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***IASB Exposure Draft ED/2013/6 / FASB File Reference No. 2013-270***

13 September 2013

Dear Board Members,

Deloitte Touche Tohmatsu Limited is pleased to comment on the IASB's and FASB's joint exposure draft (ED) on leases.

We commend the IASB and FASB for their continued efforts to improve the accounting for leases by both lessees and lessors, and we generally agree with the reasons the boards have identified for why improvements to the existing accounting for leases are warranted. In particular, the off-balance-sheet treatment of operating leases for lessees and lack of adequate disclosures restrict users' ability to obtain sufficient information about an entity's leverage and commitments that will result in cash outflows in future periods. As a result, many financial statement users adjust a lessee's balance sheet by using rough estimates about operating lease obligations derived from their own models and assumptions. In addition, the current dual model for lessees (operating or finance/capital leases) creates complexity, inconsistent accounting for leases that may be economically similar, and opportunities for accounting arbitrage.

To address the shortcomings of the current lease standards, the boards proposed a right-of-use (ROU) asset approach. We continue to believe that conceptually the ROU approach appropriately depicts the rights and obligations for lessees and should serve as the foundation for changes to the recognition and measurement requirements in the current lease standards. However, we have significant concerns with the approach currently included in the proposal.

While we recognise that the boards developed the dual-classification approach for lessees in response to comments received on the original ED, we are concerned about the conceptual merit of the Type B

lessee approach. That is, we are concerned about an approach that would result in an increasing amount of amortisation over the lease term. In addition, the proposed dual-model approach may be more costly and complex for preparers than existing standards and may not result in sufficiently improved information for users. For example, the proposal would need to contain additional guidance defining and interpreting the meaning of “property” and may result in significantly different measurements and presentation for leases that are economically similar. This may increase complexity in both application and interpretation, cause similar transactions to be accounted for differently, and create new opportunities for accounting arbitrage.

We are also concerned that the combination of the proposed measurement requirements for the lease liability and proposed disclosures may not provide financial statement users with sufficient information about a lessee’s future lease payments. Specifically, users are trying to understand the full extent of a lessee’s commitments under existing lease contracts, which may not be fully conveyed under the proposal. As a result, to arrive at data necessary for their analysis, users may have to remove the amounts recorded under the proposal from the financial statements and then make adjustments similar to those that are currently made.

We also believe that the boards have not yet sufficiently developed the ROU model for lessors and have not made a compelling case that the information provided by the proposed lessor accounting model represents a significant improvement over the existing lessor accounting model. Rather, the model introduced in the ED, if implemented, may obscure the financial statements of lessors as a result of the proposed classification requirements.

We therefore believe there are questions about whether the cost-benefit analysis of introducing this new model continues to support the case for change at this stage of the development of the ROU concept. If a majority of financial statement users confirm that an on-balance-sheet approach, combined with appropriate disclosures, would provide the information they need about the ROU assets controlled by the lessee and the cash commitments to pay for these assets, the boards should move forward with developing a single-model ROU approach for lessees (with limited-scope amendments to the lessor model) in a final standard. We recognise that this would create asymmetry between the lessor and lessee accounting models.

If users would not be satisfied with this approach for lessees, at this time the most prudent course of action may be to provide users with additional information in the notes to the financial statements and make limited-scope amendments to the current standards. If the boards opt for this alternative approach, we encourage them to continue working to develop a lease accounting model that is based on the ROU approach and that would meet the boards’ objectives of representing the leverage effects of leases on the balance sheet, reducing complexity, and eliminating the resulting opportunities for accounting arbitrage.

The appendix of this letter contains our detailed responses to the questions for respondents posed by the boards.

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If you have any questions concerning our comments, please contact Veronica Poole at +44 20 7007 0884 or Bob Uhl at +1 203 761 3152.

Sincerely,

A handwritten signature in black ink, appearing to read 'V. Poole', with a stylized flourish at the end.

Veronica Poole  
Global IFRS Leader

## Appendix — Responses to Questions Posed in the ED

**Question 1: Do you agree with the definition of a lease and the proposed requirements in paragraphs 6–19 (ASC 842-10-15-2 through 15-16) 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.**

We agree that the definition of a lease should focus on whether the arrangement (1) depends on the use of a specified asset and (2) conveys the right to use the asset for a period of time. This is generally consistent with the requirements in IFRIC 41 and ASC 840.2 However, we are concerned about the proposal's scope, the impact of substitution rights on the identification of the specified asset, and the evaluation of which party has control under the arrangement.

### Application of Lease Guidance to Intangible Assets (IASB-Only)

The IASB's proposal includes an option for lessees to apply the proposed guidance to arrangements that provide the lessee with the right to use an intangible asset. Conversely, lessors in such arrangements would be prohibited from applying the guidance. We believe that, in a manner consistent with the FASB's proposal, the scope of the final leasing guidance should exclude intangible assets for both lessees and lessors.

Application of the proposal to intangible assets assumes that the right to use the intangible asset grants the customer a right to use, but not own, the transferred intangible asset at a point in time. However, as discussed by the boards as part of the revenue recognition project, there can be significant differences in these types of arrangements on the basis of the nature of the rights granted. That is, the lessee might be viewed as not obtaining control of an intangible asset at a point in time if the intangible asset is dynamic and will change as a result of the lessor's continuing involvement in maintaining or enhancing the intangible asset. In these cases, the lessee obtains access to the intellectual property in the form in which it exists at any given moment rather than the right to use an intangible asset. The lessor has not fulfilled its obligation when it delivers the asset. Accordingly, accounting for such intangible assets in accordance with the ED would result in the inappropriate recognition of an ROU asset and lease obligation. Rather than including intangible assets within the scope of the leases proposal, the IASB should exclude intangible assets until it has considered the overall accounting for intangible assets as part of a separate and comprehensive project, as discussed in paragraph BC81 of the ED.

### Identifying a Specified Asset

We agree that substantive substitution rights should be considered in the evaluation of whether an arrangement is related to a specified asset. This analysis will be critical in the determination of whether arrangements for certain items (e.g., office equipment) are considered a service or a lease. However, the proposal is unclear on when substitution rights are considered substantive. Accordingly, the boards should clarify or provide additional guidance on evaluating when substitution rights are considered nonsubstantive as a result of a barrier to exercise the substitution right. As written, the ED's examples are unclear and potentially contradictory on how to evaluate whether a *barrier* exists that would preclude the consideration of a substitution right in the identification of a lease.

In its example of a contract for medical equipment (Illustrative Example 3), the ED concludes that the supplier's substitution rights are not substantive because the cost of replacing the equipment *creates an economic barrier* that prevents the supplier from replacing the equipment other than when it is not operating properly. Although the example does not provide a basis for this conclusion, some have interpreted this as meaning that the cost of simply removing the asset is prohibitive, which represents an

<sup>1</sup> IFRIC Interpretation No. 4, *Determining Whether an Arrangement Contains a Lease*.

<sup>2</sup> FASB Accounting Standards Codification Topic 840, *Leases*.

economic barrier, and that the threshold for concluding that the substitution rights are substantive would therefore be relatively high.

In contrast, in its example of a contract for railcars (Illustrative Example 1C), the ED concludes that the supplier's substitution rights are substantive and the contract does not contain a lease partly because "Carrier could fulfil the contract with Customer using rail cars other than those owned at the commencement of the contract, if, for example, Carrier were to decide to expand its fleet of rail cars during the contract." This implies that even though the asset is specified, a substitution right that could only be exercised if the supplier expanded its fleet of railcars would be considered substantive. It is unclear from this example, as currently written, whether the entity's ability to decide to expand its fleet implies a different threshold for evaluating whether substitution rights are substantive or whether the arrangement is not a lease because of other factors such as Carrier's ability to control and use the asset to provide services to others.

### **Customer's Involvement in Designing the Asset or in Determining the Terms and Conditions of the Contract**

The ED indicates that an entity should consider a customer's "involvement in designing the asset or in determining the terms and conditions of the contract" in determining whether a customer has the *ability to direct the use* of the asset. However, the ED does not provide any guidance on how the customer's involvement in the design of the asset should be considered in relation to its involvement with the continuing activities. For example, the ED is unclear on how, if a customer is actively involved in the design of a power plant but has only limited involvement in the future operations of the asset, the evaluation should consider the customer's involvement in the initial activities.

In addition, the boards should align this concept with the requirements in IFRS 10<sup>3</sup> and ASC 810.<sup>4</sup> Specifically, paragraph BC77 of IFRS 10 states that "[b]eing involved in the design does not necessarily mean that an investor has decision-making rights to direct the relevant activities." Further, under current U.S. GAAP, a reporting entity's involvement in the design of a variable interest entity (VIE) is typically weighted less heavily when there are meaningful ongoing activities that affect the entity's financial performance. Therefore, to limit potential diversity in practice, we recommend that the boards consider guidance from other areas of IFRSs and U.S. GAAP when finalising the leases standard to ensure that the final guidance is aligned with the concept of control in these other standards.

### **Ability to Derive Benefits From Use**

The ED provides guidance on evaluating whether an arrangement that includes (1) highly interrelated goods or services with (2) the use of a specified asset should be accounted for as a lease. Specifically, under paragraph 19 (ASC 842-10-15-16 under the FASB's proposal), such an arrangement would not be treated as a lease if (1) "the customer can obtain the benefits from use of the asset only in conjunction with additional goods or services that are provided by the supplier and not sold separately by the supplier or other suppliers" and (2) "the asset is incidental to the delivery of services because the asset has been designed to function only with the additional goods or services provided by the supplier."

While the ED illustrates the application of this provision in its example of a contract for coffee services (Illustrative Example 2), we recommend that additional guidance be provided because the ED does *not* clearly identify how an entity should interpret the term "incidental" when performing the assessment. The coffee machines in the example provided may not be significant in value compared with the other services that are only supplied by the vendor. However, there are other practical examples in which an asset with significant value is similarly linked to goods or services that can only be obtained from the supplier. For example, a company may supply expensive equipment to a customer on the condition that the customer use the supplier's employees to operate the equipment. In this case, the customer only benefits from the use of the asset in conjunction with the additional services provided and the asset has been designed to function only with the additional services provided by the supplier. Accordingly, even though the value of the equipment is clearly significant to the arrangement, the equipment may be

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<sup>3</sup> IFRS 10, *Consolidated Financial Statements*.

<sup>4</sup> FASB Accounting Standards Codification Topic 810, *Consolidation*.

considered incidental since it is not separable from the service being performed by the supplier's employees. The boards should clarify whether the use of the asset would be considered "incidental" in this arrangement.

### **Grandfathering of EITF Issue 01-08 Contracts and IFRS 1 Exemptions**

Under current U.S. GAAP, entities are permitted to account for certain contracts under the accounting requirements that were in place before the issuance of EITF Issue 01-08.<sup>5</sup> An entity was not required to evaluate these transactions under the EITF 01-08 requirements unless they were subsequently modified. This exception was designed to alleviate some of the challenges and complexities that entities might have faced when adopting that guidance.

In addition, IFRS 1<sup>6</sup> grants limited exemptions when the cost of complying with its requirements would be likely to exceed the benefits to financial statement users. One such exemption is that if a first-time adopter of IFRSs "made the same determination of whether an arrangement contained a lease in accordance with previous GAAP as that required by IFRIC 4 but at a date other than that required by IFRIC 4, the first-time adopter need not reassess that determination when it adopts IFRSs."

Under the ED, these grandfathering provisions would be eliminated. We recommend that the FASB and IASB consider whether there is any merit to extending these grandfathering provisions, since some of the contracts covered by the proposal may still be in effect and it may be even more difficult to obtain the information required to adopt the proposed requirements for such transactions.

***Question 2: 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?***

If a majority of financial statement users confirm that an on-balance-sheet approach, combined with appropriate disclosures, would provide the information they need about the ROU assets controlled by the lessee and the cash commitments to pay for these assets, the boards should move forward with developing a single-model ROU approach for lessees (with limited-scope amendments to the lessor model) in a final standard. If users would not be satisfied with this approach for lessees, at this time the most prudent course of action may be to provide users with additional information in the notes to the financial statements and make limited-scope amendments to the current standards.

We believe that if the boards move forward with developing a single-model ROU approach for lessees, the approach should reflect a lease as financing the purchase of the ROU asset. The underlying concept in the ED is that when the underlying asset is delivered, the lessee has a right to use the leased asset and an obligation to make lease payments that meet the definition of an asset and a liability in the IASB's Conceptual Framework and in FASB Concepts Statement 6.<sup>7</sup> Essentially, the transaction is the acquisition of a nonfinancial asset with deferred financing. Accordingly, we believe that it is appropriate to amortise the ROU asset similarly to how other purchased nonfinancial assets are amortised — that is, on a systematic basis reflecting the pattern in which the lessee is expected to consume the ROU asset's future economic benefits.

While we recognise that the boards developed the dual-classification approach for lessees in response to comments received on the original ED, we are concerned about the conceptual merit of the Type B

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<sup>5</sup> EITF Issue No. 01-08, "Determining Whether an Arrangement Contains a Lease."

<sup>6</sup> IFRS 1, *First-time Adoption of International Financial Reporting Standards*.

<sup>7</sup> FASB Concepts Statement No. 6, *Elements of Financial Statements* — a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2).

lessee approach. That is, we are concerned about an approach that would result in an increasing amount of amortisation over the lease term to achieve a total straight-line lease expense in the income statement. In addition, the proposed dual-model approach may be more costly and complex for preparers than existing standards and may not result in sufficiently improved information for users. For example, the proposal would need to contain additional guidance defining and interpreting the meaning of “property” and may result in significantly different measurements and presentation for leases that are economically similar. This may increase complexity in both application and interpretation, cause similar transactions to be accounted for differently, and create new opportunities for accounting arbitrage.

As noted in paragraph BC36 of the ED, the boards considered various methods for amortising the ROU asset, including an interest-based amortisation approach that they later rejected. While the Basis for Conclusions identifies the single-lease-expense approach as an alternative to the interest-based amortisation approach because the lease-related expenses are presented as a single amount in the statement of comprehensive income, the subsequent accounting for the ROU asset under the proposed Type B approach is identical to that under the interest-based amortisation approach. The boards rejected the interest-based approach because (1) it is currently prohibited under U.S. GAAP and IFRSs;<sup>8</sup> (2) it would cause the amortisation of a leased asset to be different from the purchase of a similar asset; and (3) some preparers expressed concerns about the costs of applying such an approach.

One of the primary concerns related to the current lessee accounting guidance is that it causes economically similar transactions to be accounted for differently — a result that stems from both the existence of bright lines and the dual-classification approach. We believe that the proposed approach aggravates this issue rather than resolves it. The proposed approach not only retains a dual-classification model but also introduces a new bright line based on the nature of the underlying leased asset — property versus assets other than property. As a result, leases with similar economics will be accounted for differently solely because of the nature of the underlying asset. For an explanation of why we disagree with an approach under which the lease classification is based on the nature of the underlying asset, see our response to Question 4.

Further evidence of the lack of conceptual merit for Type B leases is the boards’ decision to require the presentation or disclosure of lease liabilities arising from Type A leases separately from lease liabilities arising from Type B leases. The Basis for Conclusions indicates that “[a]lthough all lease liabilities are measured in the same way, separate presentation or disclosure would help a user to understand the liability balance to which lease expenses recognised in the statement of profit or loss and other comprehensive income relate.” A requirement to provide additional disclosures to enable users to reconcile amounts between the income statement (interest expense) and the balance sheet (lease obligation) is indicative of a move in the wrong direction.

***Question 3: 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?***

We believe that the boards have not yet sufficiently developed the ROU model for lessors and have not provided a compelling case that the information provided by the proposed lessor accounting model represents a significant improvement over the existing lessor accounting model. Rather, the model

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<sup>8</sup> See paragraph BC65 of IFRIC 12, *Service Concession Arrangements*.



introduced in the ED, if implemented, may obscure the financial statements of lessors as a result of the proposed classification requirements.

In addition, we do not believe that the existing lessor accounting requirements are fundamentally flawed and we think that they result in useful information. Further, while an approach that provides symmetry between lessees and lessors appears desirable, the boards have not done enough work studying the issues associated with the accounting by lessors to determine whether such an approach is practical. Accordingly, we believe that the boards should retain an approach that is generally similar to the current dual-model approach for lessors in IFRSs (i.e., eliminate the leveraged leases guidance from U.S. GAAP) and that lease classification should be based on principles consistent with the current requirements (see paragraphs 7 and 8 of IAS 17<sup>9</sup>). However, if the boards adopt this approach, they should consider the interaction between retaining the current lessor accounting requirements and applying the proposed ROU model in the accounting for subleases. Finally, we do not agree with the proposal that lessor accounting should depend on the nature of the underlying leased asset. As indicated in our response to Question 4, this would cause economically similar transactions to be accounted for differently solely because of the nature of the underlying leased asset.

Our recommendations are based on our understanding that users generally are satisfied with the information provided by lessors under current accounting guidance. The concerns of users who believe that the existing requirements for lessors do not provide adequate information about a lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from its retained interest in the underlying asset) could be addressed through additional disclosure requirements.

***Question 4: 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 (ASC 842-10-25-5 through 25-8), which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?***

As discussed in our response to Question 2, we recommend that the boards develop a single-model ROU approach for lessees. In addition, we disagree with the proposed classification criteria in the dual-model approach, as currently proposed.

The Basis for Conclusions indicates that lease classification is based on whether the lessee consumes more than an insignificant portion of the economic benefits embedded in the underlying asset. That is, it focuses on the expected economic benefits embedded in the underlying asset during the lease term. The boards also indicate that applying this principle without the additional delineation between property and other than property would result in additional complexity and costs. Accordingly, the boards decided to simplify the requirements in the ED by proposing to apply the classification principle largely on the basis of the nature of the underlying asset (i.e., property — land, a building, or both).

While we agree with the boards that, for leases other than land-only leases, it may be difficult to determine the level of economic benefits embedded in the underlying asset consumed by the lessee, we disagree that the nature of the underlying leased asset is an appropriate proxy for determining which accounting model to apply. This approach will result in different accounting for economically similar transactions solely because of the definition of property. For example, certain assets such as cell towers and wind farms, which are attached to property and cannot be removed and used separately without

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<sup>9</sup> IAS 17, *Leases*.



incurring significant cost, would most likely be considered “other than property” under the proposal. Accordingly, they would generally be accounted for as Type A leases even though the benefits derived from such assets depend significantly on the location of the assets. Other assets, such as ships, railcars, and storage containers, have characteristics similar to those of a building in that the consumption of the economic benefits embedded in the underlying asset occurs over an extended period. Simply because those assets are not attached to a land element that has an indefinite life, the proposed classification requirements assume that the lessee is expected to consume them over the period of a lease. As a result, we disagree with an approach that is based on the nature of the underlying asset. If the boards ultimately decide to require a dual model, we recommend that lease classification be based on an approach consistent with paragraphs 7 and 8 of IAS 17, which focus on the terms of the lease only and do not take into account the nature of the underlying asset.

In paragraph BC51 of the ED, the boards acknowledge that although an approach that is based on the nature of the underlying asset would make the classification proposals simpler, it would not always result in conclusions that are consistent with the consumption principle. Rather, the boards note that the proposed approach will cause “most leases” to be classified in accordance with that principle. We are therefore concerned that diversity in practice may arise because of the inconsistency between the underlying principle and the proposed classification requirements. In addition, delineating leases on the basis of whether the underlying asset is property would increase the complexity of defining and interpreting the meaning of “property.”

### **Major Part of Remaining Economic Life Versus Insignificant Part of Total Economic Life**

Further, in the evaluation of lease terms as part of the lease classification, the approach applied should be consistent for leases of property and other than property. As drafted, the evaluation would consider whether the “lease term for property is for the *major part* of the remaining economic life of the underlying asset” or the “lease term for other than property is for an *insignificant part* of the total economic life of the underlying asset.” To avoid confusion, the boards should decide on the use of one metric, either “major part” or “insignificant part,” for performing this evaluation. The boards should also be consistent on whether the evaluation is based on the *remaining economic life* of the asset or the *total economic life* of the asset.

### **Land-Only Leases**

In certain jurisdictions where land is owned by local governments, real estate developers often enter into land-only leases (e.g., a 999-year land-only lease) because it is not possible to purchase the land for development. Many of these long-term leases may be classified as Type A on the basis of the relationship between the present value of the lease payments and the fair value of the land as of the lease commencement date. While the classification of these long-term land leases as Type A appears to be inconsistent with the underlying consumption principle, it is unclear whether this is the boards’ intent. Accordingly, if the boards ultimately decide to require a dual model, they should address this point in the final standard.

***Question 5: 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?***

We accept the boards' conclusion that a lessee's right to extend a lease beyond the initial noncancelable period, or to terminate a lease before the end of the lease period, should be included in the measurement of lease assets and lease liabilities if specified criteria are met (the "measurement approach" indicated in paragraph BC137(c)). However, the determination of the lease term should be based on a probability threshold method. That is, an entity should include optional periods in the lease term if the exercise of the options meets a specified probability threshold.

The Basis for Conclusions indicates that the boards believe that requiring an evaluation that focuses on whether the lessee has an economic incentive "provides a threshold that can be applied more easily because it is more objective than a threshold based solely on management's estimates or intent." We disagree with this conclusion. Because the proposed approach requires determination of the lease term from the perspective of a lessee, we are concerned with how lessors would consider the relevant factors when determining whether the lessee has a significant economic incentive to exercise an option.

In addition, focusing on the existence of an economic incentive for the lessee to extend the lease may result in the inappropriate exclusion of a portion of the lease term in the measurement of the lease obligation. For example, it may be highly likely that a lessee will extend a lease even if there is no *significant* economic incentive to do so. Such a renewal period would not be reflected in the measurement of the lease obligation until the option is actually exercised.

Further, using a probability notion would align the determination of the lease term with the guidance in IAS 37.<sup>10</sup> It is not unusual for an entity to be obligated to remove leasehold improvements at the end of the lease term. Because the proposal does not amend the provisions in IAS 37 related to removing leasehold improvements, such obligations will continue to be accounted for as "best estimates" under IAS 37, regardless of the lease term definition in the proposal. Using a probability-based threshold for determining the lease term would ensure that an entity reflects the comprehensive impact of entering into leasing (including the effect of the retirement obligation) on a consistent basis. That is, if the two standards are not aligned, a lessee could conclude that a five-year lease term should be used to determine the lease obligation, while estimating the asset retirement obligation in accordance with IAS 37 is based on an assumption that the lease term will be 10 years.

Instead, the boards should retain the current "reasonably certain" or "reasonably assured" concepts in IAS 17 and ASC 840. Any renewal options that are, as assessed at inception of the lease, reasonably certain/assured to be exercised would be included in the lease term and measured as part of the ROU asset and the liability to pay rentals. The factors that would be used to evaluate whether a renewal option is reasonably certain/assured to be exercised would be the same as those currently used to evaluate renewals under IAS 17 and ASC 840 (generally, whether a significant penalty for nonrenewal exists, such as the loss of leasehold improvements). The boards note in the Basis for Conclusions that the concept of "significant economic incentive" would provide a threshold that is similar to the concepts of "reasonably certain" and "reasonably assured" in existing IFRSs and U.S. GAAP. Accordingly, rather than introducing the "significant economic incentive" concept, the boards should retain the current concepts, which are already widely understood.

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<sup>10</sup> IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

The boards may also want to discuss the proposal we highlighted in our December 2010 comment letter on the 2010 leases ED. In that response, we indicated that in a manner consistent with the original leases discussion paper, we believe that an option to extend or terminate a lease meets the definition of an asset, separate from the ROU or leased asset, for the option holder and an obligation for the option issuer. Accordingly, we had proposed an alternative to accounting for renewal options as follows:

- Renewal options that, as of lease inception, are not considered reasonably certain/assured to be exercised would be separated from the ROU asset and recognised separately and would be measured at their intrinsic value. Intrinsic value would be defined as the difference between current market lease rates for a similar asset compared with the lease renewal rates. For example, consider a three-year lease of a vehicle with an option to renew for a fourth year. The intrinsic value would be determined on the basis of the current market lease rate for a similar three-year-old vehicle compared with the lease renewal rate in the lease agreement. If the current market lease rates are higher than the renewal rates (i.e. favourable), an asset would be recognised for the positive intrinsic value separately from the ROU asset. If the rates are not favourable, the option would be measured at zero. This treatment would reflect the fact that the lessee is paying for the intrinsic value associated with the renewal option as part of the lease payments during the base lease term.
- Like other intangible assets, the asset recognised in relation to the renewal option would be subject to impairment but would not be subsequently remeasured. Rather, the asset would be amortised over the renewal period.
- In a manner consistent with a historical cost measurement of the ROU asset, the likelihood that a lessee would exercise a renewal option would not be reassessed at the end of each reporting period. Rather, the exercise of a renewal option that was not included in the original lease term would result in a “new lease” and the asset associated with the renewal option would be included as part of the new ROU asset.

We acknowledge that recognised options are not usually measured at intrinsic value and that fair value is a more common measurement attribute. However, in line with the conclusion reached by the boards in the leases discussion paper, we agree that fair value would be difficult to determine for these options. In addition, the difference between fair value and intrinsic value is primarily time value, which decays over time. When the time value of the option is included in the ROU asset, it is amortised over time and is appropriately reflected in profit or loss. Although our discussion above focuses on renewal options, we view termination options as economically similar to renewal options and therefore would propose similar accounting for termination options.

Lessors would perform a similar analysis for determining the lease term and account for a renewal option as an obligation.

### **Lessor Right to Unilaterally Cancel Lease**

We also recommend that the boards provide additional clarification on how a lessor’s ability to unilaterally cancel a lease would be considered in the determination of the lease term. This is a common provision in certain countries where the lessor is a governmental entity (under current U.S. GAAP, leases in which the lessor is a governmental entity are addressed in ASC 840-10-25-25). The boards should clarify whether both the lessee and the lessor would view such a provision as a “hard stop” — that is, the lease term could not exceed the point at which such a provision could be exercised. Because the existence of such a

right is contrary to the notion of right of use, as indicated in paragraph BC13(a) of the ED, and because such a right is stronger than the right of substitution used in identifying the lease, failure to exclude such a period from the lease term may cause the standard to be conceptually inconsistent.

***Question 6: 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?***

We agree that in the measurement of the lease obligation and the ROU asset, the lease payments should include payments that are fixed or in-substance fixed payments. However, we recommend that the boards clarify what would be considered an in-substance fixed payment. The current examples in the proposal illustrate payments that are, in fact, fixed payments rather than in-substance fixed payments, so additional examples and clarification would be beneficial.

Regarding variable lease payments, paragraph BC148 of the ED discusses three types of distinct variables that contingent rentals may be based on: (1) an index (e.g., consumer price index (CPI)); (2) usage (e.g., a car lease that requires additional payment if a specified mileage is exceeded); and (3) performance (e.g., lease payments based on a percentage of the lessee's sales arising from the underlying property). We agree with the distinction between the three categories identified and believe that the different types of contingencies have distinct attributes that deserve separate consideration and result in different accounting treatments.

#### **First Category: Contingencies Based on an Index**

We agree that lease payments that are based on an index, such as interest or CPI, should be included in the measurement of the lease obligation. The index adjustment is simply part of the ongoing measurement of that liability. In addition, although CPI escalation provisions are common in many leases, while there are predictions of the future CPI, a readily available forward rate or index is typically not available. We therefore agree that it is appropriate to use the prevailing rates or indices.

#### **Second Category: Contingencies Based on Usage**

We agree with the proposal that usage-based contingent rentals should be excluded from the initial measurement of the lease payments. In our view, contingencies based on usage are akin to renewal options. By incurring additional payments based on usage, the lessee essentially exercises a renewal option and uses an additional part of the underlying asset. In other words, the lessee is paying for an additional ROU asset rather than paying an additional amount for the same ROU asset. The additional ROU asset is not delivered, and the obligation to pay for that additional usage does not arise, until the option to use is exercised by the lessee. However, this is inconsistent with the proposed lessor accounting model, in which variable lease payments based on usage are recognised in income rather than as a reduction of the residual asset, unless the payment was included in the rate the lessor charges the lessee for Type A leases.

#### **Third Category: Contingencies Based on Performance**

While including a probability-weighted amount for performance-based variable lease payments in the measurement of the ROU asset and lease liability appears to have conceptual merit, such an approach is not consistent with the accounting for similar variable payments in several other areas of the accounting literature, including business combinations and the boards' current proposals on revenue recognition. In

addition, the boards have not yet been able to effectively address variable consideration in simple acquisitions of assets. We therefore believe that the boards should address contingent payments broadly as a separate project and then apply the conclusions reached in that project to lease accounting. In the meantime, we agree that the accounting for performance-based contingent rentals should remain unchanged from current accounting (i.e., the guidance in IAS 17 and ASC 840) and should be amended only after the boards have addressed contingent payments broadly. In addition, the costs and complexity associated with initially and subsequently remeasuring the ROU asset and the lease liability every time there is a change in estimate of variable lease payments far outweigh the benefits to users from including such payments in the measurement of the ROU asset and lease liability.

### **Additional Variable Payment Disclosures**

We recognise that some users consider variable payments based on usage and performance to be part of a lessee's obligation. In lieu of including variable lease payments in the second and third categories identified above as part of the measurement of the ROU asset and lease liability, we recommend lessees be required to provide disclosures that allow users to understand a lessee's exposure to such variable lease payments.

***Question 7: Paragraphs C2–C22 (ASC 842-10-65-1(b) through (h) and (k) through (y)) state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? 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?***

### **Transition Guidance Consistent With Revenue Recognition Transition**

While we generally support the ED's transition guidance, we are concerned about the possibility of differences between the transition provisions of the proposed leases standard and those in the final revenue recognition standard. Because lessors may have arrangements that are within the scope of both the proposed revenue recognition standard and the proposed leases standard, entities might find it difficult to adopt the two standards if the transition provisions are not consistent. Therefore, we recommend that the transition provisions of the final leases standard be consistent with those of the forthcoming revenue standard.

### **Use of Hindsight in the Determination of Lease Classification**

The boards should provide additional clarification on the use of hindsight in the determination of lease classification. In accordance with paragraph C7 of the ED (ASC 842-10-65-1(g)(2) under the FASB's proposed ASU), "an entity *may* use hindsight, such as in determining whether a contract contains a lease, in classifying a lease or in determining the lease term if the contract contains options to extend or terminate the lease" (emphasis added). The use of the word "may" seems to indicate that the lessee has the option to use either the expected term when originally performing the lease classification assessment or a revised expected lease term when using hindsight. The boards should clarify whether the use of hindsight should be applied as an accounting policy election or whether an entity can apply this provision on a lease-by-lease basis.

**Question 8: Paragraphs 58–67 and 98–109 (ASC Paragraphs 842-10-50-1, 842-20-50-1 through 50-10, and 842-30-50-1 through 50-13) set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised 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?**

We generally support the level of disclosure proposed by the ED. Such disclosure would provide financial statement users with relevant information about a lessee's and lessor's rights and obligations arising from their leasing activities.

However, as noted earlier, we recommend that, in lieu of incorporating variable lease payments into the measurement of the ROU asset and lease liability, the boards require entities to provide disclosures that allow users to understand a lessee's exposure to such variable lease payments. The boards should also consider the feedback they receive during their outreach to confirm that financial statement users have the same view.

**Question 9 (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:**

- 1. 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.**
- 2. 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?**

We would not object to allowing a nonpublic entity to use a risk-free discount rate in measuring its lease liability and ROU asset provided that the entity discloses the risk-free rate used. However, the FASB should consider whether a difference in the measurement for nonpublic entities is warranted on the basis of the costs that public entities would also incur to determine their incremental borrowing rate. In addition, when using the risk-free rate, an entity will record an otherwise larger ROU asset and lease liability. Nonpublic entities that make this election thus may record an impairment of the ROU asset more frequently.

Similarly, we would not object to exempting nonpublic companies from having to disclose the beginning and closing lease liability reconciliation requirement. This, too, would reduce some of the costs and complexity of implementing the new lease guidance. We do, however, encourage the FASB to consider the feedback received during its outreach to confirm that financial statement users have the same views.



**Question 10 (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?**

We do not agree with the proposed recognition and measurement requirements for related-party leases. Rather, we believe that it is appropriate for leases between related parties to be evaluated on the basis of their economic substance, in a manner consistent with the current requirements under U.S. GAAP.

Paragraph BC293 of the ED discusses some of the difficulties associated with considering the economic substance of the arrangement and states, in part:

[A]ccounting for leases with related parties based on the economic substance of the arrangement, may be difficult when there are no legally enforceable terms and conditions of the arrangement. Examples of difficulties include related party leases that are month to month and related party leases that have payment amounts dependent upon cash availability. In these situations, it is difficult and costly for preparers to apply the recognition and measurement requirements. Even when applied, the resulting information often is not useful to users of financial statements.

We agree that focusing on the economic substance of the arrangement may result in additional complexity from the preparer standpoint, especially when the two parties are under common control and lease provisions are subject to change. However, the FASB's approach allows an entity to structure its lease arrangements in a manner that would result in the off-balance-sheet treatment of leases. The proposal would further provide off-balance-sheet structuring opportunities for nonpublic entities that elect to apply the Private Company Council's proposed exemption from the VIE guidance. We believe that the benefits of accounting for related-party leases on the basis of their economic substance far outweigh the added complexity for preparers and will reduce structuring opportunities.

#### **IASB Considerations: Related-Party Leases**

We recommend that the IASB also address related-party leases in its final leases guidance. The potential concerns, issues, and challenges associated with the recognition and measurement of related-party leases are not unique to U.S. GAAP. Users of financial statements prepared in accordance with IFRSs have many of the same informational needs. Accordingly, the FASB and IASB should work together to develop appropriate guidance on related-party leases.

**Question 11 (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?**

We agree that it would not be necessary to provide additional disclosures beyond those required by ASC 850<sup>11</sup> for related-party leases. The disclosures detailed in ASC 850 are sufficient and will provide users with the information necessary to understand the impact of related-party lease arrangements. However, as indicated in our response to Question 10, we are concerned that the proposed recognition and measurement provisions for related parties may result in structuring opportunities.

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<sup>11</sup> FASB Accounting Standards Codification Topic 850, *Related Party Disclosures*.



**Question 12 (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?**

The IASB's decision to allow a lessee to measure its ROU asset at fair value in accordance with IAS 40<sup>12</sup> is based on the premise that a lessee is currently permitted to use the fair value model in IAS 40 to account for property held under an operating lease if that property meets the definition of investment property. As indicated in the IAS 40 Basis for Conclusions, the modification to include assets held under an operating lease within the scope of IAS 40 is a result of the previous guidance in paragraph 14 of IAS 17 requiring a lease of land with an indefinite economic life to be classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term. (The guidance in paragraph 14 of IAS 17 was subsequently superseded.)

Without this scope modification in IAS 40, the requirements in paragraph 14 of IAS 17 would prevent interests in leased assets held under operating leases from qualifying as investment properties. However, in some countries, interests in property are commonly held under long-term operating leases (e.g., a 999-year land lease). Because the substance of many of these arrangements is similar to buying the property outright, the IASB decided to include a scope modification stipulating that these interests could qualify as investment property.

In a manner consistent with the IASB's original decision in IAS 40 to allow assets acquired under operating leases to be measured at fair value, we agree that the proposed ROU asset could qualify as an investment property.

### **Other Considerations**

#### **Separation of Lease and Nonlease Components**

Currently, both IAS 17 and ASC 840 exclude executory costs, such as insurance, maintenance, and taxes to be paid by the lessor, from the definition of minimum lease payments. However, it is unclear whether these pass-through costs would meet the requirement to be treated as a separate component in an arrangement when evaluated under the guidance proposed in paragraph 20 of the IASB's ED (ASC 842-10-15-17 of the FASB proposal). This could result in the capitalisation of these future costs as part of the ROU asset, which would be a different result than if the asset were purchased. It is unclear why the accounting for such payments for leased property should differ from that for owned property. We believe that the boards should do either of the following to address this issue:

- State that executory costs, such as insurance, maintenance, and taxes, should be excluded from the lease component regardless of whether such costs meet the requirement to be treated as a separate component of a contract.
- Provide implementation guidance to illustrate how the "distinct service component" concept applies to maintenance, insurance, and taxes in a gross real estate lease (i.e., leases that include reimbursement in the monthly rental payment for maintenance, insurance, and taxes even though those costs may not be separately identified). These provisions are common in

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<sup>12</sup> IAS 40, *Investment Property*.

real estate leases, and we are aware of significant confusion in practice regarding how this concept would be applied to typical real estate leases.

### **Accounting for Embedded Derivatives**

In certain instances, a lease agreement may include an embedded derivative. We believe that the final standard should include guidance stating that when a derivative embedded in a lease is accounted for separately from the host and accounted for as a derivative under IFRS 9<sup>13</sup>/IAS 39<sup>14</sup> or ASC 815,<sup>15</sup> the classification and measurement requirements in the leasing proposal would be applied to the host contract after the derivative is separated out.

### **Cotenancy Clauses**

The boards' discussions of contingent rent have primarily focused on contingent rents as a percentage of sales. However, cotenancy clauses are common in retail leases in which rental payments may fluctuate because another tenant vacates the building or does not sign a lease. In addition, in the telecommunications industry, certain leases of cell tower assets include contingent rentals based on how many tenants the lessor can attract to the cell tower. We recommend that the boards include a discussion of these arrangements in their deliberations to understand the breadth and complexities of contingent rental arrangements and the estimates that would be required under the ED.

### **Lease Modifications**

The ED notes that a change in the contractual terms of a lease that is considered substantive would be accounted for as a new lease; the previous ROU asset and lease obligation would be replaced with a new asset and obligation related to the new lease. For both Type A and Type B leases, the lease obligation on the previous lease will generally be greater than the carrying amount of the ROU asset. Accordingly, when an entity derecognises the ROU asset and related lease obligation as a result of a lease modification, a gain would be recognised. To eliminate any potential abuse of recognising a gain on a lease modification, the boards should consider whether it is appropriate to recognise this gain, particularly when the parties negotiating the lease amendments typically consider the terms of the current lease as part of the negotiations.

### **Consequential Amendments to Regulatory Accounting (FASB-Only)**

The FASB's proposal includes consequential amendments to other ASC topics and subtopics that may have resulted in certain unintended consequences. Specifically, the elimination of ASC 980-840<sup>16</sup> could have a pervasive effect on regulated entities (e.g., public utilities) that currently rely on this guidance for lease accounting. Under regulatory accounting, entities are permitted to defer certain allowable costs and recognise those costs at a rate approved by the regulatory authority. While other accounting guidance under ASC 980 may still apply to leases (e.g., ASC 980-340<sup>17</sup>) it could be implied that the removal of ASC 980-840 was intended to prohibit the regulatory accounting treatment for leases. The ED, as drafted, is

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<sup>13</sup> IFRS 9, *Financial Instruments*.

<sup>14</sup> IAS 39, *Financial Instruments: Recognition and Measurement*.

<sup>15</sup> FASB Accounting Standards Codification Topic 815, *Derivatives and Hedging*.

<sup>16</sup> FASB Accounting Standards Codification Topic 980-840, *Regulated Operations: Leases*.

<sup>17</sup> FASB Accounting Standards Codification Topic 980-340, *Regulated Operations: Other Assets and Deferred Costs*.

unclear on whether the removal of ASC 980-840 would eliminate the regulatory accounting overlay provided by ASC 980. If it was not the FASB's intent to preclude regulatory accounting treatment for leases, we recommend that the FASB retain the requirements in ASC 980-840 to avoid possible confusion on this point.