarification is needed so that the boundaries between lease contracts, sale/purchase contracts and service contracts are more robustly defined. Failure to do so would create structuring opportunities and lead to inconsistencies similar to those seen today due to the distinction between operating and finance leases. These concerns are considered in more detail in our responses to questions 4(b) and 4(c) below.

Question 4 (b)

Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

41. We are concerned that the guidance is not clear enough in this area.
42. We note that the exposure draft identifies sale/purchase contracts as those that transfer 'control of the entire underlying asset and all but a trivial amount of the risks and benefits

associated with the entire underlying asset'. We are concerned that 'all but a trivial amount' is not clearly defined. Unless this is clarified, it could be interpreted inconsistently. Moreover, contracts could be structured to achieve a particular accounting outcome.

43. At a broader level, we are concerned that these proposals are inconsistent with the revenue recognition proposals which only require the transfer of control as a condition to recognise a sale. A preferable approach would be for the leasing proposals to be consistent with the revenue recognition proposals so that if a contract meets the definition of a sale under the revenue recognition proposals, it would also be classified as a sale under the leasing proposals without additional reference to risks and benefits.
44. We are also concerned that there are some inconsistencies with IFRIC 12 *Service Concession Arrangements*. A grantor has control of infrastructure assets where it regulates what services the operator must provide, to whom it must provide them and at what price and it controls any significant residual interest. Control in this context is normally taken to exist where the grantor has any form of purchase option, not just a bargain purchase option. Contracts falling within IFRIC 12 are likely to be either within the scope of the exposure draft (where there is a fair value option) or classified as 'in-substance purchases' (where there is a bargain purchase option or automatic transfer of ownership). There is therefore likely to be some confusion over which standards to apply to these arrangements, particularly because the exposure draft, unlike IFRIC 4, does not specifically scope-out arrangements that also fall within IFRIC 12. Bearing in mind that IFRIC 12 is an interpretation and does not have the status of a standalone standard, we encourage the IASB to consider whether it remains consistent with the both the proposed right-of-use model for leases and the proposed contract-based model for revenue.

Question 4 (c)

Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

45. We are concerned that the guidance is not clear enough in this area. We are not convinced that the criteria which have effectively been carried forward from IFRIC 4 provide a clear distinction between leases and service contracts. Again, failure to provide more clarity in this area will lead to inconsistencies and structuring opportunities.
46. We believe that the boards should take this opportunity to improve on what is currently contained within IFRIC 4 and address issues that are known to cause diversity in practice, including the following:
- The meaning of 'fixed price' or 'fixed price per unit of output'. For example, in certain power supply contracts there is diversity in practice regarding whether the criterion should be interpreted literally (that is, there is a stated single price for the entire term) or in a broader sense encompassing arrangements under which the price per unit of output is predetermined (that is, there is a series of stated prices that vary over time).
 - The meaning of 'output' and whether it should be viewed in a physical or economic context. For example, again considering power supply contracts, there is diversity in practice regarding whether the output of a power station is just the energy it produces, or also includes by-products like steam and heat, or includes other economic benefits such as renewable energy certificates and similar carbon credits.
 - The meaning of 'ability or right to operate', which can be unclear in the context of certain time charter shipping transactions where the ship is operated by people who are not employees of the 'lessee'.
 - Greater explanation of what are specific assets, especially in the context of exchangeable assets and an entity's practice of exchanging them. This matter is of particular concern to entities in the outsourcing and telecommunications industries.

Question 5

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

47. We agree with the scope of the proposed IFRS. Although we believe there is no conceptual reason why a lease accounting standard should exclude intangible assets, pragmatically we agree that it is best to do so as there would be significant impacts in certain sectors (for example, pharmaceuticals, media) if there was a change of scope. We would not support such a change unless a proper impact assessment was undertaken. We agree that this issue should be returned to in the future when the boards consider accounting for intangibles more broadly.

Question 6

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

48. We support the IASB's viewpoint from both a lessee and lessor perspective as this approach provides more useful information and increases transparency for users. While in practice this approach may be difficult to apply for lessors adopting the derecognition model, we believe it is possible and the benefits are likely to outweigh the costs.
49. We believe that in practice there will not be many occasions where services will not be considered 'distinct'. For example, if we consider contracts in the property or automotive sectors it would appear that the service element meets the definition of distinct in most if not all cases. However, we recognise that there might be some cases (specifically regarding certain property and time charter shipping transactions) where the services are not considered distinct under the proposed criteria. We raised concerns about the definition of 'distinct' in our recent response to the boards' revenue recognition proposals. Those concerns relate to part (b) (ii) of the definition, which for the reasons explained in our previous letter, risks introducing unwelcome subjectivity and confusion into this key area.

Question 7

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

50. We believe that purchase options should be accounted for in the same way as options to extend a lease. However, see our response to question 8 below regarding options generally.

Question 8

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

51. We do not support the proposed approach. We believe that it results in assets and liabilities being recognised by lessors and lessees respectively that do not meet the definitions thereof set out in the Conceptual Framework.
52. The lessee does not have an unconditional obligation to pay rentals during an optional lease extension period unless the option is exercised. Therefore it should not recognise a liability. Similarly, the lessor has neither an unconditional right to receive these payments nor control over them until the lessee exercises its options. Therefore it should not recognise an asset. Consequently, we believe that the proposals do not provide useful information to the users of the financial statements.
53. We suggest that the lease term should be limited to the minimum contractual lease term, with the option to extend only recognised when it is exercised or when there is no genuine

commercial possibility that the option will not be exercised because structuring of the contractual terms as an option was non-substantive. As with other options in financial accounting, we believe lease term extension options do not represent obligations for a lessee and should not be accounted for as if they were already exercised.

54. The boards' proposals include narrative disclosures about optional lease periods. We believe that the approach we propose above alongside such disclosures will provide more useful information for the users of the financial statements than recognising spurious assets or liabilities on the statement of financial position.
55. Our position is therefore similar in many ways to the alternative view and we agree with many of the arguments expressed therein.

Question 9

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

56. We believe that some, but not all, contingent rentals should be included in the measurement of assets and liabilities arising from the lease. Consistent with our views regarding lease extension options set out in our response to question 8 above, contingent rentals should be only be included in the measurement of assets and liabilities arising from a lease where they represent unavoidable obligations for the lessee. Some contingent rentals, such as those based on usage of the leased asset, are avoidable and only where the contingency is crystallised (in this case, the asset is used) does the lessee have an obligation to make lease payments. In effect, the lessee has an option to 'acquire' more of the leased asset and we believe the accounting should be consistent with the model we propose for extension options as described above. It follows that where the lessee is not able to control or avoid the lease payments (such as where payments vary with an underlying index) that they should be included in the measurement of lease assets and liabilities.
57. Our position is similar in some ways to the alternative view and we agree with many of the arguments expressed therein.
58. We also feel that the proposed measurement approach is flawed as applying an analysis of probabilities will in reality be extremely difficult and the outcome could be entirely spurious. Instead, where contingent payments are included in the measurement, we believe it should be based on management's best estimate of the probable cash flows. This would not necessarily be based on assigning probabilities to alternative outcomes.
59. We believe a consistent approach should be applied for lessees and lessors, that is there should be a reliable measurement threshold. That is not to say that lessees should not recognise any liability where measurement is considered unreliable, but the boards should consider developing guidance similar to that in IAS 36 *Impairment of Assets* where amounts are included in respect of periods that go beyond the lessee's normal planning horizon.
60. We agree that residual value guarantees and term option penalties are too similar to contingent rentals to be accounted for differently.

Question 10

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

61. As noted in our responses to questions 8 and 9 above, we do not support the boards' proposals regarding options to extend and contingent rentals. If the boards were to proceed with their proposals in these areas, we feel that the requirement to perform a reassessment at each reporting date would be very onerous. Therefore, we support the proposal that reassessment should only be required in the limited circumstances where there is a significant change.
62. We are however concerned that the process of determining whether a reassessment is required will be a matter of considerable judgement. In particular, we are concerned that 'significant change' is not clearly defined and could therefore be interpreted inconsistently in practice.
63. We are also concerned that the only way to determine whether a change in facts or circumstances will have a significant impact will be to undertake detailed calculations, which may ultimately prove to be of little benefit in practice.
64. A reassessment may involve a significant amount of work, especially if a large number of leases are affected by similar factors. In such circumstances, we would suggest that the reassessment can be undertaken on a portfolio basis. In some cases this may be the only feasible way of implementing the proposed requirements.
65. If our views on lease term are accepted, and contingent rents are based on a best estimate with a reliability threshold, this issue is diminished. For example, updating expected contingent rentals is easier where management's best estimate of the expected cash flows is used, as we suggest, rather than where the weighted-average approach proposed by the exposure draft is applied.
66. We agree that where changes to lessees' estimates relate to contingent rentals from current or prior periods, their impact should be recorded in the income statement and where they relate to future periods, they should be recorded as an adjustment to the carrying amount of the right-of-use asset. For lessors, which we believe should apply the derecognition approach in all cases, we agree that the impact of changes to estimates of contingent rentals should be recorded in the income statement. In view of our proposal that lease extension options should only be taken into account when 'reasonably certain' to be exercised, we believe that changes in estimates of lease term will be rare. However, where they do occur we agree with the boards' view that the impact should be reflected as adjustments to the lessee's right-of-use asset and to the lessor's residual asset in the manner proposed.

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

67. We refer to our concerns raised in response to question 4(b) above. In particular, we reiterate that we believe that there is a need for more clarity as to the boundary between sale/purchase contracts and lease agreements.
68. We do not believe that there should be a higher threshold applied to sale and leaseback transactions when determining whether a sale has taken place (as described in paragraph B31) as compared to separate lease transactions (paragraphs B9 and B10). In both cases we

believe there should be a consistent definition of what constitutes a sale/purchase and our preference is for the approach set out in the boards' revenue recognition proposals, that is, a sale is dependent on transfer of control.

69. We are surprised that the proposals do not include any transitional relief for 'failed' sale and leaseback transactions that fall to be accounted for as financing transactions and encourage the boards to reconsider whether this is needed.

Question 12 (a)

Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

70. We do not believe that a lessee's obligation to pay rentals should always be presented separately on the face of the statement of financial position. We consider that disclosure in the notes will be sufficient in most cases. We believe there is sufficient guidance in IAS 1 *Presentation of Financial Statements* as to what should be disclosed on the face of the primary statements and do not support cluttering these statements with additional categories of assets and liabilities that can be satisfactorily disclosed in the notes. This is consistent with our recent response to the proposed amendment to IAS 1. We would prefer disclosures to be in the notes instead unless separate presentation is relevant to an understanding of an entity's financial position.
71. We agree that the right-of-use asset should be presented according to the nature of the underlying leased item, that is, included within property, plant and equipment or investment properties rather than, as some propose, as a separate intangible. Again mandatory disclosure on the face of the statement of financial position is not considered necessary. Leased and owned items should be separately disclosed in the notes.

Question 12 (b)

Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totalling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

72. Generally we do not support the performance obligation approach. However, if the boards decide to pursue this option then we agree that the proposed 'linked presentation' is the preferred option.
73. We have similar concerns to those cited in our response to question 12(a) above regarding cluttering of the primary statements and would prefer disclosures generally to be in the notes instead.

Question 12 (c)

Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

74. We have similar concerns to those cited in our response to question 12 (a) above regarding clutter in the primary statements and would prefer disclosures to be in the notes instead.

Question 12 (d)

Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

75. Where there are separate arrangements, we agree that the position should be presented gross. In cases where there is an agency or pass through arrangement, we believe a net presentation is more appropriate.
76. We have similar concerns to those cited in our response to question 12(a) above regarding cluttering of the primary statements and would prefer disclosures generally to be in the notes instead.

Question 13

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

77. As noted in our response to question 12(a) above, we believe there is sufficient guidance in IAS 1 as to what should be disclosed on the face of the primary statements and do not support cluttering these statements with potentially immaterial items, consistent with our recent response to the proposed amendment to IAS 1. We would prefer disclosures generally to be in the notes instead unless separate presentation is relevant to an understanding of an entity's financial performance.

Question 14

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

78. We have similar concerns to those raised in our responses to questions 12(a)-(d) and 13 above regarding cluttering of the primary statements.
79. We are concerned about the requirement to classify lessee cash flows as financing cash flows. In practice entities enter into leases for many reasons, sometimes as an alternative source of finance and sometimes for operational reasons. There is an argument that they would be better classified as operating or even investing cash flows and the boards have acknowledged this dichotomy in their deliberations concerning financial statement presentation. In the meantime we are willing to accept presentation as financing cash flow as an interim measure. However, we believe the interest component should be treated in a manner consistent with other interest cash flows.

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that (a) identifies and explains the amounts recognised in the financial statements arising from leases; and (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

80. We welcome the requirement to disclose relevant quantitative and qualitative information as this will provide useful information to users of the financial statements and enhance their

understanding of the role and impact of lease arrangements on the entity, though we recognise that similar disclosures are not currently required for all assets and liabilities.

81. Individually each proposed disclosure has some merit but if entities were to comply with all of the proposed requirements it would add up to a very onerous task. Therefore, we welcome the requirement in paragraph 71 that states that 'an entity shall consider the level of detail necessary to satisfy the disclosure requirements... and how much emphasis to place on each of these requirements' as this allows some flexibility and will ease the reporting burden in many cases. We would recommend that the boards clearly state that all of the disclosures listed should not be regarded as mandatory in all situations. If the intention is that they must be disclosed in all instances we would struggle to support the inclusion of such voluminous requirements.
82. We also note that paragraph 71 allows entities to 'aggregate or disaggregate disclosures'. We welcome this too, as presumably this allows entities to apply a portfolio approach where appropriate. Perhaps this option should be explicitly stated to remove any doubt or confusion as to whether it is acceptable.
83. The proposals in paragraph 77 whereby a lessee is required to disclose a reconciliation of opening and closing balances of right-of-use assets and liabilities to make lease payments are particularly welcome and will be of great interest to users of the financial statements and analysts alike. Similar disclosures for other types of long-term debt, other than just lease liabilities, would also be welcomed.

Question 16 (a)

The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

84. We agree that mandatory full retrospective application would be too onerous in many cases and therefore agree that some simplified transitional arrangements are necessary. However, we are not convinced that what the boards are proposing is a suitable solution.
85. We share the concerns raised in the alternative view; the proposed approach will lead to a misleading reduction in lessees' profits on transition and increased profits in subsequent periods with the opposite effect for lessors. In common with the alternative view, we believe alternative transitional provisions should be considered for both lessees and lessors. Full retrospective application should be permitted or the transitional provisions adjusted so that the right-of-use asset is not necessarily set equal to the transition liability, but instead takes account of the impact of the remaining lease term compared to the original lease period.

Question 16 (b)

Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

86. Yes, for the reasons set out above, but on an optional rather than mandatory basis.

Question 16 (c)

Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

87. As noted in our response to question 11 above, we believe additional transitional relief is needed for 'failed' sale and leaseback transactions

Question 17

Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

88. While we acknowledge that the boards have considered the costs and benefits of the proposals, we are concerned about their wider effect on businesses, such as the potentially significant impact on metrics, key performance indicators, employee remuneration, bank covenants, regulatory capital, taxation, audit costs etc. In addition, consideration should be given to the possibly high cost of changing systems and processes to accommodate the proposed requirements, not just on initial adoption but on an ongoing basis.
89. Many leases are sold and priced with the knowledge that a particular tax treatment will apply. The boards’ proposal to amend the accounting in the way that it does (particularly the removal of the distinction between finance leases and operating leases classification) requires that, in certain territories (such as the UK), tax legislation be changed and this can only proceed on a particular legislative timetable. The proposed timing of the application of the standard, and any permitted early adoption, will cause significant transitional difficulties if the tax treatment operates on any existing lease in a different way to previously, with consequent difficulties for tax accounting. This is likely to lead to confusion in the industry, or unexpected losses for one party or another. Early adoption is also likely to be impractical as lessors will have significant problems in writing and pricing new leases until tax legislation is in place.
90. The potential impact for regulated institutions also needs to be considered. For example, consideration needs to be given to how the lessee’s right-of-use asset will be treated for regulatory capital purposes. While we appreciate that this is primarily a regulatory matter, clarification as to the nature of the asset (ie, is it tangible or intangible?) would be helpful, both for this and debt covenant purposes.
91. IAS 17 has often been criticised as failing to meet the needs of users and quite rightly one of the stated aims of this project is to provide users with a complete and understandable picture of an entity’s leasing activities. However, we are concerned that the proposals fall short of achieving this objective and may not always provide useful information to users of the financial statements.
92. We urge the boards to undertake more research in this area and to refine their proposed approach accordingly. This should include, but not be limited to, determining what users think should be recognised in the financial statements and what they are happy to see disclosed in the notes so that the right balance can be reflected in the final standard.
93. Some of the costs arising from the proposals would be reduced if our suggestions relating to renewal options, contingent rentals and short-term leases were incorporated into any new standard.
94. We are concerned that the proposed changes will have a disproportionate impact on SMEs if these proposals affect the updating of the IFRS for SMEs. We urge the IASB to develop a simplified model for SMEs that recognises their limited resources and the realistic needs of users. Some of the suggestions we make in this letter regarding lease term, contingent rentals and remeasurement of lease obligations would go a long way towards achieving this.

Question 18

Do you have any other comments on the proposals?

95. Given the fundamental concerns raised above and the additional work we believe is needed before the boards can finalise their proposals, we feel that a June 2011 deadline for completing this project is not feasible. We believe a delay is more than worthwhile if it results in a more robust standard and encourage the boards to reconsider their timetable. As noted above, we propose in this letter a number of solutions in each of these areas, which we believe

will enhance the benefits for users and, in many cases, also reduce the cost and complexity for preparers. We also believe that plenty of time needs to be allowed before a new standard becomes effective in order to give reporting entities, tax authorities and other interested parties opportunity to prepare properly. We will return to this subject when we respond to the boards' consultation on effective dates, but given the current significant economic situation, in which the private sector is being looked to to lead a recovery, we would prefer the final standard to have a much longer implementation period than the norm.

96. The following matters are not dealt with in the exposure draft. We believe it is important that the boards address these matters in order to reduce the risk of a proliferation of application issues in the years following adoption.
- What constitutes a lease payment? Whilst the exposure draft defines lease payments in terms of 'payments arising under a lease', the detail of the proposed model demonstrates that the boards have focussed on cash payments by a lessee to a lessor. The boards do not appear to have addressed the accounting for a number of other types of payments relating to lease contracts, such as non-monetary lease incentives, key money, 'make good' provisions and security deposits. We believe that the boards should clarify how to account for each of these common payments in the final standard.
 - How do you account for a modification of a lease? Should it be treated as an extinguishment of one lease and recognition of a new lease, or as an extension of an existing lease with revised terms? Existing literature in IAS 39 *Financial Instruments: Measurement* is used to determine whether there has been an extinguishment or modification of a financial liability. The boards could use such literature as a basis for developing lease modification guidance and to clarify that both qualitative and quantitative factors should be considered.
 - There are many issues concerning the passage of time between lease inception and commencement. How is the time value of money reflected? What if there are rental payments or modifications during the period? How are assets under construction dealt with? We believe the boards could address these issues by means of application guidance.
 - The exposure draft proposes that a lessee measures the right-to-use asset initially at the amount of the liability to make lease payments, plus any initial direct costs incurred. Meanwhile a lessor includes initial direct costs in its initial measurement of its lease receivable. We observe that the accounting treatment of costs of obtaining a contract is not unique to leases. The recently issued exposure draft for insurance contracts requires inclusion of incremental acquisition costs in the present value of the fulfilment cash flows and exclusion of all other acquisition costs. The revenue exposure draft, on the other hand, allows capitalisation of certain contract costs, but requires that the costs of securing a contract are expensed as incurred. In view of the different approaches proposed for these three projects, we would urge the boards to undertake a more comprehensive project on costs to ensure consistency.
97. There is an inconsistency between paragraphs 12(a) and B11; the former refers to 'readily determined', while the later refers to 'reliably determined'.
98. There is an inconsistency between paragraphs 50 and B30; the former refers to 'fair value', while the example in B30 uses 'present value'.
99. Paragraphs 7, 7(b) and Appendix C imply that investment property held for lease (as opposed to investment property that is leased-in) is scoped out of the proposed standard but this is not clear.

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