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Deloitte Touche Tohmatsu

08.12.2000

Sir Bryan Carsberg
**THE SECRETARY-GENERAL**
International Accounting Standards Committee
166 Fleet Street
LONDON EC4A 2DY
United Kingdom

Dear Sir Bryan:

**Re: Leases: Implementation of a New Approach**

Deloitte Touche Tohmatsu and its Member Firms are pleased to comment on the G4+1 Position Paper, Leases: Implementation of a New Approach (the "Position Paper"), of which the IASC has solicited comments.

**General Comments**

We support the continual development of the rights and obligations approach for accounting for lease transactions. We support the general concept that the rights and obligations under leases should be reported at fair value, and with much of the guidance in the Position Paper. We also support the concept of providing for the recognition in lessees' balance sheets of assets and liabilities arising from operating leases. We believe under current standards, the distinction between operating leases and finance leases is arbitrary and inadequate. We believe that the comparability of financial statements will be enhanced if such a model is introduced.

**Scope of Position Paper**

We believe the Position Paper should be broad enough to distinguish between leases and other types of arrangements. Due to the increasing uniqueness and complexity of certain transactions (e.g., synthetic leases, fiber optics, software, power purchase contracts), it is often difficult to determine what types of contracts fall within the scope of current leasing standards. As a result of the lack of guidance under current leasing standards, there exists diversity in the application of those standards for these types of transactions.

**Discussion of fair value in the Position Paper**

We support the fair value concept for lease accounting if reliable measures of fair value can be established. We understand that the most reliable measure of fair value should be the present value of the minimum payments (assuming that the lease is negotiated on an arm's length basis). However, there may be instances where the present value of the minimum payments is not the most reliable measure of fair value. For example, if there are active trades on an open market for the asset leased, a quoted market price may be more reliable. Given the significance of the concept of fair value in the context of leases, we believe that the discussion of fair value in the Position Paper should be considerably expanded.

We attach as an appendix to this letter our responses to the specific questions raised in the Position Paper, including a detailed discussion of the matters referred to above.

If you have any questions concerning our comments, please contact Mr. Stig Enevoldsen at 45 33 76 36 90.

Very truly yours,

## APPENDIX

**Q1 Chapter 1 sets out the deficiencies of existing accounting standards for leases and the problems associated with an arbitrary distinction between different types of leases. Do you agree that standard-setters should aim to develop a single accounting method that can be applied to leases of all kinds?**

Yes. We agree with the aim of developing a single method for dealing with leases of all kinds.

**Q2 Chapter 2 discusses the scope of any revised accounting standards for leases. It distinguishes contracts that would fall within the scope of leases and other contracts, in particular executory contracts, that would not.**

**(a) Do you agree that the distinction has been made appropriately in Chapter 2? If not, what other factors do you think are particularly relevant?**

We believe a greater distinction should be made in the Position Paper. We believe that the Position Paper should be broad enough to distinguish between leases and other types of arrangements. Due to the increasing uniqueness and complexity of certain transactions, it is will be difficult to determine what types of contracts fall within the scope of the proposed leasing standard.

**(b) Do you agree that leases of intangible assets (including agreements to explore for or use natural resources) should not in principle be excluded from the scope of revised standards?**

Yes. We agree that leases of intangible assets should be within the scope of the revised standards. We also believe that due to the increasing uniqueness and complexity of certain transactions, the proposed standard should be broad enough to distinguish between leases and other types of arrangements. It is often difficult to determine what types of contracts fall within the scope of current leasing guidance. The following are a few examples of these types of arrangements:

- Contracts for the use of software and fiber optics;
- Synthetic leases that produce differing results for book purposes and tax purposes;
- Management contracts that allow a party to manage the underlying business of the property (e.g., hotels); and
- Power purchase contracts.

Due to the lack of guidance under current leasing guidance, there exists diversity in the application of leasing guidance for these types of arrangements

**(c) What practical problems might arise if the proposals were applied to leases of intangible assets?**

We believe problems would arise relating to the measurement of intangible assets. We support the requirement to recognize all assets that are objectively discernible and reliably measurable and meet the other asset recognition criteria. However, in many instances, identified intangibles cannot be reliably measured. We also are concerned that application of the recognition criteria could have a significant operational difficulty—determining what is meant by "reliably measurable." Measurements of intangible assets often include a wide range of values affected significantly by underlying assumptions.

**(c) Do you agree that no specific exemption should be proposed for short leases and that reliance should instead be placed on the principle of materiality?**

Yes. We agree that no specific exemption should be proposed for short leases.

**Q3 Do you agree that leases of land and buildings, as accounted for by lessees, should not be excluded from the scope of revised standards (see Chapter 13)?**

Yes. We agree that leases of land and buildings, as accounted for by lessees, should not be excluded from the scope of revised standards.

**Q4 Do you agree with the Group's recommendations related to lessee accounting in Chapter 3 that:**

**a) assets and liabilities should be recognised by a lessee in relation to the rights and obligations conveyed by a lease when the lessor has substantially performed its obligation to provide the lessee with access to the leased property for the lease term?**

Yes, assets and liabilities should be recognized by a lessee in relation to the rights and obligations conveyed by a lease. Once the lessor provides the lessee access to the leased property, the lessee has control and therefore can derive future economic benefits from the leased property and also has an obligation to pay rentals under the lease. This is consistent with the recognition criteria of assets and liabilities.

We believe the group should focus on the definition of an asset and a liability rather than setting guidelines based upon substantial performance. What constitutes substantial performance can be very subjective. Using the criteria as to what constitutes an asset and a liability will result in less interpretation.

**b) the objective should be to record, at the beginning of the lease term, the fair value of the rights and obligations that are conveyed by the lease?**

Yes, the objective should be to record, at the beginning of the lease term, the fair value of the rights and obligations that are conveyed by the lease. We support the fair value concept for lease accounting if reliable measures of fair value can be established.

**c) the fair value of the rights obtained by a lessee cannot be less than the present value of the minimum payments required by the lease (assuming that the lease is negotiated on an arm's length basis)?**

Yes, we believe the fair value of the rights obtained by a lessee cannot be less than the present value of the minimum lease payments required by the lease, assuming no option features or residual value guarantees. We believe the present value of the minimum lease payments is the best evidence of the fair value of the rights obtained.

**Q5 Chapter 4 discusses the treatment of optional features of leases and contingent rentals. It proposes that the rights that are reflected in the initial lease asset (and liability) that is recorded by the lessee will comprise the rights to use the property and also options, for example to extend the lease, to purchase additional usage of the property in exchange for usage-related rentals, or to purchase the property itself (in those cases where such options can be measured reliably).**

**(a) Do you agree with the proposal that leases containing lessee options to renew or cancel leases should not be accounted for on the basis that renewal options will be exercised, even if that is thought to be the probable outcome?**

Generally, leases containing lessee options to renew or cancel leases should not be accounted for on the basis that renewal options will be exercised. An option gives the lessee the right but not the obligation to renew or cancel the lease. Assessing the probability of whether the option will be exercised at the inception of the lease would not represent the true asset and liability under the lease; that is, the lessee is obligated under the fixed term but not under the optional renewal period. If the lease includes a renewal option, an asset should be recognized based upon the option's fair value. However, we believe there may be instances where an option to renew or cancel should be accounted for on the basis that the option will be exercised such as if the renewal option is considered a bargain or if failure to renew the lease imposes a penalty on the lessee such that renewal is considered reasonably assured. Therefore, one must review the substance of the terms of the agreement.

**(b) Do you agree that, except in those circumstances where it can be demonstrated that an option has significant value (and assuming its value can be ascertained with sufficient reliability), the payments required by the lease should be deemed to relate to the right to use the property for the lease term?**

Yes, payments required by the lease should be deemed to relate to the right to use the property for the lease term unless it can be demonstrated that an option has significant value.

**Q6 Chapter 4 discusses (paragraphs 65-77) the treatment of contingent rentals that are a proportion of the lessee's revenues or profits derived from the leased property.**

**The Group's view as reflected in the Paper is that if the minimum payments required by the lease are clearly unrepresentative of the value of the property rights conveyed by the lease, assets and liabilities of a greater amount, reflecting the fair value of such rights, should be recognised. The fair value of the property rights conveyed by a lease might be determined by having regard to the payments required by a similar lease that had no provision for contingent rentals.**

**An alternative view is that the initial asset and liability should reflect only the present value of the minimum payments required by the lease.**

**Which of the two approaches do you support, and why?**

We agree with the first approach. The asset and liability recorded by the lessee should always be the fair value of the rights conveyed by the lease. Generally, the most reliable measure of fair value would be the minimum lease payments required by the lease. We believe lease payments that depend on a factor that does not exist or is not measurable at the inception of the lease would be contingent rentals in their entirety and, accordingly, should be excluded from minimum payments and not used in determining fair value at inception of the lease. However, a lease that contains contingent rental provisions that lack economic substance should be evaluated to determine whether they are indeed contingent rentals or minimum payments. If the contingent rental provisions lack economic substance, an analysis of the true fair value of the rights needs to made. One way of performing this analysis is to use a "with and without method" as described in the first approach. However, if the lessee is unable to determine the fair value of the rights without the contingent rental provision, other methods that can establish a reliable measure of fair value should be specifically identified in the proposed standard.

**Q7 Chapter 4 discusses (paragraphs 78-88) the treatment of contingent rentals that vary in line with prices.**

**The Group's view as reflected in the Paper is that estimates of future price changes should be reflected in the amount of assets and liabilities recorded at the beginning of the lease.**

**An alternative view is that only the existing level of rentals should be reflected in the amount of assets and liabilities recorded at the beginning of the lease.**
**Which of the two views do you support, and why?**

We agree that estimates of future price changes should be reflected in the amount of assets and liabilities recorded at the beginning of the lease. However, we believe the proposed standard should provide guidance as to whether the effective rate at the beginning of the lease or the effective rate at the adjustment date should be used by a lessee at each adjustment date to determine the asset and liability to recognize.

**Q8 Chapter 5 discusses various arrangements where the lessee has rights and obligations relating to the residual value of the leased asset, such as those arising from a residual value guarantee.**

**The Group's view as reflected in the Paper is that an asset and liability should be recognised at the beginning of the lease term measured at the present value of the payments the lessee is required to make during the lease term and the fair value of guarantees or other residual value agreements (if it is practical to quantify them).**

**An alternative view is that in circumstances where in substance the lessee has exposure to risk on substantially all of the property's value, it should record an asset and liability at the beginning of the lease reflecting the full fair value of the property, regardless of the cash flows that are specified in the lease contract. (Those who hold this view believe that Examples 4 and 5 in Chapter 5 are economically similar and therefore the accounting treatment should be similar.) Which of the two views do you support? If you support the alternative view, how would you define the circumstances in which gross asset and liability amounts should be reported?**

We agree that an asset and liability should be recognized at the beginning of the lease term measured at the present value of the payments the lessee is required to make during the lease term and the fair value of guarantees or other residual value agreements (if it is practical to quantify them). We believe it would be misleading to record the full fair value of the property when the lessee has rights and obligations for only a specified period of time.

**Q9 Chapter 5 (paragraphs 35-39) also discusses the accounting treatment of subsequent changes in the value of the lessee's obligations in relation to residual value guarantees.**

**The Group's preferred view is that the carrying amount of both the lease liability and the lease asset should be increased or decreased (subject to the carrying amount of the asset not being increased above a value that would cause an impairment write-off), and that the asset's revised carrying amount should be depreciated over the remainder of the lease term.**

**An alternative view is that the difference between the remeasured liability and its previous carrying amount should be recognised immediately as a loss or gain in income.**

**Which of the two treatments do you support?**

We agree with the preferred view that the carrying amount of both the lease liability and the lease asset should be increased or decreased (subject to the carrying amount of the asset not being increased above a value that would cause an impairment write-off), and that the asset's revised carrying amount should be depreciated over the remainder of the lease term. We agree that subsequent changes in the residual value of the equipment are a component of changes in the current value of the equipment, which affects the cost of the right to use the equipment. Therefore, reflecting those changes in the carrying amount of the asset is appropriate.

**Q10 Chapter 5 (paragraphs 61-66) discusses the accounting where a renewal option is accompanied by a residual value guarantee. The Group's view as reflected in the Paper is that the concurrent existence of these two features in a lease should not give rise to the recognition of additional assets and liabilities (i.e. by anticipating the exercise of renewal options). An alternative view is that additional assets and liabilities should be recognised. What is your view?**

We agree with the Group's view that the concurrent existence of a renewal option and a residual value guarantee in a lease should not give rise to the recognition of additional assets and liabilities (i.e. by anticipating the exercise of renewal options). However, we believe there may be instances where an option to renew or cancel should be accounted for on the basis that the option will be exercised such as if the renewal option is considered a bargain or if failure to renew the lease imposes a penalty on the lessee such that renewal is considered reasonably assured.

**Q11 Do you agree with the recommendation in Chapter 6 relating to the discount rate that should be applied to the rental payments?**

Yes. We agree with the recommendation in Chapter 6 relating to the discount rate that should be applied to the rental payments.

**Q12 Chapter 7 discusses two approaches to accounting for sale and leaseback transactions. Do you agree with the Group's view as reflected in the Paper that a sale and leaseback should be accounted for as one transaction, with any gain restricted to that which relates to the rights that have not been retained by the lessee?**

Yes. We agree that a sale and leaseback should be accounted for as one transaction, with any gain restricted to that which relates to the rights that have not been retained by the lessee. We also believe proposed standard should include detailed continuing involvement criteria that would preclude sale-leaseback accounting. Additionally, the proposed standard should address whether partial sales are permitted and, if so, the appropriate accounting for such sales. We also agree with the measurement approaches outlined in paragraphs 7.14 through 7.18.

**Part III-Lessor accounting**

**Q13 Do you agree with the general principle (Chapter 8) that a gain should be recognised at the beginning of the lease term if (a) there is evidence that the value**

**of the lessor's assets (less its liabilities) has increased as a result of its performance in entering into the lease contract, and (b) the increase can be measured reliably?**

Yes. We agree with the general principle that a gain should not be recognized at the beginning of the lease term unless: (a) there is evidence that the value of the lessor's assets (less its liabilities) has increased as a result of its performance in entering into the lease contract, and (b) the increase can be measured reliably. We believe the proposed standard should include guidelines on how to reliably measure the increase in value of the lessor's net assets.

**Q14 Do you believe that accounting standards should specifically restrict the recognition of a gain by a lessor at the beginning of a lease to the two circumstances described in paragraph 18 of Chapter 8?**

Yes. We agree that accounting standards should specifically restrict the recognition of a gain by a lessor at the beginning of a lease to the two circumstances described in paragraph 18 of Chapter 8. We believe the proposed standard should define what constitutes "long before the lease was granted." We also believe the proposed standard should state that the criteria for a sale should be met before the lessor recognises any gain at the beginning of the lease.

**Q15 Do you have any comments on the recommendations in Chapter 9 relating to disclosure of separate components of the lessor's assets?**

We agree with the presentation of lease receivables as a separate financial asset, but believe the disclosure around the residual value guarantees is important for an understanding of the lessor's residual interest exposures.

**Q16 What practical problems, if any, do you foresee with the recommendations in Chapter 10 relating to the initial measurement of receivable and residual interest assets?**

Conceptually we agree with the present value measurement techniques recommended in Chapter 10 relating to the initial measurement of receivable and residual interest assets. However, we do foresee practical problems with the lessor being able to accurately determine a reasonable risk rate to use, especially as it relates to residual interest risk. We do not see any application problems between the two methods of calculating discounted present value cash flows as both models should produce the same present value and in the second model, the risk adjustment factor can be derived by using the same risk adjusted rates that are used in the first model.

**Q17 Chapter 11 discusses the treatment of optional features of leases and contingent rentals from the lessor's perspective. The Group's view is that it should be presumed that if a lease contract gives rise to a liability for the lessee (as discussed in Chapter 4) it will give rise to a corresponding receivable asset for the lessor.**

**(a) Where contingent rentals are a proportion of the lessee's revenues or profits derived from the leased property, the Group's view as reflected in the Paper is that if the minimum payments required by the lease are clearly unrepresentative of the value of the property rights conveyed by the lease, the lessor's initial receivable asset (corresponding to the asset and liability that is recognised by the lessee) should be a greater amount, reflecting the fair value of such rights.**

**An alternative view (corresponding to the alternative view of the appropriate lessee accounting noted in Question 6) is that the lessor should recognise a receivable asset of only the present value of the minimum payments required by the lease.**

**Which of the alternative approaches do you support, and why?**

We agree with the first approach. The asset and liability recorded by the lessor should always be the fair value of the rights received from the lease. Generally, the most reliable measure of fair value would be the minimum lease payments required by the lease. We believe lease payments that depend on a factor that does not exist or is not measurable at the inception of the lease would be contingent rentals in their entirety and, accordingly, should be excluded from minimum payments and not used in determining fair value. However, a lease that contains contingent rental provisions that lack economic substance should be evaluated to determine whether they are indeed contingent rentals or minimum payments. If the contingent rental provisions lack economic substance, an analysis of the true fair value of the rights needs to be assessed. One way of performing this analysis is to use a “with and without method” as described in the first approach. However, if the lessor is unable to determine the fair value of the rights without the contingent rental provision, other methods that can establish a reliable measure of fair value should be specifically identified in the standard.

**(b) Where contingent rentals vary in line with prices, the Group's view as reflected in the Paper is that estimates of future price changes should be reflected in the receivable asset recognised by the lessor.**

**An alternative view (corresponding to the alternative view of the appropriate lessee accounting noted in Question 7) is that only the existing level of rentals should be reflected in the receivable asset that is recognised by the lessor at the beginning of the lease.**

**Which of the alternative approaches do you support, and why?**

We agree that estimates of future price changes should be reflected in the amount of assets and liabilities recorded at the beginning of the lease. However, we believe the proposed standard should provide guidance as to whether the effective rate at the beginning of the lease or the effective rate at the adjustment date should be used by a lessor at each adjustment date to determine the asset and liability to recognize.

**Q18 Chapter 12 discusses three alternative views on how a lessor's residual interest asset should be measured and accounted for during the lease term. Do you agree with the Group's view as reflected in the Paper that the initial carrying amount (measured at the present value of the estimated residual value at the end of the lease) should be accreted over the lease term by 'unwinding' the discount?**

We agree with the Groups view that the residual interest should be recognized at a discounted amount and the discount accreted over the lease term. We believe the asset should be evaluated periodically for impairment. If there is an indication that the undiscounted amount will not be realized in full then the unwinding may need to be adjusted on a prospective basis as a change in estimate. If there is an indication of impairment on the amount of residual interest asset already recorded, a write-down may be necessary.

**Part IV-Other issues**

**Q19 Do you agree with the recommendation in Chapter 13 that lessors of land and buildings should report as separate assets in their balance sheets the amount of their investment that represents lease receivables, and that which represents their interest in the residual value of the property, and that the finance income for the lease receivables and changes in the interest in the residual value should be reported separately? If not, what alternative treatment would you favour and why?**
**Do you agree that information on fair values should be preserved?**

We support the proposal and agree that information on fair values should be preserved.

**Other**