Deloitte.

Deloitte Touche Tohmatsu Limited
2 New Street Square
London EC4A 3BZ
United Kingdom

Tel: +44 (0) 20 7936 3000
Fax: +44 (0) 20 7583 1198
www.deloitte.com

Direct: +44 20 7007 0884
Direct Fax: +44 20 7007 0158
vepoole@deloitte.co.uk

15 December 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Dear Board Members,

Re: Exposure Draft ED/2010/09 Leases

Deloitte & Touche Tohmatsu Limited ("DTTL") is pleased to respond to the Exposure Draft: Leases (the "Exposure Draft" or the "ED").

We support the efforts of the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (collectively the Boards) to improve the Standards on the accounting for leases. We agree with the proposed right-of-use model when it is applied to very simple lease arrangements that include a fixed term with fixed payments as we believe this will increase transparency of the economic effects of leasing arrangements to users of the financial statements. However, we have significant concerns over the application of the right-of-use model when the arrangement includes other terms such as options and contingencies. We believe that significant changes and improvements must be made to the ED before it becomes a final Standard. If not, achieving the objectives of providing information that is relevant and gives a faithful representation of lease arrangements may be challenged. In addition, there could be significant implementation issues (which are likely to require further standard setting), significant diversity in accounting for lease arrangements, and considerable increases in the costs of accounting for lease arrangements without a proportionate increase in benefits.

In summary, our most significant concerns about the ED relate to the following items:

- Determining whether an arrangement is or contains a lease
- Renewal options
- Contingent rentals
- Lessor accounting model

We have fundamental concerns about the proposed guidance for determining which arrangements will be within the scope of the leasing Standard. Although the proposed guidance is mostly consistent with the guidance currently contained in EITF 01-8 and IFRIC 4, the determination that an arrangement contains a

lease will now result in a drastically different accounting treatment within the context of the overall proposals in the ED.

Therefore, we believe that the ED's guidance for determining whether an arrangement contains a lease and distinguishing between leases and service arrangements must be strengthened. Otherwise any final Standard will result in significant implementation issues and will require the Boards to revisit lease accounting in the near future. We believe that the definition of a lease should be strengthened by:

- emphasising the concept of exclusivity in the right-of-use of an asset;
- highlighting that leases do not generally allow for an unrestricted right of substitution of the underlying asset by the lessor; and
- providing more guidance around what is a specified asset.

We also believe that the Boards should clarify the guidance about arrangements containing a service component where the service component is not distinct but represents a significant portion of the overall value of the arrangement. We do not believe that these contracts should necessarily be accounted for as a lease. However, we are concerned that such arrangements may fall within the scope of any final Standard based on the ED as currently drafted.

As noted above, we support a single lessee accounting model that results in the recognition of a right-of-use asset and a liability to make lease payments for very simple lease arrangements that include a fixed term with fixed payments. However, we do not agree with the proposed guidance for (1) the accounting for options to renew and (2) the treatment of contingent lease payments.

We believe that renewal options should be included in the measurement of the right-of-use asset only if they are virtually certain of being exercised. Otherwise, they should be measured and accounted for separately. We propose an alternative measurement approach in the Appendix to this letter that would measure renewal options at their intrinsic value at inception.

We disagree with the proposed model for recognising contingent rentals where payments are contingent on usage or performance. We believe that contingencies based on usage are akin to renewal options and should be treated similarly. For payments based on performance, the proposed model developed by the Boards is not consistent with the accounting for variable payments in several other areas of accounting literature including business combinations, franchise accounting and the Boards' current proposals on revenue recognition. 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. If the Boards do not have the capacity to add this project at this time, we believe that the accounting for contingent rentals should remain unchanged from current accounting (i.e., the guidance in ASC 840 and IAS 17).

We are concerned about the proposed accounting model for lessors. We believe that the guidance in the ED for lessors is essentially at the "Discussion Paper" stage and needs further development and refinement. Consistent with our preference for a single accounting model for lessees, we believe a single model would also be preferable for lessors. The Boards 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. In addition, the Boards have not clearly articulated how the two approaches proposed in the ED reconcile with the Boards' Conceptual Frameworks and the proposed right-of-use model for lessees.

Our detailed responses to the ED questions are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 207 007 0884.

Sincerely,

Veronica Poole
Global Managing Director
IFRS Technical

Appendix 1

The accounting model

The exposure draft proposes a new accounting model for leases in which:

(a) a lessee would recognise an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortise the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.

(b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease, depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23–BC27).

Question 1: Lessees

(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?

(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?

We agree that a single model with a broad principle that results in the recognition by a lessee of a right-of-use asset and a liability to make lease payments will increase transparency of the economic effects of leasing arrangements to users of the financial statements. We agree with the statement in paragraph BC7(b) that "a simple lease is not an executory contract after the date of commencement of the lease". We believe that this represents an important distinction between lease contracts and executory contracts and firm commitments. However, we recommend that the Boards articulate more clearly why a lease is an executed contract and that delivery of the right-of-use asset occurs on the date of commencement of the lease.

Although we agree with the right-of-use accounting model for lessees, we have significant concerns regarding the guidance in the ED for identifying whether an arrangement contains a lease, distinguishing between service and lease arrangements and measuring the right-of-use asset and the liability to make lease payments (including the treatment of renewal options and contingent rents). These concerns are discussed in our responses to Questions 3, 4, 6, 8 and 9 below.

We agree that if the lessee has recognised a right-of-use asset and an obligation to make lease payments then the lessee should recognise amortisation expense of the right-of-use asset and interest expense on the liability to make lease payments.

Question 2: Lessors

(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?

(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?

(c) Do you agree that there should be no separate approach for lessors with leveraged leases, as is currently provided for under US GAAP (paragraph BC15)? If not, why not? What approach should be applied to those leases and why?

We would prefer a single lessor accounting model and recommend that the Boards devote additional time to develop such an approach. We acknowledge the difficulty in developing a single lessor accounting model that can be applied to all leasing transactions. However, we believe that the benefit of producing a single, conceptually sound lessor accounting model that can be applied to a wide range of leasing transactions is worth the effort.

The lessor accounting model in the ED has two different accounting approaches for lessors: the performance obligation approach and the derecognition approach. The Boards 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. In addition, the Boards have not clearly articulated how these two approaches reconcile with the Boards' Conceptual Frameworks and the proposed right-of-use model for lessees.

The guidance in the exposure draft for the lessor is essentially at the "Discussion Paper" stage and needs further development and refinement. This may be the result of the fact that the Boards have spent far more time discussing the lessee accounting model. The lessor accounting model in the ED is likely to increase complexity compared to the current lessor accounting model. For example, the application guidance in paragraphs B22–B27 is not clear or robust enough to expect that consistent conclusions will be reached regarding which model to apply. As an additional example, under the derecognition approach, the ED does not indicate what the nature of the residual asset is on the lessor's books. Specifically, it is not clear whether the asset represents the lessor's interest in the underlying asset (that is, its remaining interest in the underlying property, plant and equipment) or the lessor's portion of the right-of-use asset (the other portion of which is recognised on the lessee's books).

We are also concerned that the Boards have not clearly articulated how the proposed approaches to lessor accounting reconcile with the Boards' Conceptual Frameworks and the proposed right-of-use model for lessees. The derecognition approach appears more consistent with the underlying principle in the right-of-use approach for lessees when the asset is one that cannot be physically divided, such as equipment. That is, upon commencement of the lease, the lessor has transferred control of an asset (being the exclusive right to the benefits of use of the asset for a designated period of time or specified level of usage) to the lessee. Conversely, the performance obligation approach implies that the lessor's transfer of control of an asset (being the right to the benefits of use of the asset for a designated period of time or specified level of usage) is satisfied continuously during the lease term. Further, the criterion proposed to distinguish between the two approaches is based on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. It is unclear, under the Boards' Conceptual Frameworks, why the retention of significant risks or benefits should govern if and when an asset is transferred and a performance obligation is satisfied. We recognise that the derecognition approach may not provide a meaningful basis of financial reporting when an asset can be physically divided among various lessors (e.g. different floors in a building) or in short-term leases that do not meet the scope exemption. Thus, we believe that further discussion of these issues is necessary by the Boards in order to ensure that the lessor accounting model is conceptually sound.

Lastly, we believe that the lessee and lessor models should be developed together in one comprehensive leasing Standard. That is, we do not believe that the Boards should split the project into a lessee phase and a lessor phase. If a decision is made to proceed only with lessee accounting at this time, the Boards will need to dedicate significant time to deal with the ramifications of such an approach (e.g. how to address sub-leasing).

We agree that there should be no separate approach for lessors with leveraged leases. However, the Boards should consider further outreach to determine whether additional transition guidance is warranted for leases previously accounted for as leveraged leases (e.g. which of the lessor approaches leveraged leases would fall under).

Question 3: Short-term leases

This exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less.

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor

derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).

(See also paragraphs BC41–BC46.)

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?

We understand the Boards' desire to provide a practical exemption to the lease guidance for certain arrangements. However, we do not believe there is a conceptual basis for the exception provided based on the potential length of the lease term. This exception creates exactly the type of "bright-line" that the Boards are trying to eliminate with this project and could result in significant negative consequences such as creating potential structuring opportunities.

We believe that if the Boards can make the appropriate distinction between a service and a lease arrangement then many of the contracts that are most troubling to constituents could be scoped out of the leasing guidance and accounted for as service contracts. See our discussion on distinguishing between service and lease arrangements in our comments to Questions 4 and 6. Lease arrangements that are determined to be within the scope of this guidance and are truly short-term lease arrangements (e.g. month-to-month arrangements) could be dealt with on a materiality basis.

If the Boards are unable to improve the scope of arrangements that are within the lease guidance then we would accept, on pragmatic grounds, an exemption for lessees and lessors for short-term leases. However, we do not believe that the simplified accounting proposed for lessees is sufficient. Based on extensive outreach with preparers, we believe that the cost to lessees will far exceed the benefits of recording these short-term leases on their statement of financial position (based on the current scope of the ED). Acknowledging the potential for structuring opportunities, we believe that a lessee that has a short-term lease should instead be permitted to elect not to recognise a right-of-use asset and a liability to make lease payments. Such an election would be consistent with the simplified requirements proposed for lessors.

Definition of a lease

This exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). This exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

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?

(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?

(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?

We agree with the ED's basic principle that a lease is defined as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration. However, we believe the Boards need to clarify further the definition of a lease to enable preparers to differentiate service arrangements from lease arrangements. We believe that the definition of a lease should:

- emphasise the concept of exclusivity in the right to use an asset;
- highlight that leases do not generally represent an unrestricted right of substitution of the asset; and
- provide more guidance around what is a specified asset.

Emphasising these concepts would strengthen the definition of a lease and could help differentiate between service and lease arrangements. Further, the Boards should consider arrangements which can be long term,

where the lease and service elements are not distinct but the service element holds most of the value as the right to use may have trivial value without the service. For example, season tickets to entertainment events may contain both service and lease elements, but the right to use a specified seat should not be the focus of the transaction.

We generally agree with the criteria in paragraphs B9 and B10 to determine a purchase or sale. However, consistent with our recommendation on how to account for renewal options and purchase options in our comments to Questions 7 and 8, we recommend that the threshold applied for exercising a purchase option should be virtually certain rather than the proposed threshold of reasonably certain. This higher threshold would eliminate from the scope of the leasing guidance arrangements that are truly a purchase or sale and would create greater distinction from those leases that a lessor would account for under the derecognition model. In addition, we believe that paragraph B9 should be reconciled with the proposed revenue recognition Standard with respect to the transfer of trivial risks and benefits associated with the underlying asset.

We do not believe that the guidance to distinguish leases from service or purchase contracts is sufficient. This guidance was essentially carried forward from EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease", (FASB Accounting Standards Codification Subtopic 840-10, *Leases: Overall*) and IFRIC 4, *Determining Whether an Arrangement Contains a Lease*. There have been numerous practice issues (as noted below) that have developed in the application of EITF 01-8 and IFRIC 4 since their original issue. Those practice issues are not as critical under the current lease accounting model because the difference between operating lease accounting and executory contract accounting is often not significant. However, the difference between the right-of-use model and executory contract accounting will be far more significant under the proposed guidance and, therefore, it is critical that the Boards resolve these practice issues prior to finalising the guidance in the ED.

The following concepts in paragraphs B1–B4 should be clarified further as significant diversity exists in practice in how these concepts are applied under EITF 01-8 and IFRIC 4:

- Clarification of the term "output" — For example, in certain power purchase agreements "outputs" may include physical outputs (such as electricity) as well as intangible outputs (such as renewable energy credits, capacity credits and production tax credits). Different interpretations exist in practice as to whether "outputs" should be limited to physical outputs only, or whether certain intangible outputs must also be included in this evaluation.

- Clarification of the phrase "contractually fixed per unit" — For example, certain arrangements may contain a fixed escalator clause in which the price per unit of output increases by a fixed percentage each year of the arrangement (e.g. price per unit of CU5, CU7 and CU9 in years 1, 2 and 3 respectively). Other arrangements contain different fixed rates per unit of output depending on when the output is produced (e.g. different pricing for peak and off-peak usage periods). Different interpretations exist in practice as to whether these arrangements represent pricing that is considered "contractually fixed per unit."

- Clarification on whether a pro rata portion of the output of an asset can be the subject of a lease — When the Task Force was debating EITF 01-8, they could not agree and therefore agreed to be silent on this issue. Consequently, there is still diversity and debate around this concept. The following examples from the energy and resources industries illustrate a few of the types of arrangements that should be considered:

    - A contract to book 25 per cent of the capacity in a pipeline for one year or for the life of the pipeline

    - A contract to purchase 50 per cent of the output of a power plant for five years

    - A contract to purchase 500mwh of power from a specific power plant

    - A contract to provide gas storage capacity in a specific facility

We expect that other industries will struggle with this concept once the importance of applying this guidance is heightened by the lease guidance.

- Clarification on "specified asset" — In many arrangements, particularly those that are not based on the productive output of the underlying asset, there are different interpretations as to whether an asset is specified in the arrangement (e.g. usage of data warehousing centres, satellite service providers, use of fibre optic strands in a cable and certain retail licensing arrangements which allow one retailer to operate within the selling space of another retailer). Certain rights of the "lessor" under these arrangements have resulted in mixed application of the EITF 01-8 and IFRIC 4 guidance related to specified assets (for example, the right of a "lessor" to move the "lessee" to another space within a retail store, or the right of the owner of a data warehouse centre to move "lessees" to different physical space within the warehouse). Additional application guidance for fact patterns other than production-based sales arrangements may be helpful in clarifying this guidance.

  In addition, paragraph B2 notes that "[a]n asset is implicitly 'specified' if . . . a lessor can substitute another asset for the underlying asset **but rarely does so in practice**" (emphasis added). The highlighted phrase is an addition to the guidance in EITF 01-8 and IFRIC 4, but it is not discussed in the basis for conclusions. As the Boards left most of the remainder of the EITF 01-8 and IFRIC 4 guidance unchanged, the reason for this addition should be discussed further. Is this meant to scope in additional arrangements that the Boards believe should be in the scope? We think that the addition of this provision further confuses the distinction between lease and service arrangements. An asset that is fungible and could be substituted with no change in service could be indicative of a service being provided rather than a lease of an asset. As noted above, we believe that the right of substitution is a critical element to distinguish between a service and lease arrangement. For example, an entity receiving copying services wants a certain level of quality and reliability. The actual equipment producing the copy may be irrelevant to the entity and they would accept the substitution of the equipment as long as the quality and reliability met their required standard and there was no break in service. We therefore strongly recommend that the Boards clarify in the proposed guidance that the right to substitution of the asset is an indicator of an arrangement not being a lease.

We also recommend that the Boards consider the wide array of arrangements that could be impacted by the guidance in the ED. For example, it is common that certain professional sports franchises that own or lease stadiums also sell season ticket licences to customers. Do the Boards believe that such season ticket licences represent the lease of space within the stadium — or is there a point (other than a materiality threshold) at which the lease component of an arrangement is so insignificant as compared to the rest of the arrangement that the costs of identifying a lease for accounting purposes outweigh the benefits? The Boards should deliberate such arrangements further to clarify the intended application of the proposals in the ED.

Question 5: Scope exclusions

This exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

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?

We generally agree with the scope proposed in the ED. However we do not believe that the Boards have given enough consideration as to whether certain intangible assets should be within the scope of this guidance. Certain licensing arrangements are currently within the scope of IAS 17, Leases, and we believe that the Boards should give more consideration as to whether these arrangements and others should be within the scope of the proposed guidance.

In our comment letter responding to exposure draft ED/2010/6, *Revenue from Contracts with Customers* (ED/2010/6), we stated that we do not agree with the pattern of revenue recognition proposed for licensing of intellectual property. We recommended that if the Boards believe it is necessary to recognise income over time where an exclusive licence is granted for only part of the life of intellectual property, this would be better

achieved by scoping such arrangements out of the proposed revenue Standard and into the proposed leasing Standard.

We also note that the proposed scope includes what some believe is an important change from the existing scope of current US GAAP. The transition guidance in paragraph 16 of EITF 01-8 allowed for certain arrangements to be grandfathered and not evaluated under the EITF 01-8 framework unless they were subsequently modified. The transition and scope provisions of the ED appear to eliminate these grandfathering provisions. If this was the Boards' intention, we recommend that this decision is explicitly stated in the Basis for Conclusions of the final IFRS.

In addition, since the definition of "underlying asset" is not restricted or specified, the Boards should consider clarifying that leases of certain types of assets such as financial instruments and gold are to be scoped out from the final Standard to avoid unintended consequences.

Also, we believe that the scope section should state that in the case of derivatives that are embedded in leases which are separated from the host and accounted for as derivatives under IFRS 9 (or IAS 39), the requirements of the leasing IFRS shall be applied to the host contract after separating out these derivatives.

Question 6: Contracts that contain service components and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) the IASB proposes that:

- *(i) a lessee should apply the lease accounting requirements to the combined contract.*
- *(ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.*
- *(iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.*

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?

We agree that guidance for revenue recognition should be applied to a distinct service component of a contract that contains service and lease components. This will ensure that the service elements of leases are accounted for consistently with the appropriate revenue recognition guidance, and the lease elements are accounted for under the final lease guidance. If the service component is not distinct and not significant, except for executory costs discussed below, we believe that the lease accounting requirements should be applied to the combined contract by both lessees and lessors. However, we do not believe that an arrangement in which the service component is not distinct but represents a significant portion of the value of the contract should necessarily be accounted for as a lease. Our example in Question 4 illustrates this potential situation. A professional sports franchise that owns or leases a stadium also sells season ticket licences to customers. The service/entertainment portion of the arrangement would clearly be the most significant aspect of this arrangement. If the lessee or lessor is unable to allocate the payments because the elements are not distinct then, under the proposals in the ED, they would be required to account for the entire arrangement as a lease, which does not seem appropriate. This reiterates our position regarding the need for the Boards to distinguish appropriately between service and lease arrangements as stated in Questions 3 and 4.

In our comment letter responding to ED/2010/6, we generally agreed with the concept of identifying distinct goods or services in order to account for the revenue related to the transfer of those goods or services. However, we disagreed with some of the aspects of the proposed guidance. Please see our comments therein.

Specifically relating to lease accounting, we observe that the concepts are difficult to apply to executory costs[1] that are commonly included in many real estate leases, or they produce anomalous results. For example, it does not appear that the pass through of property taxes to a lessee would meet the definition of a distinct service nor is it a service provided by the lessor. This conclusion results in the capitalisation of future property taxes, which is a different result than if the asset were purchased. It is unclear why the accounting for property tax payments should differ for leased property and owned property.

To address this issue we believe the Boards should either:

- state that executory costs such as insurance, maintenance and taxes should be excluded from the lease component regardless of whether the executory costs meet the definition of being a distinct component of the contract, or
- provide implementation guidance to illustrate how the "distinct service component" concept applies to maintenance, insurance and taxes in a gross real estate lease (that is, 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 real estate leases and we are aware of significant confusion in practice as to how this concept would be applied to typical common area maintenance charges in a real estate lease.

We also recommend that the Boards clarify how initial direct costs should be treated in arrangements that contain a lease component and a non-lease component. Do the initial direct costs need to be allocated between the two components? If so, we observe that initial direct costs accounted for under ED/2010/6 will be treated differently than those accounted for under ED/2010/09. If the Boards intend for these costs to be treated differently depending on which guidance they are allocated under, the Boards should clearly state the reasoning and conceptual basis for that decision.

Question 7: Purchase options

This exposure draft proposes that a lease contract should be considered terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

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?

We believe that a purchase option that is virtually certain of being exercised should result in the transaction being treated as a purchase or sale (see Question 4 above) outside the scope of the lease Standard. Purchase options that are below this 'virtually certain' threshold should be recognised and measured at their intrinsic value as of the lease inception date. The intrinsic value would be defined as the difference between the current market price for a similar asset and the lease purchase option price (such that typically no amount would be recognised for a market price purchase option). An example of this concept would be a three-year lease of a car with an option to purchase the vehicle at the end of the three years for CU 20,000. At lease inception, the lessee would compare the option price of CU 20,000 to the estimated market price of a similar three-year-old vehicle as of the date of lease inception. If the current market price is more than the option price, then the purchase option has intrinsic value and this amount would be recognised separately from the right-of-use asset. Similar to other intangible assets, the asset recognised in relation to the purchase option would not be remeasured, but would be subject to impairment.

We also propose that a lessor performs a similar analysis to account for purchase options. However, consistent with our response to Question 2, we believe the Boards need additional time to consider the lessor accounting model fully.

[1] "Executory costs" are currently defined under FASB Statement No. 13, *Accounting for Leases*, as insurance, maintenance and taxes. IAS 17 also excludes costs for services and taxes to be paid by and reimbursed to the lessor from minimum lease payments.

Measurement

This exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

(a) *assumes 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 (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).*

(b) *includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.*

(c) *is updated 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 (paragraphs 17, 39, 56 and BC132–BC135).*

Question 8: Lease term

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?

We do not 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 because the lessee does not have an unconditional obligation to pay rentals in optional renewal periods until the lessee has actually exercised the renewal option. Similarly, a lessor does not have an unconditional right to receive lease payments in optional renewal periods until the lessee has exercised the option. We believe that options to extend or terminate a lease meet the definition of an asset, separate from the right-of-use or leased asset, for the option holder and a liability, separate from the performance obligation, for the option issuer. The Boards reached the same conclusion in the Leases Discussion Paper. However, the Boards decided not to require separate recognition of these options, largely due to concerns that measuring the fair value of options would be difficult.

In our comment letter on the Leases Discussion Paper we agreed with the Boards' concerns about the cost and complexity of a components approach that required the measurement of options at fair value and we supported an approach that is similar to that now included in the ED. However, we also expressed concerns regarding (1) whether renewal options meet the definition of a liability since the obligating event does not occur until the lessee exercises the renewal option and (2) the cost benefit analysis of reassessing the lease term in each reporting period. We have developed our thinking on this issue further and, in our view, the approach for renewal options proposed in the ED, including the requirement to reassess the likelihood of renewal at the end of each reporting period, would result in similar costs and complexity as a components approach — particularly for lessees with a large lease portfolio. As such, we recommend an alternative approach as follows, which we believe is aligned with the conceptual definition of assets and liabilities in the Frameworks, but also addresses the concerns regarding the complexity of a fair value measurement for options.

For lessees, our recommended alternative approach for determining the lease term and accounting for renewal options is as follows.

- Any renewal options that are virtually certain of exercise at lease inception would be included in the lease term and measured as part of the right-of-use asset and liability to pay rentals. The "virtually certain" criterion is consistent with the recognition criterion for contingent assets in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and would reduce structuring opportunities around lease terms designed to minimise the recognised asset and liability. The factors that would be used to evaluate whether a renewal option is virtually certain of exercise would be the same as those currently used to evaluate renewals under Statement 13 and IAS 17 (generally, whether a significant penalty for non-renewal exists, such as the loss of leasehold improvements).

- Renewal options that are not considered virtually certain of exercise at lease inception would be separated from the right of use asset and recognised separately, measured at their intrinsic value. Intrinsic value would be defined as the difference between current market lease rates for a similar asset compared to 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 based on the current market

lease rate for a similar three-year-old vehicle compared to the lease renewal rate in the lease agreement. If the current market lease rates are higher than the renewal rates (i.e. favourable), then an asset would be recognised for the positive intrinsic value, separately from the right-of-use asset. If the rates are not favourable, then the option would be measured at zero. This treatment would reflect the fact that the lessee is paying for the time value associated with the renewal option as part of the lease payments during the base lease term.

- Similar to other intangible assets, the asset recognised in relation to the renewal option would not be subsequently re-measured, but it would be subject to impairment.

- Consistent with a historical cost measurement of the right-of-use asset, the likelihood of a lessee exercising renewal options would not be reassessed at the end of each reporting period. Rather, 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 options would be included as part of the new right-of-use asset.

We acknowledge that recognised options are not usually measured at intrinsic value and fair value is a more common measurement attribute. However, we believe 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. By including the time value of the option within the right-of-use 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.

We also propose that a lessor performs a similar analysis for determining the lease term and accounting for renewal options as liabilities. However, consistent with our response to Question 2, we believe the Boards need additional time to consider the lessor accounting model fully.

Question 9: Lease payments

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?

In paragraph BC121, the ED discusses three types of distinct variables upon which contingent rentals may be based: (1) index based (e.g., interest, CPI) (2) usage based (e.g., a car lease that requires additional payment if a specified mileage is exceeded) and (3) performance based (e.g., lease payments based on percentage of the lessee’s sales arising from the underlying property).

The ED does not make a distinction between the various categories of variability and attempts to account for all contingent rentals in the same way. However, we believe that the different types of contingencies have very distinct attributes that deserve separate consideration and result in different accounting treatments. Our proposed treatment for each type of variable is set out below.

First Category: Contingencies Based on an Index

We agree that contingencies based on an index, such as interest or CPI, should be included in the measurement of the lessee’s obligation. The index adjustment is simply a part of the ongoing measurement of that liability.

Lease payments are generally indexed to broad categories of index: interest, inflation, and foreign currency. Ignoring indices that would be considered not to be closely related to the lease obligation (and thus embedded derivatives required to be bifurcated), there are inconsistencies in the treatment of the three categories of indices in terms of whether readily available forward rates are used (e.g., IAS 21 requires use of spot rates in

measuring foreign currency denominated amounts) and whether changes in the lease obligation due to a change in the referenced index are recognised in income or adjust the right-of-use asset (only changes in an inflation index related to future periods may adjust the right-of-use asset). The Boards should address these inconsistencies.

Further, paragraph 19 limits changing the discount rate only to scenarios where payments are contingent on an interest rate index. However, IFRSs have not precluded certain inflation indices embedded in debt to be viewed akin to an interest index. The Boards should address any potential inconsistencies before issuing a final Standard.

Paragraph 14(a) requires that, if contingent rentals depend on an index or a rate, the lessee shall determine the expected lease payments using readily available forward rates or indices. Paragraph 14(a) also states that, if forward rates or indices are not readily available, the lessee shall use the prevailing rates or indices. We agree that if forward rates are used that only those that are readily available should be incorporated in these measurements as it would be very difficult to estimate the index or rate that will exist in the future. However, we believe the Boards should amend the statement made in Paragraph BC 131 of the ED as follows: "Therefore, this exposure draft proposes that if lease payments are contingent on changes in an index or rate, such as the consumer price index or the prime (basic) interest rate, the entity should measure the present value of lease payments using readily available forward rates or indices, <u>unless they are not readily available in which case the prevailing rates or indices should be used</u>". [Additions underlined.] The current wording in the ED seems to state as fact that a forward rate or index is readily available for the consumer price index. Our experience shows that although there are predictions of the future consumer price index, there is not a readily available forward rate or index. As consumer price index escalation provisions are common in many leases we believe the Boards should clarify this statement and perform further outreach on whether such a forward rate or index exists and is readily available.

Second Category: Contingencies Based on Usage

We disagree with the proposal to recognise usage based contingent rentals in the base lease obligation. 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 right-of-use asset, rather than paying an additional amount for the same right-of-use asset. The additional right-of-use 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. Consistent with our response to Question 8 on renewal options, we believe that contingencies based on usage (i.e., in substance renewal options) should not be recognised until exercised unless they are virtually certain of exercise at inception of the lease.

Third Category: Contingencies Based on Performance

We disagree with the proposed model for recognising performance based contingent rentals (e.g. rents based on percentage of sales). The model developed by the Boards is not consistent with the accounting for similar variable payments in several other areas of accounting literature including business combinations, franchise accounting and the Boards' current proposals on revenue recognition. We therefore believe that the Boards should address contingent payments broadly as a separate project and then apply the conclusions reach in that project to lease accounting. If the Boards do not have the capacity to add this project at this time, we would recommend that the accounting for performance based contingent rentals remains unchanged from current accounting (i.e., the guidance in ASC 840 and IAS 17) and is amended only once the Boards have addressed contingent payments broadly.

Should the Boards choose to continue with the accounting for performance based contingent rentals as proposed in the ED, we have the following comments regarding the proposed model:

- We do not agree with using an expected outcome technique using a probability-weighted average of different outcomes for the following reasons:

- The requirement to perform probability weightings involving multiple outcomes will be onerous and costly for lessees and lessors with a large lease portfolio, and it is not clear that this approach provides more useful information than other, less costly, approaches.

- The probability weighting proposed in the ED suggests a level of precision in the estimate that, in many cases, does not exist. In many cases, this probability-weighted approach would result in an amount whose reliability is questionable and therefore raises serious doubt as to whether it provides a faithful representation. For example, consider a lessee that entered into a 20 year lease in 1999 that included rentals based on a percentage of the lessee's sales. It is difficult to imagine that a lessee could possibly predict the recent economic downturn and its extent when projecting its sales amounts. In addition, we understand that many lessees do not perform such a long-term projection of sales, even when they enter in an arrangement that would require rental payments based on sales for a long period. The Boards have not presented a compelling argument as to why requiring such an exercise purely for accounting purposes is justified.

• A best estimate approach would be preferable, i.e., the measurement of contingent rentals based on the lessee's best estimate of the total contingent rental payments over the lease term. We also believe that guidance should be developed for estimating the future lease payments similar to that for estimating future cash flows in determining value-in-use under IAS 36. This would significantly alleviate concerns about the reliability of the estimate and it would reduce the cost and effort to preparers by using information that they might have prepared already for impairment testing purposes. We recommend that the guidance for estimating the contingent rental payments should incorporate the following criteria in paragraph 33 of IAS 36, adapted to leases:

  (a) Base projections on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence.

  (b) Base projections on the most recent financial budgets/forecasts approved by management, but it shall exclude any estimated future projections expected to arise from future restructurings or from improving or enhancing the asset's performance. Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified.

  (c) Estimate projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.

The source of variability in payments in a lease contract may be due to an embedded derivative. We agree with retaining the current guidance that requires embedded derivatives that are not closely related to the lease contract to be bifurcated and accounted for separately. If the embedded derivative is closely related to the lease contract and thus not bifurcated, then it would be subject to the contingent payments guidance within the proposals in the ED.

For lessors, we propose a similar analysis for contingent rentals. However, consistent with our response to Question 2 we believe that the Boards need additional time to consider the lessor accounting model fully. In addition, Question 9 in the ED indicates that payments under term option penalties are subject to being "reliably measurable". However, paragraphs 35(c) and 52(c) in the ED do not indicate that payments under term option penalties are subject to this reliability threshold. Please see our additional comments on term option penalties below.

Regardless of whether the Boards accept our alternative recommendation for contingent rentals, we have the following observations regarding the guidance in the ED on term option penalties and rentals contingent on an index or rate:

Term Option penalties

It is not clear from the ED, how term option penalties should be treated. Paragraph 14 states that "a lessee shall determine…the present value of lease payments payable during the lease term…on the basis of expected outcome. The expected outcome is the present value of the probability-weighted average of the cash flows for a reasonable number of outcomes….In determining the present value of lease payments payable, a lessee shall include….an estimate of expected payments under term option penalties." This language indicates that in measuring the lease liability a lessee should include a term option penalty in the probability-weighted average of cash flows, i.e., it should include a measure of the likelihood that the term option penalty will be payable (unless the Boards are just referring to term option penalties that are not for a fixed amount, in which case that should be clarified). In contrast, the example in paragraph B19 indicates that a lessee should first determine the lease term, and then recognise a liability that is consistent with that lease term. Assessing whether or not a lease will be terminated is part of assessing the lease term. Thus, consistent with our recommended approach to reflecting renewal options in the lease term, only if a lessee concludes that it is virtually certain the lease will run its full term (thus avoiding the early termination penalty) would the term option penalty be excluded from the lease liability. We recommend that the Boards clarify this point and amend paragraphs 13 and 14 of the ED to state clearly that the example in paragraph B19 illustrates that term option penalties and residual value guarantees would only be included in the measurement of the lease liability if such inclusion is consistent with the lease term.

Question 10: Reassessment

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?

See our comments in Question 8 regarding the reassessment of renewal options where we propose that renewal options should not be reassessed as part of our alternative recommendation. If the Boards do not accept our alternative approach to accounting for renewal options, then we believe the following statement from paragraph BC133 in the Basis for Conclusions should be elevated to the final Standard as it appears critical to understanding the Boards' intent: "[A] detailed examination of every lease is not required unless there has been a change in facts or circumstances that would indicate that there is a significant change in the lease asset or lease liability".

We agree that lessees and lessors should remeasure assets and liabilities arising from 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 contingent payments (including expected payments under residual value guarantees) since the previous reporting period.

We also agree that changes in the liability arising from changes in contingent rentals or residual value guarantees should be recorded in net income to the extent that those changes relate to current or prior periods and as an adjustment to the right-of-use asset to the extent that those changes relate to future periods. However, we believe that further clarification is needed around the phrase "changes relate to current or prior periods" as per our comments below.

"Changes Relate to Current or Prior Periods"

Paragraph 18 states that "[a] lessee shall distinguish changes in contingent rentals and expected payments under term option penalties and residual value guarantees that relate to current or prior periods from those that relate to future periods". Paragraph 18 goes on to state that changes related to current or prior periods are recognised in net income, while changes related to future periods are recorded as an adjustment to the right-of-use asset. We believe that the distinction between changes that "relate to" current or prior periods on the one hand and future periods on the other hand should be clarified — perhaps through an illustrative example.

Consider the following example:

> A contract provides for contingent rent based on sales. Under the contract, once rent is increased by contingent payments, it can never go down below that increased level. Under the ED's proposals, the lessee originally estimates rents as follows: Year 1 – CU100, Year 2 – CU110, Year 3 – CU120, Year 4 – CU130, Year 5 – CU140. The ED appears to require that, if in Year 1 rents increased to CU150 because of an unexpected increase in sales, the difference between CU150 and the CU100 estimate in Year 1 would be recognised in net income in the period. However, the ED could also be interpreted to require the upward increase from the originally estimated rents (from the original estimates to the new minimum of CU150) for all remaining years to be recognised in net income in the current period.

We believe the nuance illustrated in the previous example should be clarified or more clearly illustrated in the final Standard. A similar type of rent adjustment provision often exists in rents with CPI escalators. For example, once the rent is increased over the base year rent as a result of an increase in CPI the increased rent creates a new "floor", such that rent in all future years can never decrease below that level. This is a common fact pattern that would result in a similar accounting question as in the previous example, if contingent rent based on a change in CPI is included in measuring the liability. Accordingly, we believe there is a significant risk of misapplication if this concept is not more clearly illustrated in the final Standard.

Sale and leaseback

This exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents a sale of the underlying asset, the leaseback also would meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

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?

We agree that a transaction should be treated as a sale-and-leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset.

We do not object to the Boards including additional criteria to help distinguish whether continuing involvement in a sale-and-leaseback transaction should preclude sale treatment (i.e. would result in a conclusion that control has not passed). However, we believe the Boards need to deliberate further the criteria in paragraph B31. These criteria include many of the same concepts that exist in current US GAAP to evaluate whether a sale of real estate or integral equipment has occurred. The Boards should be mindful that, as written, the ED would now expand these concepts to all sale-and-leaseback transactions (not just those involving real estate or integral equipment). We believe the Boards should deliberate these criteria further and also consider whether, and how, those deliberations should interact with the revenue recognition project.

Furthermore, we believe many of the criteria that have been carried over from the current sale-and-leaseback guidance were written as anti-abuse guidance; as such, their application could produce results that are not intuitive. For example, it appears that under paragraph B31(j), if the seller/lessee had an option to purchase a 20 per cent interest in the buyer, the transfer would not be considered a sale. It is unclear to us why this should be the result, and we encourage the Boards to evaluate critically each of the criteria before carrying them forward to the final Standard.

Presentation

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

Question 12: Statement of financial position

(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?

(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?

(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?

(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?

We support the Boards' approach of presenting the right-of-use asset separately from owned assets and classifying the asset on the basis of the nature of the leased item. This would provide users with the information they need to differentiate leased assets from owned assets while still reflecting that the asset is used in the same way as a similar owned asset.

Therefore, we agree that when the underlying asset is property, plant or equipment, the right-of-use asset should be presented within property, plant and equipment as the asset. If the Board considers expanding the scope to include intangible assets, we believe the right-of-use asset, where the underlying asset is an intangible, should be presented with other intangible assets.

As noted above, we encourage the Boards to develop a single model for lessor accounting. Should the Boards proceed with the current proposals, we 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. We believe that the information is useful for users of financial statements as it clearly distinguishes lease assets and lease liabilities from other assets and other liabilities. In addition, the linked presentation shows that those items are interdependent and it clearly identifies the total net position from leasing activities of the entity.

We 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 (or with intangible assets if the Boards extend the scope of the leasing guidance to include intangible assets and the underlying asset is an intangible). This is appropriate to demonstrate clearly that there are differences in characteristics and method of measurement between the residual assets and other property, plant and equipment.

We agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position. This is useful for users of financial statements to help them distinguish subleases from head leases and from other assets and other liabilities.

Question 13: Statement of comprehensive income

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?

We agree that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement. We believe that separate presentation provides more useful information to the financial statement users.

Question 14: Statement of cash flows

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?

We agree that cash flows arising from leases should be presented separately from other cash flows either on the face of the statement of cash flows or in the notes to the financial statements.

With respect to lessees, we observe that the requirement to classify cash payments for leases entirely as financing activities is inconsistent with the treatment of interest payments on other financings. We believe interest payments for leases should be treated consistent with interest payments on other financings.

Disclosure

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?

We 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. We believe that such disclosures will enable financial statement users to understand the nature of the entity's leases and the entity's exposures to risks and uncertainties from its leasing activities.

We also recommend that the Boards provide specific disclosure examples, especially for the new disclosure requirements that were not included in IAS 17 or ASC 840 to ensure consistency in practice.

For the reconciliations required in paragraphs 77 and 80, we recommend that the Boards consider fully whether the benefits outweigh the complexity and additional costs associated with presenting such reconciliations.

Transition

Question 16

(a) *This 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?*

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

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

We believe that the full retrospective approach should be permitted (but not required) because it is more representationally faithful and may be easier for some entities, particularly lessors, to apply. In addition, many lessees will desire the option of a retrospective approach as it will avoid "resetting" the front loaded expense impact of the right-of-use model. While we support the simplified retrospective approach as it provides some cost-benefit relief from full retrospective application, we strongly believe that full retrospective application should be provided as an option.

If the full retrospective approach is permitted, we believe the lessee's incremental borrowing rate at the date of inception of the lease should be used, unless it is impracticable to determine, in which case the rate at the date of adoption should be used.

We believe the following issues are not addressed by the transition guidance:

Sale-and-Leasebacks

It is not clear whether sale-and-leaseback transactions in prior periods must be re-evaluated at transition using the revised sale-leaseback guidance in the ED or whether prior sale-and-leasebacks should be evaluated within the transition provisions of the revenue recognition guidance. This applies to both sale-and-leaseback transactions that achieved sale accounting and those that did not (for example, sale accounting would have been precluded for US GAAP preparers if a lease included a fair value purchase option, however, fair value purchase options do not preclude sale accounting under the revised guidance in the ED). In addition, it is not clear how deferred gains associated with past sale-and-leaseback transactions should be treated on transition.

Lessor: Determination of Which Model to Apply

The final Standard should indicate whether a lessor should account for a pre-existing lease at transition under the performance obligation approach or the derecognition approach based on an assessment as at the inception of the lease or as at the date of initial application.

Lessor: Determination of Fair Value Under the Derecognition Approach

Paragraph 95(b) states that for a lessor applying the derecognition approach the lessor shall "recognise a residual asset at fair value determined at the date of initial application". We note that fair value measurements for the purpose of lease measurement are excluded from the scope of FASB Accounting Standards Codification Topic 820, Fair Value Measurements and Disclosures. As such, it is unclear whether the measurement of the residual asset at transition (and other fair value measurements required under paragraph 50 for the derecognition approach) is within the scope of ASC 820 (and, if not, what measurement guidance applies). Practice issues associated with the measurement of lessor residual values was one of the reasons the FASB excluded leasing measurements from the scope of ASC 820.

Lessor: Transitioning Out of Leveraged Lease Accounting

For US GAAP transition purposes, the final Standard should indicate whether a lessor that ceases to apply leveraged lease accounting on transition should recognise the related non-recourse debt at the current balance of the debt or at its fair value at the transition date.

Leasehold Improvements

Useful lives of leasehold improvements are often tied to the lease term for accounting purposes. If lease terms are revised based on the new guidance, it is unclear whether useful live assumptions for leasehold improvements also need to be revised under the simplified retrospective approach.

Initial Measurement of Lease Assets and Lease Obligations

When applying the simplified retrospective approach, it is unclear whether a lessee or lessor should determine lease terms and contingent lease payments with the benefit of hindsight (i.e. determined at the date of transition such that the initial lease liability includes actual sales for contingent rents even though the actual amounts would not have been known at lease inception, should estimates for impairment charges change, and should previous impairment charges change, etc.)

Liabilities Recorded Under ASC 420 (Formerly Statement 146)

For US GAAP transition purposes, the transition guidance does not address liabilities for leases previously recorded as operating leases that were recorded under FASB Accounting Standards Codification Topic 420, Exit or Disposal Cost Obligations.

Uneven Rental Payments for Lessors

The ED addresses how to account for uneven lease payments for lessees upon transition in paragraph 91, but corresponding guidance is not provided for lessors.

EITF 01-8

See our response in question 5 relating to paragraph 16 of EITF 01-8.

Benefits and Costs

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?

We encourage the Boards to seek the input of the preparers and users of the financial statements to assess the costs and benefits of the proposed Standard. Based on the outreach that we have performed, the cost to implement and maintain this proposed lease guidance will be very significant to lessees and lessors with significant lease transactions. The Boards should ensure through their outreach that the information provided and amounts recognised through these proposals are useful to investors and analysts. It would be helpful to present this outreach information in the basis of conclusion to help support the conclusions the Boards reach.

Other Comments

Question 18

Do you have any other comments on the proposals?

The following issues should also be considered:

- Lease incentives.
- Build-to-suit leases.
- Determination of the "rate the lessor charges the lessee" for property leases — Paragraph B12 notes that for property leases, the rate the lessor charges the lessee could be "the yield on the property". We are aware of different interpretations of how that calculation should be performed. Some view it as a simple yield calculation (annual rent divided by the cost of the property), others view it as a calculation similar to the "rate implicit in the lease" calculation (which would require an estimate of the lessor's unguaranteed residual value). We recommend the Boards deliberate this matter further as it will be relevant to all property lessees and lessors.
- Co-tenancy clauses — The Boards' discussions of contingent rent have primarily focused on contingent rents as a percentage of sales. However, co-tenancy clauses are common in retail leases where rental

payments may fluctuate based on another tenant vacating the building or not signing a lease. In addition, in the telecommunications industry, certain leases of cell tower assets include contingent rentals based on how many tenants the lessee can attract to the cell tower. We recommend 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 — We note that the ED does not specifically discuss lease modifications. Should the Boards proceed with the current proposals, the final Standard should make clear whether the prohibition in paragraph 29 against changing the lessor accounting approach after the date of inception of the lease applies even if a lease has been modified substantially — or whether there are any situations where a substantial modification may warrant a change in the lessor accounting approach.

- Payments for excess wear and tear — US GAAP currently provides guidance that a lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to contingent rentals. The Boards should clarify whether such arrangements are considered "contingent rentals" under the ED.

- Short-term leases — We also recommend that the Boards clarify whether recognising lease payments in the income statement "over the lease term" (for both lessees and lessors) requires recognising expense or income on a straight-line basis or another systematic and rational basis, or whether rentals may be recognised as expense or recognised as income over the lease term as it becomes payable/receivable.

- Leases cancellable by the lessor — The ED does not address how a lessor's right to terminate a lease should be addressed. This is a common provision in certain countries when the lessor is a governmental entity (under US GAAP, leases where the lessor is a governmental entity are currently addressed in ASC 840-10-25-25). The ED is not clear as to whether the lease term should include options from the lessee's perspective or the lessor's perspective, or both.

- We support the FASB's convergence project to measure investment property for certain entities at fair value. This would appropriately result in these properties being scoped out of the proposed leasing guidance consistent with the proposal under IFRSs.

- Amendment to IFRS1 – Appendix C states that the transitional relief for simple finance leases is not applicable for first-time adopters. This prohibition should be removed in the final standard and first-time adopters should be given a choice to use IAS17 or the new standard upon adoption of IFRSs. The accounting for simple finance leases is similar or identical to IAS17 in some jurisdictions and the Board should not assume that the transition relief is of no use to such first-time adopters. To avoid having detailed rules about similarity or identity, the Board can simply refer to IAS17 for first-time adopters.

Non-public entities

Question 19

Should any of the proposed guidance be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

We recommend that the proposed guidance be applied to both public and non-public entities. However, the Boards should consider deferring the effective date for non-public entities due to potential challenges in implementation of the guidance. We recommend the Boards perform additional outreach on this matter to ensure the concerns of non-public entities are addressed.