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12 September 2013

Dear Sir/Madam

Comment letter on IASB Exposure Draft ED/2013/6 and FASB Proposed Accounting Standards Update (Revised), *Leases*

We appreciate the opportunity to comment on the Exposure Draft ED/2013/6 and Proposed Accounting Standards Update (Revised), *Leases* (the ED or the proposals), issued respectively by the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) (together, the Boards). We have consulted within the KPMG network in respect of this letter, which represents the collective views of the KPMG network, including KPMG LLP (U.S.).

We continue to support the Boards' objective to develop a single, less complex approach to lease accounting and the broad principle that assets and liabilities arising under leases be recognised in a lessee's statement of financial position. However, the Boards' work on this project to date has not produced a broadly consistent view among their constituents about what a lease represents, or how it should be reported in the financial statements.

Regarding the current ED, we are concerned that:

- the proposals will not increase the relevance of, or eliminate the adjustments that users make to, financial statements;

- the proposals are complex and will be costly for preparers to implement; and

- there is no conceptual basis for key aspects of the proposals and many are inconsistent with the Boards' conceptual frameworks.

For these reasons, we do not believe that the Boards should issue a final standard based on the proposals in the ED.

The remainder of this letter sets out our overall views on the proposals, and the alternative ways forward we believe the Boards should consider at this stage in the project. The appendices to this letter contain our answers to questions included in the ED and additional comments on the proposals.

The project to date

The leases project continues to attract widespread attention throughout the financial reporting community. Rarely, if ever, has there been such a passionate and engaged debate on an accounting topic. We compliment the Boards and their staff on the resilience and responsiveness they have shown throughout this process. We also sympathise with the desire to bring this long-running project to a close. However, we believe that much work remains to be done.

There is no consensus – current or emerging – amongst the Boards' constituents about the proposals or future direction of the project. Each round of debate identifies new arguments and new concerns while the fundamental issues remain unresolved. Crucially, there is no consensus about whether all leases represent financing transactions and whether there is only one type of lease, two types of leases, or more. This diversity of views spreads across constituencies. In particular, and most importantly, initial indications suggest that there are a variety of perspectives within the user community.

In response to this diversity in views, a primary focus of the redeliberations on the 2010 ED was the recognition of lease income and expense, particularly for leases of real estate. The Boards' latest proposals in these areas are creative (in several senses) and are likely to be welcomed by some. However, the new proposals regarding real estate leases immediately generated new concerns about the different treatment of leases of other long-lived assets (e.g. why is a building with a 30-year life different to a ship with a 30-year life?). At the same time, a solid block of constituents remain unmoved in their belief that a real estate lease should not appear on the lessee's balance sheet.

Concerns with the current proposals

We appreciate that this outcome has left the Boards in a difficult position. The proposals are, by design, a series of compromises – a well-intentioned attempt to accommodate a variety of perspectives. In many respects, the compromises appear to reflect the Boards' focus on a single objective: that of requiring on-balance sheet accounting for leases by lessees. However, we have serious concerns about these compromises, as follows.

Firstly, and perhaps most importantly, it is not clear that the proposals will satisfy users. Understanding whether this is the case – and understanding the range and apparent variety of user needs – will be a key priority of the Boards following the comment period. However, it seems evident from the extensive proposed disclosures, including separate disclosures for Type A and Type B leases, that the Boards do not expect the proposals to eliminate adjustments to financial statement amounts by users. On the contrary, the proposals seem designed to facilitate an increase in adjustments. If the proposals do not clearly reduce the propensity for users to make adjustments, then the accounting changes cannot be considered more useful and the benefits of the changes do not outweigh the costs.

Secondly, the proposals remain complex and costly for preparers to implement and apply on an ongoing basis. While there have been some simplifications since the 2010 ED, many complexities remain. The dual model, with its new lease classification test, is itself a cause of complexity. Additional areas of complexity include, among others, lease term, variable lease payments, reassessments, and lessor accounting for Type A leases. Further, at many points the Boards propose to replace well understood and serviceable definitions or criteria with something new, introducing new interpretative challenges and unnecessary complexity. Examples include the new definition of a lease, and the replacement of 'reasonably certain' with 'significant economic incentive' in the assessment of options.

Thirdly, the proposals have little conceptual basis. This is particularly true of the accounting models for Type B leases. Irrespective of whether one believes that a given lease is or is not a financing transaction, we can see no basis for the lessee and lessor models taking different positions on this point. In addition, the proposal that a lessee in a Type B lease measure its right-of-use asset as a balancing figure has no place in a high quality financial reporting framework. The Boards have a responsibility to evaluate the financial reporting preferences of their various constituencies (including users) and determine whether they can be reconciled to the Boards' respective conceptual frameworks. If they cannot be, then the Boards should not proceed with an accounting model based on those preferences. Creating accounting and financial reporting requirements that are inconsistent with the Boards' conceptual frameworks is ill-advised because of the ongoing maintenance necessary to maintain the standards, the potential for inappropriate analogies, and the potential effect of the decisions on the Boards' future work in other areas. Standards that lack conceptual grounding create a need for significant implementation guidance because it is not possible to evaluate circumstances that are not explicitly addressed in the standard without specific rules.

Whilst the proposals achieve the objective of bringing all leases on-balance sheet, we do not believe the proposals represent an improvement over current lease accounting standards, will not satisfy financial statement users, and will not justify the considerable cost and complexity of implementation and ongoing application.

Next steps for the leases project

Reflecting on the progress of the project to date, we can see that there are no quick or easy fixes for lease accounting. We urge the Boards to resist the temptation to make changes to lease accounting that do not result in an improvement to current GAAP simply because of the extent of the work invested to date or the timing of other projects (e.g. revenue recognition).

Instead, the next steps should be to:

- re-articulate the essential attributes of an improved lease accounting standard, building on what has been learned from the work on the project to date; and

- identify the lease accounting model(s) that could form the basis of a lease accounting standard with those essential attributes.

Essential attributes of an improved lease accounting standard

We believe that an improved lease accounting standard should have all of the following essential attributes:

- Relevance to financial statement users – An improved lease accounting standard should provide more useful information to the users of general purpose financial statements. In particular, the model should result in fewer adjustments to financial statement amounts by financial statement users as compared to current GAAP. It should also reduce financial statement users' need for supplemental information with which to make adjustments – i.e. there should not be a need to both change the accounting requirements and increase the required disclosures.

- Complementary lessee and lessor accounting model(s) – The lessee and lessor accounting model(s) should be complementary. In particular, the financial reporting characterisation of any given lease should be the same for the lessee and lessor, assuming no third party involvement. We strongly believe that if a lease is a financing transaction, then it is a financing transaction for both the lessee and the lessor.

- Internal consistency – The lease accounting model(s) should be internally consistent. If the reason that a lease is on-balance sheet is that the transaction is considered to be a financing transaction, then the remainder of the financial statements (statement of comprehensive income and statement of cash flows) should also reflect the transaction on that basis.

- External consistency – The lease accounting model(s) should be fully consistent with the Boards' conceptual frameworks, and with other standards that are also consistent with the Boards' conceptual frameworks. On the lessor side, there should be a close relationship with the Boards' new revenue recognition guidance. For both lessees and lessors, there should be

a clear and consistent basis for distinguishing between contracts that are and are not executory.

- The lowest increase in cost and complexity for preparers consistent with the other attributes – Transition to a new standard will inevitably involve some cost for preparers, and there may be ongoing costs to provide improved financial information. However, the Boards should seek to minimise such costs by, for example, retaining current terminology and thresholds where appropriate. In addition, the accounting model(s) should not result in increased costs of application over time as compared to current GAAP without commensurate benefits.

In addition, we believe that a new leases standard should not result in significantly different accounting for transactions that are substantively the same, and should not create structuring incentives. However, we do not believe that the standard should be designed as an anti-avoidance measure. Rather, we believe that a standard that has the above attributes would result in consistent treatment of similar transactions and reduce structuring incentives.

We accept that limited exceptions from these attributes might be deemed appropriate on cost-benefit grounds. However, any such exceptions should be clearly identified as practical expedients.

Possible lease accounting models

Conceptually, we are attracted to an approach in which there is a single lease accounting model, with complementary accounting by lessees and lessors.

We continue to believe that a rigorously applied version of the right-of-use model would have many theoretical benefits. Under this model, all leases other than short-term leases (as a practical expedient) would be reported as financing transactions in all of the primary financial statements by lessees and lessors. During the redeliberations of the 2010 Leases ED, members of the IASB often seemed to support such a model in preliminary votes.

If the Boards were to revert to a rigorously applied version of the right-of-use model, then the resulting complexity could in part be alleviated by two practical expedients:

- a revised version of the exception for short-term leases. One possible revision would be to amend the exception so that it would apply to leases that on commencement had a lease term of one year or less. While this would place additional pressure on the determination of lease term for some leases, it would reduce the costs associated with applying the right-of-use model to leases that give rise to short-term receivables and payables. This approach would also be consistent with the guidance in the new revenue recognition standard not to account for the time value of money on contracts with customers when payment is expected within 12 months of performance; and

- a new exception under which a lessor would not be required to apply the model when it measures an underlying asset at fair value through profit or loss. This would be responsive to concerns from the real estate sector in some jurisdictions and may allow lessors in other sectors the opportunity to benefit from the exception.

An alternative model for consideration would be the underlying asset model. This has not been considered in detail by the Boards since the earliest stages of the project, though some aspects of the model seemed to inform the staff thinking at various points in the redeliberations. We believe that there may be benefits in developing a version of the underlying asset model that builds on thinking in other recent standard-setting projects to meet the attributes of an improved lease accounting standard.

Under this approach, the unit of account would be the underlying asset, or a physically distinct portion thereof. The lessee and lessor would assess on lease commencement which entity controls the underlying asset. This would be a binary assessment of whether the lease conveys control of the underlying asset to the lessee, under which the underlying asset would always be recognised by either the lessee or lessor over the entire lease term. Development of a control-based test could be further informed by the Boards' work on consolidation, revenue recognition and, in the case of the IASB, Conceptual Framework.

If the lease has transferred control of the underlying asset to the lessee, then this would be a financing transaction in which the lessee is paying over time for an asset that it now controls. In this case:

- the lessee would report the entire underlying asset on its balance sheet along with a liability to make lease payments and return the underlying asset to the lessor; and

- the lessor would report an investment in the lease comprising a receivable for lease payments and a residual asset for return of the underlying asset.

If the underlying asset remains under the lessor's control, then:

- the lessee would report the transaction as an executory contract, i.e. as an off-balance sheet transaction; and

- the lessor would report the transaction as an executory contract, continuing to recognise the underlying asset.

Limited scope improvements to current GAAP

If the Boards conclude that there is no alternative lease accounting model that could form the basis of an improved lease accounting standard (e.g. because there is no way to design a model that is both satisfactory to financial statement users and fully consistent with the Boards' conceptual frameworks), then the Boards should refocus the project on making limited scope

improvements to current GAAP. These improvements would likely include the elimination of leveraged lease accounting from U.S. GAAP, and reconsideration of the content of the disclosure requirements in both IFRS and U.S. GAAP.

Conclusion

The Boards have made an admirable attempt to overhaul lease accounting considering the diverse perspectives on what a lease represents and how it ought to be reflected for financial reporting purposes. However, bringing leases on-balance sheet should not be seen as an end in itself, to be pursued at any cost. We believe the current proposals do not represent an improvement over current GAAP, will not satisfy users, and will not justify the costs of implementation and ongoing application. Change for the sake of change does not necessarily equate to progress. We believe the Boards should aim for a high quality accounting standard, not settle for the least bad compromise.

If you have any questions about our comments or wish to discuss any of these matters further, please contact Mark Vaessen or Brian O'Donovan with KPMG's International Standards Group in London on +44 (0)20 7694 8871, or Mark Bielstein on +1 (212) 909-5419 or Kimber Bascom on +1 (212) 909-5664 with KPMG LLP in New York.

Yours faithfully

KPMG IFRG Limited

KPMG IFRG Limited

Appendix 1 - Responses the Boards' questions

Following are our comments on the proposals if the Boards do not accept our overall recommendations on how to move forward with the project. For ease of readability, paragraph and other references are to the IASB ED.

Question 1: Identifying a lease

Do you agree with the definition of a lease and the proposed requirements in paragraphs 6-19 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease?

We do not agree with the definition of a lease and the proposed requirements in paragraphs 6-19 for how an entity would determine whether a contract contains a lease. Overall we do not believe the proposals represent a significant improvement over IFRIC 4, *Determining whether an Arrangement contains a Lease*, and the corresponding guidance in ASC Topic 840, *Leases*.

Firstly, we believe that the ED does not provide sufficient guidance to distinguish between leases and service contracts. We expect this would be a key issue when implementing the proposals because of the significantly different accounting outcomes for leases and executory contracts, as the latter would remain off-balance sheet. Given the potential impact this determination may have, it would be helpful if the proposals contained more detailed examples and application guidance on how to distinguish such arrangements.

Secondly, as acknowledged by the Boards (BC105(d)), the proposed criteria to determine the right to control the asset would narrow the scope of the proposals and result in certain contracts currently accounted for as leasing arrangements no longer meeting the definition of a lease. This appears to be inconsistent with the Boards' objective to improve transparency of existing lease accounting by increasing the recognition of assets and liabilities arising from current lease arrangements. Specifically, we do not believe the guidance in paragraph 19 regarding additional goods or services provided by the supplier is clear and believe it will result in a number of arrangements currently accounted for as leases no longer meeting the definition of a lease (see examples below).

Thirdly, we believe the proposals will enable structuring opportunities which may lead to many arrangements being excluded from the proposals. Illustrative example 5B of the proposals indicates that when a supplier maintains and operates a power plant on a daily basis the arrangement does not result in a lease even when a single customer takes substantially all of the plant's output. We question the merits of this analysis. Similarly, we also have concerns regarding the phrase 'throughout the term of the contract' when applying the control criteria as it may easily allow for abuse. For example, assume a five-year agreement in which the customer has the right to use the asset for the entire five-year period, but only has the ability to appoint the operator of the asset for the first four years of the agreement. It is unclear if the customer has the ability to direct the use of the asset as it cannot make a decision that can significantly affect

the economic benefits *throughout* the entire term of the contract (i.e. only in four of the five years).

As a result of the concerns raised above, as an alternative approach we recommend retaining the current criteria of IFRIC 4 and the corresponding guidance in U.S. GAAP. We believe that IFRIC 4 is generally well understood and is relatively consistently applied in current practice. In addition, we believe that IFRIC 4 could be further enhanced to address known practice issues – e.g. pricing and unit of account issues. Maintaining the current guidance in IFRIC 4 would ensure more existing lease contracts would be within the scope of the proposals and reduce potential structuring opportunities. Such an approach would also help to reduce the overall cost and complexity of the proposals and allow for more consistent application.

However, if the Boards retain the current proposals for identifying a lease, we recommend the Boards address the following additional concerns regarding the requirements in paragraphs 6-19 of the proposals.

- We have concerns regarding arrangements in which the supplier has a right to substitute an asset 'throughout the term of the contract', as it will easily enable structuring opportunities to avoid application of the proposals. We prefer that an underlying asset that is subject to a right of substitution be considered 'specified' until another underlying asset is actually substituted for it. This should not be limited to a specified date of potential substitution as noted in paragraph 10. In addition, it is unclear what is meant by an alternative asset (i.e. must the asset be identical, or simply perform a similar function?). Likewise, it is unclear what would constitute a 'technical upgrade' under paragraph 10. Finally, the Boards do not illustrate how to determine whether substitution costs are so significant that they create an economic disincentive for the supplier to substitute alternative assets or discuss their views on it in the Basis for Conclusions.

- We believe that the proposals do not provide sufficient guidance on how to determine the ability to direct the use of an asset and believe additional illustrative examples would assist preparers and enable more consistent application. The Boards indicated that the presence of contractual restrictions intended to protect the supplier's interest in an asset would not, by themselves, preclude a customer from having the ability to direct the use of an identified asset (a maximum-use restriction is given as an example). However, we understand that the Boards believe the customer generally does not have the ability to direct the use of an identified asset in arrangements in which the supplier maintains operational control of the asset (e.g. the supplier or its designee operates the asset on behalf of the customer and has discretion over the inputs used in the operations). It is unclear what substantive differences the Boards see in these contrasting arrangements given the fact that the economic impact of the restrictions could be the same regardless of whether they are imposed by the supplier operating the asset on the customer's behalf or by contractually limiting the actions the customer is permitted to take in operating the asset itself. Further, paragraph 15 indicates that in some contracts an entity that is involved in the design of an asset is deemed to be in control of the asset. It is not clear how this guidance should be applied in practice, or

whether this is intended to function as a contra-indicator, e.g. is a lack of involvement in design an indicator that an entity does not control an asset?

- We have concerns regarding arrangements in which a customer has the right to receive 100% of an asset's output (e.g. a power plant). Such arrangements are generally considered to be a lease under current GAAP. However, based on the proposals it appears that, depending on facts and circumstances, such a contract may not represent a lease, irrespective of the pricing of the arrangement, as the customer must demonstrate the ability to direct the use of the plant throughout the term of the contract (see comments on example 5B above).

- It would be helpful to have additional guidance on factors to consider to determine if the customer has the ability to derive substantially all of the potential economic benefits of use of the asset under paragraph 18, similar to the guidance in paragraph 14 regarding the ability to direct the use of an asset. The additional guidance should also indicate what effect, if any, pricing has on the analysis. For example, in arrangements in which payments are 100% contingent, are there circumstances in which the pricing may indicate which party has the risks inherent in the benefits?

- The criteria in paragraph 19 do not appear to meet the Boards' desired objective. For example, it appears that the Boards intend for cable or satellite television set-top boxes supplied by cable/satellite TV companies to their customers to not meet the definition of a lease. However, in cases where these companies sell their entertainment services separately (e.g. in service renewal periods or to customers who obtain their set-top box through an alternative supplier such as a retailer), a set-top box would not meet the criterion in paragraph 19(a). For example, in the U.S. the Federal Communications Commission (FCC) requires cable television providers to deliver linear content (i.e. channels other than on-demand) through the use of a CableCARD to customers that wish to use their own CableCARD-enabled device. As a result, it is not clear that a customer's right to use a cable/satellite set-top box supplied by the cable/satellite TV company would be excluded from meeting the ED's proposed definition of a lease. More generally, additional guidance should be provided on the intended meaning of 'incidental.' It appears that the Boards intend that the concept should apply primarily to 'small-ticket' items such as set-top boxes, but could it also apply to more significant assets that are used in conjunction with other assets in large-scale manufacturing or similar activities?

- We recommend that the Boards include an explicit statement that the proposed guidance on control of the use of an asset is not fully aligned with the control concepts in other standards and projects. At present, the ED states in BC104 that "the Boards decided to change the proposed application guidance supporting the definition to align the concept of control more closely with… consolidation requirements and to address practice issues...." This is true as a comparative statement only and we believe it would be inappropriate for constituents to interpret the control concept in other standards and projects by reference to the proposals. For example, we note that paragraph 15 of the ED is inconsistent with the requirements of

IFRS 10: paragraph 15 indicates that in some contracts an entity that is involved in the design of an asset is deemed to be in control of the asset, whereas IFRS 10.B51 states that, "Being involved in the design of an investee alone is not sufficient to give an investor control."

- We recommend that the Boards consider further the interaction between the ED and other standards when assessing control. For example, consider the case of a special purpose vehicle that is established to own a single asset that is used by another entity. This scenario, seen commonly in practice, prompts two accounting questions: which party controls the use of the asset, i.e. is there a lease; and which party controls the special purpose vehicle, i.e. who should consolidate? In cases such as this, we are unclear whether the Boards intend the two questions to be addressed separately, and whether the Boards intend there to be any hierarchy or other relationship between the manner of application of the two control concepts.

Question 2: Lessee accounting

Do you agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ for different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We do not agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset.

Firstly, we do not agree with the proposed dual model approach for lessee accounting as we believe the model to be conceptually flawed. We believe that the current accounting model for Type B leases (most property leases) does not have a supportable conceptual basis, as in order to generate a straight-line expense profile, the right-of-use (ROU) asset is measured simply as a plug or balancing figure, which is inconsistent with the Boards' respective conceptual frameworks. Measurement of the ROU asset arising from a Type B lease would be inconsistent with the measurement of other non-financial assets which are measured on a cost basis. We also question how this determination of the ROU asset balance would be beneficial to users of the financial statements, who we understand generally do not differentiate between leases on the basis of the lessee's consumption of the economic benefits of the underlying asset during the lease term. We fail to understand why consumption of the underlying asset should have a direct impact on the amount of interest expense that is recognised on the financial liability. We question whether having a liability and asset of basically the same amount (i.e. effectively just grossing up the balance sheet) warrants the costs of applying the proposals.

Secondly, we believe the accounting to be operationally complex, particularly with respect to the dual model approach to expense recognition as well as the initial measurement and

subsequent remeasurement requirements. We note one of the original objectives of the project was to remove reliance on bright lines and that the ED retains the use of the criteria that generally caused these bright lines in the first place (i.e. use of major part of the useful life and substantially all the fair value criteria). In addition, the model includes new concepts and judgemental criteria that are not defined or thoroughly explained in the proposals, which will add greater complexity for users, preparers and auditors. We believe the proposals will also allow for lease structuring opportunities and will cause difficulties for users in making useful comparisons between different entities with similar leases. Further, the model is based on a complex, conceptually baseless classification test which is discussed in our response to question 4.

Lastly, we question the usefulness of the dual model's approach of requiring significantly different presentation depending on the classification of the lease, including increasing the number of line items in entities' statements of financial position. Notably, Type B leases would be presented in profit or loss and the statement of cash flows as if they were not financing transactions – despite the fact that the lessee recognises a financial liability measured at discounted present value. Further, the proposals do not specify the line item(s) in which short-term lease payments, variable lease payments, and payments for non-lease components should be presented. We believe that the lack of specific guidance in the presentation requirements, coupled with the additional line items in the financial statements will make it more difficult for users of the financial statements to make comparisons between different entities.

However, if the Boards do proceed with the proposed accounting models for lessees, we recommend the following concerns be addressed.

- The Boards should develop a conceptually sound Type B model for lessees, which is complementary to the corresponding model for lessors.

- The Boards should define or more thoroughly explain with additional illustrative examples the intended interpretation of the new judgemental thresholds and terms, including 'property', 'insignificant', 'substantially all' and 'significant economic incentive'.

- The Boards should perform further outreach with users of financial statements to determine whether the increased number of line items and disaggregation in presentation, together with the proposed disclosure requirements, will provide useful and practicable information. Additionally, the Boards should clarify the presentation requirements for short-term lease payments, variable lease payments, and payments for non-lease components.

- The Boards should simplify the reassessment guidance by limiting the requirement to subsequently adjust the discount rate only due to a lease modification.

- The Boards should provide additional guidance on the accounting for residual value guarantees provided by the lessee. Specifically, the Boards should address:

- whether a lessor's right to require the lessee to purchase the underlying asset at termination of the lease for a fixed or determinable amount is considered a lessee guarantee or another type of lease payment (e.g. such as a purchase option payment);

- whether a lease provision requiring the lessee to fund a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive use is considered a residual value guarantee or a contingent rental;

- whether lease payments structured as residual value guarantees (which are included in the lease receivable for Type A leases by the lessor under paragraphs B17 - B18) should be measured as residual value guarantees or as another type of lease payment by the lessee; and

- whether the right-of-use asset should be adjusted due to a remeasurement of the lease liability as a result of a change in estimated payments under a residual value guarantee. An increase in a residual value guarantee payment typically corresponds to a decrease in the value of the underlying asset; therefore it does not seem appropriate that the right-of-use asset would be increased in such instances.

- Current GAAP precludes the lessee in a finance (capital) lease from measuring the asset recognised at an amount that is greater than the fair value of the underlying asset at lease inception. We recommend that the Boards include a similar requirement that the carrying amount of a right-of-use asset at initial recognition should not exceed the fair value of the underlying asset.

Question 3: Lessor accounting

Do you agree that a lessor should apply a different accounting approach to different leases, depending on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?

We do not 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 and, therefore, we do not support the proposed dual model for lessor accounting.

As noted in our response to question 2, we disagree with the proposed dual model approach as we believe it:

- is conceptually flawed;

- substantially increases the complexity of lease accounting; and

- does not provide users with more useful information.

In addition, we have specific concerns regarding the proposals over both the Type A and Type B lessor accounting models.

We do not support the application of the Type B model for lessors as it violates a key objective of the project to recognise assets and liabilities that arise from lease contracts on-balance sheet. The proposed Type B model does not represent an improvement over operating lease accounting under current GAAP. Furthermore, the Type B model is conceptually flawed as although the lessee recognises a financial liability for its obligation to make lease payments, the lessor does not recognise a financial asset. There is no conceptual basis for the asymmetrical accounting treatment for Type B leases between lessees and lessors or the benefit of only having a single party to a contract recognise a financial instrument. If a Type B lease gives rise to a recognisable right-of-use asset and lease liability for the lessee pursuant to the Boards' conceptual frameworks, it is unclear why the lessor's right to receive lease payments under a Type B lease does not also meet the definition of an asset.

Unlike the proposed Type B model, lessor accounting under Type A is somewhat symmetrical to the lessee accounting proposals, as the lessor would account for a partial disposal of the underlying asset on deferred payment terms, in the same way that the lessee would account for the acquisition of the ROU asset. However, we note that the model itself is difficult to apply, even in simple scenarios (e.g. no variable lease payments, no lease incentives, etc.) with most of the complexity related to the accounting for the residual asset. As such, we have concerns that the model will be even more difficult and costly for entities to apply in complex situations. In addition, although we agree with the partial sale aspect of the model, we do not support accretion and recognition of interest income on the residual asset because it is conceptually flawed in the context of a right-of-use accounting model and is inconsistent with how other non-financial assets are accounted for under current GAAP.

If the Boards intend to proceed with the proposed Type A model for lessors, we have the following additional concerns and recommendations.

- We note that the ongoing reassessment of the Type A lease receivable and residual asset during the lease period (paragraphs 78-81) will result in potentially significant changes in reported profits and losses arising from these leases during the lease period even when there is no change in the lease terms and conditions.

- We believe the discount rate guidance can be simplified by limiting the discount rate to the interest rate implicit in the lease, and not subsequently adjusting the interest rate unless there is a lease modification.

- We believe the reassessment requirements should be simplified by requiring the lessor to allocate any changes in its lease receivable between the carrying amount of the residual

asset and profit and loss by applying the ratio used to calculate the initial carrying amount of the residual asset.

- The Boards need to clarify the guidance in paragraph 78 about how to determine the profit or loss from a reassessment that affects the measurement of the residual asset. We believe the Boards intended for a revised amount of unearned profit or loss to be determined in the same manner as it would be determined at lease commencement.

- The guidance on consideration of the present value of variable lease payments expected to be earned during the lease term in the initial measurement of the residual asset in paragraph 72 greatly increases the complexity of the model. The Boards should clarify when a lessor is required or permitted to include an estimate of variable lease payments in the discount rate.

- It is not clear how lease incentives immediately paid to the lessee are accounted for. We presume they will be taken into account in the calculation of the profit/loss on derecognition of the underlying asset, although that is not obvious from the proposals. The Boards should clarify the lessor accounting for lease incentives.

Question 4: Classification of leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 28-34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

We do not 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, which differ depending on whether the underlying asset is property.

Firstly, consistent with our responses to questions 2 and 3, we believe that the underlying basis of the proposed dual model is conceptually flawed. Specifically, we do not support a dual model based on the consumption of the benefits of the underlying asset to achieve different expense/income recognition for some lease arrangements within a right-of-use framework. We believe that the more important issue for the Boards to resolve is whether some leases are executory in nature and should not be recognised on the lessee's statement of financial position, which would likely mean abandoning a pure right-of-use approach to lease accounting. In this regard, we believe additional guidance is needed to enable consistent identification and consistent accounting treatment by both parties to the contract.

However, if the Boards conclude that all leases should be reported as financing transactions on the lessee's balance sheet, we do not support the need for a separate classification test to determine if interest expense should be recognised on the arrangement. We believe there is a conceptual basis within a right-of-use framework for concluding that all leases contain a financing element. Even if an argument can be made that a particular leasing arrangement is

more akin to a service, as an entity is simply using the asset over an extended period of time and did not enter into the transaction for financing purposes, the future obligation to make payments are still recognised utilising the concept of time value of money. Accordingly, the discounting effects resulting from time value of money are reflected as interest expense under current GAAP. It is unclear why an exception should be made for only certain lease arrangements. We disagree with BC40-BC49 that straight-line income/expense recognition under Type B leases, excluding the presentation of interest expense/income better reflects the economics of such transactions in the context of a right-of-use framework.

Secondly, the principle of the test – i.e. the extent of consumption of the underlying asset – appears to be disregarded in the actual application of the classification test, as a result of the use of a practical expedient based on the nature of the underlying asset. Therefore, we do not believe that the current proposals can be characterised as resulting from that principle. In addition, we believe that applying the suggested classification test based on a consumption based principle would not be relevant as it contradicts the fundamental premise of the proposed lessor and lessee models – i.e. accounting for the right to use an underlying asset rather than the underlying asset itself.

Thirdly, we believe the proposed dual model approach significantly increases the operational complexity of lease accounting. As previously stated, we support the Boards' initial objective of achieving a less complex single lease accounting model, which would not require a classification test. In addition to having more than one accounting model, the proposed classification test adds additional difficulty by introducing new concepts and judgemental thresholds, which are not defined within the proposals (e.g. 'significant economic incentive' and 'insignificant'). It is also unclear if the terms 'major part' and 'significant' included in the classification test are intended to be interpreted to have the same meaning as current GAAP. As under the proposals, lease classification will only be assessed at lease commencement and upon a lease modification, and thus substantial weight will be placed on these thresholds at lease commencement, which are rooted in uncertain future assumptions. In addition to adding to the cost and complexity for financial statement preparers, we believe that the proposals will also further complicate a financial statement user's ability to assess an entity's leasing arrangements as assessments will need to be made over two different lease models, solely due to an arbitrary classification test. The fact that additional disclosures are necessary to supplement the recognition and measurement proposals raises serious questions about how beneficial the proposed dual model approach will be to financial statement users (see question 8).

Lastly, we believe that the introduction of the proposed classification test, which for all intents and purposes is based on a practical expedient, may lead to many instances in which the accounting does not properly reflect the economics of the lease and thus will not achieve another major objective of the Boards for undertaking the leases project. As proposed, the classification test could result in leases that have identical terms and appear to be economically similar, particularly in the context of a right-of-use accounting framework, being accounted for differently simply due to the nature of the underlying asset. For example, assuming the same terms and conditions, under the proposals a 30-year lease of a building and a 30-year lease of an

airplane may be accounted for in different ways, including no reflection of the lease transaction on a lessor's statement of financial position for leases of property (i.e. the building). We believe this outcome is evidence that the proposals would not improve financial reporting.

However, if the Boards retain the proposed lease classification test, we recommend the following concerns regarding the requirements set out in paragraphs 28-34 be addressed.

- We disagree that only one of the criteria in the lease classification test for non-property assets must be met to qualify for Type B accounting and believe it allows for potential structuring opportunities. For example, a non-property lease could be classified as a Type B lease by structuring the lease payments as predominantly variable lease payments so that the present value of the lease payments meets the insignificance test, even though the lease is for more than an insignificant part of the asset's total economic life. In this example, classification as a Type B lease does not seem to reflect the economics of the transaction as intended by the proposals.

- It is not entirely clear if the proposed classification test would result in few non-property leases being treated as Type B, as currently intended by the Boards' proposals. As noted above, this issue is further complicated by the introduction of new, undefined thresholds which may not be interpreted or applied consistently in practice. If the Boards decide to proceed with the proposed classification test, we believe further outreach must be performed in order to assess whether it will operate as intended.

- We believe the lease classification test for property is not properly designed in relation to the consumption principle – i.e. it will not identify all circumstances in which the lessee will consume more than an insignificant portion of the economic benefits embedded in the underlying asset. For example, we believe the lessee may consume more than an insignificant portion of the economic benefits embedded in the underlying asset when the lease term is more than an insignificant, but less than a major, part of the asset's remaining economic life.

- We disagree with the difference in the assessment of economic life for property and non-property leases. We believe the remaining economic life should be used in the classification of both classes of underlying assets regardless of the point in the economic life at which the lease commences if the principle is consumption of the underlying asset.

- We believe that the Boards should provide additional guidance on lease modifications, and give further consideration as to whether there are other circumstances in which lease classification should be reassessed. Lease modifications are common in practice and give rise to practice issues. One key question is how to identify lease modifications. For example, should exercise of a renewal option that is contained in a lease be considered a lease modification? In this case, the contractual conditions remain the same but an agreement that previously contained optionality is now a fixed commitment. Should exercise of a purchase option be considered a modification? Does this depend on whether

the current lease accounting assumes exercise? If a lessor waives a lease payment or agrees to reduce lease payments for a limited period due to economic distress of the lessee, should that be considered a lease modification? A second key question is at what point in time a lease modification should be recognised. For example, many leases that contain a renewal or purchase option require the lessee to give binding notice as to whether it will exercise the option before the end of the lease, to allow the lessor time to remarket the underlying asset if necessary. If a lessee gives binding notice at the end of year 5 of a lease that it will purchase the underlying asset at the end of year 6, should the lessee account for a new lease at the end of year 5? Depending on the answers to these questions, the Boards may also need to reconsider whether there are circumstances in which lease classification should be reconsidered even in the absence of a lease modification. For example, if a lessee gives notice that it intends to exercise a purchase option in a Type B lease (i.e. the lessee did not originally have a significant economic incentive to exercise), then if this is not a lease modification should the lessee reassess the classification of the lease?

- We do not agree that the classification should be based on the primary asset if a lease includes more than one underlying asset. Instead, we would prefer for the lease of each asset to be classified separately. Given that the determination of the primary asset may be highly judgemental and difficult to apply in practice, we recommend that the Boards develop further guidance if they decide to proceed with this approach. In addition, we do not agree that the determination of the primary asset should only be made at lease commencement and instead believe that it would need to be reassessed in the event the entity changes the use of the asset and/or its business model.

- We also have concerns about application of the lease classification test to combined leases of land and buildings. Whilst land will generally clearly meet the criteria that the underlying asset is not being consumed, the application of the fair value of the minimum lease payments criterion to a combined lease of land and buildings would often require a lease of land that is a substantial component of the arrangement to be classified as Type A, which is not consistent with the underlying principle. We also note that use of the building life to assess whether Type B or Type A, is not consistent with the principle if land and buildings are not to be separated.

- We believe that the Boards should clarify how an entity applying the modified retrospective transition approach would determine the classification of an existing lease upon adoption of the proposed requirements. For example, if a lessee currently accounts for a combined lease of land and building as a finance lease of the building and an operating lease of the land, how would it identify the number and nature of the lease components at the transition date? If the lessee concludes there is a single lease component on transition, then should it treat that lease component as having been a finance lease or an operating lease previously?

Question 5: Lease term

Do you agree with the proposals on lease term, including the reassessment of the lease term if there is a change in relevant factors? Why or why not? If not, how do you propose that a lessee and a lessor should determine the lease term and why?

Generally, we agree with the proposals on lease term with the exception of the introduction of the new judgemental threshold of 'significant economic incentive'. Additionally, it is unclear how, in practice, an entity would ignore changes in market-based factors – e.g. market rates – when performing a reassessment of the lease term.

We do not agree with the introduction of the new judgemental threshold of significant economic incentive in the determination of the lease term. It is unclear whether this undefined threshold is intended to be a higher or lower threshold than the current practice thresholds of 'reasonably certain' (under IFRS) or 'reasonably assured' (under U.S. GAAP), which may lead to different outcomes in its application. Consistent application of this threshold will be crucial if meaningful comparisons are to be made between different entities, and we question whether the proposals provide enough direct guidance in order to achieve this. If the Boards intend for the threshold to be interpreted in the same way as the thresholds in current GAAP, then we see no reason for changing the terminology that describes the threshold.

As an alternative, we would prefer the lease term to be the period that the underlying asset is reasonably certain to be under lease. This would retain a generally well understood recognition threshold and reduce the need for reassessments due to a change in the lessee's economic incentive. However, if the Boards retain the current use of significant economic incentive, then we believe further explanation and illustrative examples are required to ensure consistent application in practice.

We note that under current GAAP all lease term extensions controlled by the lessor are included in the lease term. However, that requirement was not included in the ED's proposed definition of lease term. The Boards should clarify whether lessees and lessors would be expected to include all extensions controlled by the lessor in the lease term for accounting purposes.

Generally, we agree with the reassessment of the lease term if there is a change in relevant factors. For example, we agree with the reassessment of the lease term if the lessee elects to exercise an option even though the entity had previously determined that the lessee did not have a significant economic incentive to do so, or when the lessee does not elect to exercise an option even though the entity had previously determined that the lessee had a significant economic incentive to do so.

However, it is unclear why the Boards have decided to exclude significant changes in market-based factors from circumstances that would require a reassessment of the lease term. This is inconsistent with the requirement to consider them in determining the initial measurement of the lease liability. Specifically, as the Boards concluded in BC142, an entity should take into

account all relevant factors in assessing significant economic incentive, "because many of the factors are interlinked and it would be both difficult and illogical to require an entity to consider any one factor in isolation." As such, it is unclear how an entity would ever isolate market-based factors from other factors.

Further, it seems counterintuitive to ignore certain market-based factors such as market rentals for comparable assets which would likely be a significant incentive, if not the sole incentive in some cases, in a lessee's decision to either extend or cancel a lease. Application of this guidance in practice is likely to be operationally impracticable.

Question 6: Variable lease payments

Do you agree with the proposals on the measurement of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments? Why or why not? If not, how do you propose that a lessee and a lessor should account for variable lease payments and why?

Initial measurement

We agree with the proposals on the initial measurement of variable lease payments.

In our view the proposals on initial measurement of variable lease payments are a pragmatic solution to a difficult issue. We recognise that as a result of those proposals the actual lease payments a lessee is obligated to make may exceed the estimated lease payments used in measuring assets and liabilities of the lessee and lessor. However, the proposals demonstrate the sharing of risk between a lessee and lessor that is reflected in variable lease payments. In addition, there are many lease arrangements (e.g. leases of retail space with rentals that are a percentage of the lessee's sales, sometimes with lease payments that are entirely contingent on sales) in which there is significant uncertainty about the timing and amount of variable lease payments. We believe that uncertainty increases the potential complexity and cost of estimating variable lease payments while reducing the potential benefits of such estimates. We agree that disclosure of the basis, terms and conditions on which variable lease payments are determined is a more appropriate alternative than recognition and measurement of such payments. Therefore, we support the proposals on initial measurement of variable lease payments, even though they may not be fully consistent with the decisions in the Boards' revenue recognition project.

If the Boards decide to require additional information in the financial statements about estimated variable lease payments, we believe that information should be limited to disclosure by lessees of information about commitments under variable lease payments and analysis of actual variable lease payments in the current and comparative periods.

Reassessments

We disagree with the proposals on reassessment of variable lease payments, including reassessment if there is a change in an index or a rate used to determine lease payments.

We believe the benefits of the proposed reassessment requirements for variable lease payments based on an index or rate do not justify their costs in economic environments other than highly inflationary economies. Various examples that we have considered demonstrate that the periodic income statement impact of such reassessments is clearly immaterial (usually trivial, even in a highly inflationary economy). Although the balance sheet impact of such reassessments could potentially be material in highly inflationary economies, it is not clear that the benefits outweigh the costs because the reassessment merely results in an equal adjustment of the lessee's right-of-use asset and lease liability (i.e. it is simply a gross-up or down of the balance sheet).

As an alternative, we recommend that the Boards eliminate the requirement for reassessments of lease payments based on an index or rate.

However, if the Boards decide to retain such a requirement, we recommend that it be limited to reporting entities in highly inflationary economies. We also believe the Boards should clarify that a reassessment is required only at the end of reporting periods in which there is a change in contractual payments due to a change in an index or rate on which variable lease payments are based.

Additional comments

Additionally, we would like to raise the following concerns regarding the proposed accounting for variable lease payments:

- We believe that the Boards should clarify and define the meaning of variable lease payments that are 'in-substance fixed payments'. Although the proposals include an example that provides some guidance, there is no discussion of the principle or objective for determining whether variable payments are in-substance fixed payments. For example, it would be useful to include an example on whether a minimum portion of variable lease payments should be considered in-substance fixed payments. Example fact patterns might include: lease payments based on sales when the lessee has a stable history of sales; electricity generation in a wind farm or hydroelectric plant when there is a long history of stable climactic conditions; or usage-based payments when a base level of usage is necessary if the entity is to remain a going concern. Distinguishing between variable and in-substance fixed payments will be a key issue given the significantly different treatments that will apply to these payments. Therefore, it is important for the Boards to provide additional guidance to avoid diversity in practice.

- We believe that the Boards should clarify and define the meaning of payments that depend on an 'index' (i.e. what an appropriate 'index' is to determine whether variable lease

payments should be included at initial measurement). For example, it is unclear whether payments based on market rent reviews, could meet the definition for being based on an 'index' under the proposals. Economically, these types of payments could be the same or similar to payments reflecting movements in CPI. Therefore, we believe that the Boards should clarify whether payments based on a market rent review, and in particular if it is known to be based on a widely accepted market index, would meet the definition of payments based on an 'index'.

- The proposed requirements for lessors that include an expectation of variable lease payments in their discount rate are a significant source of complexity in the proposed lessor accounting model for Type A leases. The Boards should clarify how the lessor should determine whether it is required or permitted to include an expectation of variable lease payments in its discount rate. Additional examples illustrating the subsequent measurement of a lease when the lessor includes an expectation of variable lease payments in its discount rate would also be helpful. The Boards should include an explanation in the Basis for Conclusions about why the lessor is required to defer any profit related to variable lease payments when the lessor includes an expectation of such payments in its discount rate. The Boards should also clarify and illustrate how to apply the reassessment requirements when the lessor's discount rate includes an expectation of variable lease payments.

Question 7: Transition

Do you agree with the transition proposals? Why or why not? If not, what transition requirements do you propose and why? Are there any transition issues the boards should consider? If yes, what are they and why?

We do not fully agree with the transition proposals, and we believe there are additional transition issues the Boards should consider. In addition, although we support both lessees and lessors having an option to apply the proposals retrospectively, we suggest that the Boards clarify whether any of the specified transition reliefs are available to entities that elect to apply this option.

The volume of leases to be considered by lessees and lessors under a lease-by-lease assessment (in some instances tens of thousands) will make initial application of the proposals extremely challenging. In addition, the transition proposals may lead to anomalies in the accounting, particularly by lessors, as described further below. As such, we believe the Boards should consider further transition reliefs in addition to those proposed, including:

- the use of a cumulative effect transition method that does not require revision of comparative periods presented;

- additional transition relief for sale and leaseback transactions;

- additional transitional discount rate alternatives for both lessees and lessors; and

- additional alternatives for transitional measurement of the residual asset by lessors in Type A leases.

Firstly, we believe that the Boards should provide an alternative for both lessees and lessors to apply the proposals by recording a cumulative effect adjustment at the beginning of the period of adoption without revision of comparative periods presented. We note that the Boards' transition guidance for initial application of their new revenue recognition requirements will provide a corresponding alternative. Furthermore, as multiple element revenue arrangements might also contain leases, it is unclear how a lessor that is also a seller under such arrangements would initially apply the new revenue recognition requirements utilising a cumulative effect transition alternative, while applying the new lease accounting requirements retrospectively.

Secondly, we recommend that the transition guidance be revised to permit retention of previous conclusions reached with respect to sales for all sale and leaseback transactions entered into prior to the date of initial application. Otherwise, despite the significant proposed changes in accounting for sale and leaseback transactions, under the current proposals there would be no transition relief available for these transactions if they were not accounted for as sales or were accounted for as sales and operating leases. We also recommend that the Boards stipulate, solely for transition purposes with respect to sale and leaseback transactions, that ownership by an entity may be deemed to occur when title transfers, not when the entity has executed a purchase order or assigned a purchase order to another party in an agreement that contains provisions exposing the entity to constructive risks of asset ownership (e.g. an indemnification of the assignee). For many leases of equipment entered into at, or shortly after, the date the asset is acquired and placed in service (e.g. within 90 days), the lessee's accounting records likely would not identify whether the transaction involved a sale and leaseback because these transactions often receive the same treatment for current GAAP, income tax, and general legal purposes regardless of whether the lessee temporarily acquired asset ownership. Consequently, a lessee may not be able to determine whether the lease arose from a transaction that would be considered a sale and leaseback if the lessee were potentially considered an owner for accounting purposes without holding legal title.

Thirdly, we recommend that on transition both lessees and lessors should be permitted to apply the discount rate used to classify and account for a lease under existing GAAP (i.e. the discount rate determined at lease inception). This may facilitate a more cost-effective transition for some entities. We recommend that lessors applying the discount rate determined at lease inception under existing GAAP also be permitted or required to measure the residual asset for leases classified as Type A leases at the present value of the estimated future residual value at lease inception under existing GAAP accreted to the date of initial application. This would provide consistency between the discount rate used in accounting for the lease and the other assumptions affecting measurement of the residual asset and lease receivable.

We also recommend that the Boards permit lessors to apply a discount rate on transition determined using information at the beginning of the earliest comparative period presented. It may be difficult for lessors to determine the rate charged to the lessee at lease commencement

because that rate would not necessarily be the same as the implicit rate, which lessors previously would have been required to determine at lease inception under existing GAAP. Lessors with long-term leases (e.g. real estate leases) may find it particularly difficult to determine the rate charged to the lessee as of the commencement of the lease.

Fourthly, we note that the application of the modified retrospective transition approach to existing operating leases that are classified as Type A leases may result in recognition of a lease receivable and gross residual asset measured at a total amount that does not equal the fair value of the underlying asset at the beginning of the earliest comparative period presented. This is attributed to the proposed requirement to use the rate the lessor charges the lessee determined at lease commencement as the discount rate, but using information at the beginning of the earliest comparative period presented to determine the estimated future residual value of the underlying asset. As such, we recommend that the Boards permit or require the lessor to apply a discount rate based on information at the beginning of the earliest comparative period presented in instances when the residual asset is measured using information as of that date.

Finally, we recommend that the FASB work with the SEC staff to understand what information SEC registrants will be required to provide in selected financial data upon adoption of the new requirements. If registrants will be required to provide information in accordance with the new requirements in each of the five most recent fiscal years, the effective date should be established in contemplation of that requirement.

Question 8: Disclosure

The disclosure 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 the disclosure proposals? Why or why not? If not, what changes do you propose and why?

We do not agree with the disclosure proposals.

Firstly, we believe the proposed disclosure requirements are symptomatic of the complexity of the Boards' recognition and measurement proposals, and the failure to develop an accounting model that increases transparency and comparability of lease accounting and otherwise achieve the Boards' objective of a single simplified accounting model for lease accounting. We note that a number of disclosures require information to be segregated between Type A and Type B leases. It is difficult to understand how an increase in disclosure requirements compared to existing GAAP can be justified when the intention of the proposals is to recognise lease assets and liabilities on-balance sheet and thereby make them more transparent. As a practical matter, the sheer quantity of leases in some organisations, each with their own individual terms, will lead to aggregate disclosures that are boilerplate in nature. Organisations with a significant number of leases likely will not be able to provide useful information on an aggregate basis in

relation to the extensive list of possible disclosures about the nature of an entity's leases and the significant judgements and assumptions made in applying the proposals.

Secondly, the disclosure requirements appear to be excessive in many areas, but inadequate or completely lacking in other areas. For example, it is unclear why the Boards have decided to require a more detailed maturity analysis for lease liabilities and lease receivables compared to the maturity analysis for other finance liabilities and finance assets under existing GAAP. Similarly, a roll-forward reconciliation is not required for non-lease financial liabilities or non-lease financial receivables under existing GAAP. In contrast, there are no specific requirements regarding the disclosure of variable lease payments or for total lease expense incurred for the period. We also believe that the reconciliation disclosures are not meaningful for Type B right-of-use assets as the ending balances for these right-of-use assets are merely balancing figures.

For entities applying U.S. GAAP, we note that there is not a requirement to disclose a maturity analysis of commitments for executory contracts. Accordingly, a requirement to disclose a maturity analysis of commitments for non-lease components related to leases would create an inconsistency with the disclosure requirements for similar commitments that arise from other executory contracts. We believe that disclosure of an accounting policy for leases, significant judgements and estimates applied under IAS 1, *Presentation of Financial Statements*, and ASC Topic 205, *Presentation of Financial Statements*, a maturity analysis consistent with IFRS 7, *Financial Instruments: Disclosure*, and ASC Topic 470, *Debt*, for financial liabilities, and the disclosure of gross rentals, would be appropriate and consistent with the level of disclosure in other areas.

Lastly, although the proposals would allow entities to consider the extent of detail provided, we believe that the Boards have not given sufficient guidance about how to determine the appropriate level of aggregation in the disclosures. In light of the Boards' consideration of the costs and benefits of disclosures in its broader project to develop an overall disclosure framework, we recommend that the Boards:

- provide additional guidance about how to determine the appropriate level of aggregation in the disclosures;

- make the roll-forward disclosure requirements for Type A right-of-use assets consistent with the requirements of IAS 16, *Property, Plant and Equipment*, IAS 38, *Intangible Assets*, and IAS 40, *Investment Property*;

- limit or eliminate the following disclosures:

  – lessee reconciliation of the opening and closing balances of the lease liability for Type A and Type B leases;

  – lessee reconciliation of opening and closing balances of right-of-use assets for Type B leases;

- lessor reconciliation of the lease receivable and residual asset for Type A leases;
- lessor tabular reconciliation of lease income;
- maturity analysis of commitments for non-lease components related to leases for lessees applying U.S. GAAP; and

- require disclosure by lessees of information about commitments under variable lease payments and analysis of actual variable lease payments in the current and comparative periods.

Question 9 (FASB-only): Nonpublic entities

Will the specified reliefs for non-public entities help to 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 agree that the specified reliefs for non-public entities will help reduce the cost of implementing the new lease accounting requirements without unduly sacrificing information necessary for users of their financial statements.

Question 10 (FASB-only): Related party leases

Do you agree that it is not necessary to provide different recognition and measurement requirements for related party leases? If not, what different recognition and measurement requirements do you propose and why?

We do not agree that it is unnecessary to provide different recognition and measurement requirements for related party leases.

We believe the proposals make it possible for a reporting entity to achieve financial reporting outcomes that are inconsistent with the reporting for leases with unrelated parties. For example, under the proposals a reporting entity could exclusively enter into short-term leases with related parties even though it may be unable to enter into short-term leases of those underlying assets with unrelated parties. Consequently, the reporting entity's financial statements would not be consistent with those of other entities that have entered into leases of similar underlying assets with unrelated parties.

We recommend that the guidance on accounting for leases between related parties in existing U.S. GAAP be retained with slight clarifications. This guidance has been in place for many years and, in our experience, generally has proven to be effective in practice. However, to clarify the guidance, we recommend that the last sentence of ASC 840-10-25-26 be modified to state: "In such circumstances the classification and accounting shall be modified as necessary to

recognize the transactions based on terms consistent with those that would be available from an unrelated party" (emphasis added).

Question 11 (FASB-only): Related party leases

Do you agree that it is not necessary to provide additional disclosures for related party leases? If not, what additional disclosure requirements would you propose and why?

We do not agree that it is unnecessary to provide additional disclosures for related party leases.

Without these disclosures, financial statement users would be unable to make comparisons between the financial impacts of the reporting entity's leasing transactions with related parties and the financial statements of other reporting entities leasing similar underlying assets from unrelated parties. However, if the FASB makes the changes we recommend in our response to question 10, then we believe that it would not be necessary to provide additional disclosures for related party leases.

If the FASB retains its proposal not to provide different recognition and measurement requirements for related party leases, then we recommend that lessees and lessors be required to disclose:

- whether the terms of the transactions have been significantly affected by the fact that the lessee and lessor are related; and, if so

- the financial statement effects of accounting for the transactions based on terms consistent with those that would be available from an unrelated party.

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

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?

We do not agree that an ROU asset should be mandatorily within the scope of IAS 40 if the leased property meets the definition of investment property as we question the practicability of entities determining the fair value of an ROU asset.

Firstly, we note that the proposal for having all ROU assets which meet the definition of investment property in scope of IAS 40 is inconsistent with the Boards' previous conclusion that determining the fair value of an ROU asset is impracticable. Previously, the Boards concluded that determining the initial measurement of ROU assets at cost is easier and less costly for entities to apply than fair value measurement because there is usually no active market for ROU assets. It is unclear why this position would no longer be relevant. We believe that determining the fair value of an ROU asset in the majority of cases may be impracticable as

the ROU asset's value is dependent on the individual asset and the specific terms and economics of the lease. As such, we question whether entities will be able to establish clear evidence for reliably determining the fair value of ROU assets on a continuing basis.

Secondly, we believe that the lack of specific application guidance of IAS 40 will likely result in a number of practical issues, including:

- whether certain aspects of the lease not included in the initial measurement of the ROU asset would be included or excluded from the fair value determination – i.e. variable lease payments or unrecognised optional lease payments;

- whether the ROU asset is to be treated as an intangible or a tangible asset. If the ROU asset is deemed to be an intangible asset, it is unclear how it will meet the definition of investment property as it is not land and/or building; and

- whether the ROU asset would qualify as investment property if the lessee is also a sub-lessor leasing out the property in order to earn rentals. Refer to Appendix 2 for a further discussion of subleases.

For the above reasons, we do not believe that the approach proposed by the IASB will meet the objective of achieving greater consistency in the accounting for investment property. As an alternative, we support the IASB's previous position from the 2010 ED for the scope exclusion for measuring ROU assets at fair value if the underlying asset meets the definition of investment property.

If the IASB decides to retain the current proposals, then we recommend that it address the following concerns:

- we recommend the IASB complete further outreach to determine whether it is practicable to determine the fair value of an ROU asset; and

- we suggest the IASB develop practical application guidance for preparers to determine the fair value of ROU assets. For example, the IASB should provide guidance on whether items such as variable lease payments or unrecognised optional lease payments should be included or excluded from the fair value determination.

Appendix 2 – Other comments

In addition to the specific questions raised in the ED, we would also like to comment on the following items with respect to the proposals:

Scope

Intangible assets. There is a tension between the ED's proposal for an accounting policy choice for lessees to apply the guidance to leases of intangible assets, and the related consequential amendments to paragraph 6 of IAS 38 which explicitly includes leases of certain intangible assets within the scope of IAS 38. We believe that this tension could be avoided by the following changes to the proposed consequential amendment to paragraph 6 of IAS 38: "Rights held by an entity under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are within the scope of this Standard, unless an entity chooses to apply [draft] IFRS X Leases" (emphasis added).

Non-regenerative resources. Regarding the scope exception for the exploration for leases of minerals, oil, natural gas and other similar non-regenerative resources, it is not clear if the exception would also include leases of related buildings. We believe that the proposals could result in a significant change from current practice due to the fact that there would no longer be a requirement to consider and allocate payments of leases of land and buildings separately.

Lease assessment. The assessment of whether a contract is a lease is made at the inception of the contract and no guidance is provided on if and when a reassessment should be performed.

Separation of lease and non-lease components

The current proposals on separation of lease and non-lease components may result in diversity in practice and inconsistencies between lessee and lessor accounting.

We recommend that the Boards clarify the interaction between the proposals in paragraphs 20-24 and paragraph 19. The ED's proposed guidance on separation of lease and non-lease components is likely to create practice issues when these components are not separable. For example, there are likely to be issues around the level of significance that a lease component would need to have to the overall arrangement for the arrangement to be within the scope of the leases guidance. Issues also are likely to arise with respect to the accounting for a non-separable arrangement as a lease in its entirety because it includes an insignificant lease component when the pattern of overall performance under the arrangement differs significantly from the pattern of income or expense recognition that would result from applying the guidance in the ED to the entire arrangement. In addition, it is unclear whether changes in consideration after commencement of the contract would be allocated on the same basis as at contract commencement or whether they could be allocated to one or more specific components.

In addition, we believe the Boards should provide additional guidance regarding the following issues:

- how to determine whether two or more leased assets are highly dependent on, or highly interrelated with, each other;

- when to combine separate lease contracts for accounting purposes consistent with the guidance in the new revenue recognition standard on when to combine contracts for revenue recognition purposes. Otherwise, the classification and accounting for separate leases of individual underlying assets may be different than if the underlying assets were leased under a single contract; and

- how to allocate remeasurements of lease payments upon a reassessment to lease components that qualify for separate accounting.

Sale and leaseback transactions

We are concerned that the proposals regarding sale and leaseback transactions are internally inconsistent, and inconsistent with the proposals in the revenue project.

Firstly, the criteria in paragraph 112 of the ED regarding sale and leaseback transactions are inconsistent with paragraphs 12-19 of the ED on identification of a lease. In particular, the identification of a lease in paragraphs 12-19 of the ED utilises a new control-based approach, but the assessment under paragraph 112 of the ED for sale and leaseback transactions retains the risk and rewards model under current IAS 17 to make such an assessment.

Secondly, the proposals appear to be inconsistent with the application of the new revenue recognition standard. Paragraph 111 of the ED states that the determination of whether the transfer of an asset is a sale should be assessed based on the criteria in the proposed revenue recognition standard. However, paragraph 112 of the ED goes on to state that the transferor is considered to direct the use of, and obtain substantially all of the remaining benefits from, the asset if:

- the lease term is for the major part of the remaining economic life of the asset, or

- the present value of the lease payments accounts for substantially all of the fair value of the asset.

The criteria in paragraph 112 of the ED noted above are different than the transfer of control criteria under the new revenue recognition guidance. Therefore, we recommend that the Boards develop detailed implementation guidance to clarify the approach to take when considering these criteria. In addition, we suggest that the proposals should be amended either to conform strictly to the proposed revenue recognition standard, or to clarify why paragraph 112 is

inconsistent with the requirements to meet the revenue recognition criteria as set out in paragraph 111 and the control criteria in paragraphs 12-19.

Thirdly, as noted in BC289(c) if it is deemed that a sale has not occurred, then the entire arrangement should be accounted for as a financing arrangement. It is unclear how this treatment would be applied for Type B leases (most leases of property), given the Boards' assertion that such leases are not financing transactions. It would be helpful for the Boards to provide an illustrative example of the mechanics of such a transaction for both seller-lessees and buyer-lessors.

Fourthly, the Boards should address when legally separate transactions should be combined for accounting purposes, including for the purposes of applying the sale and leaseback guidance. Although the new revenue recognition standard will require that entities combine two or more contracts entered into at or near the same time with the same customer (or related parties) and account for the contracts as a single contract in some circumstances, it is unclear whether the buyer-lessor would meet the definition of a customer such that the revenue recognition guidance on combining contracts would apply.

Lastly, we note that the rationale in BC291 stating that, "The Boards decided not to propose a partial asset approach because it would be complex to apply and would not provide a proportionate benefit in improved information to users of financial statements," is inconsistent with the Boards' overall conclusion on lessor accounting for Type A leases.

In addition to addressing these inconsistencies, we believe that the Boards should also clarify the measurement guidance for sale and leaseback transactions in paragraph 114 of the ED.

In particular, we note that paragraph 114 of the ED requires an adjustment to recognise the sale at fair value if either the consideration for sale is not at fair value or the lease payments are not at market rates. However, the adjustment in either case is to reset the lease payments to market rates. This suggests that there may be no adjustment in cases where the consideration for the sale is not at fair value but the lease payments are at market rates.

Instead, we believe the seller-lessee's lease liability should be measured based on the contractual terms and the right-of-use asset adjusted for any difference between the sale price and the market price of the underlying asset. This would preserve the linkage between the reported amount of the lease liability and the seller-lessee's contractual commitments while adjusting the gain or loss on the transaction (and the seller-lessee's future expense) to reflect market terms. Effectively, the seller-lessee would reflect a deficiency between the sale price and the market price of the asset as a prepayment of rent. It would reflect an excess of the sale price over the market price of the asset as additional financing obtained from the buyer-lessor. Similarly, we believe the buyer-lessor should reflect a deficiency between the purchase price and the market price of the asset as a prepayment of rent received from the seller-lessee. It should reflect an excess of the purchase price over the market price of the asset as other financing provided to the seller-lessee.

We believe this approach is consistent with the proposals in paragraph 114 of the ED and would be less complex than the approach illustrated in Example 23.

Finally, we recommend that the Boards address whether the guidance on sale and leaseback transactions applies to non-monetary exchange-leasebacks, spin off-leasebacks, and contribution-leasebacks.

Subleases

We note that the proposals could lead to asymmetry between how an intermediate lessor accounts for a head lease and a sublease relating to the same underlying asset, even if the contractual terms of the two leases are similar.

This asymmetry would be particularly pronounced for a head lease and a sublease that are classified as Type B leases, as will be the case for many property leases. In this case, the intermediate lessor would recognise a financial liability for its obligation to pay rentals to the head lessor, but would not recognise a financial asset for its right to receive rentals from the sublessee. This will be a common circumstance in jurisdictions in which ownership of land, or property generally, is restricted and most property interests take the form of leasehold interests.

We question whether this asymmetrical accounting provides valuable information and recommend that the Boards consider developing guidance on circumstances in which an intermediate lessor may link or even net the accounting for a head lease and sublease when the contractual terms of the two leases are substantially similar.

In addition, we believe that the proposals should contain additional guidance to identify when the head lessee's lease is in substance terminated as a result of entering into a sublease, as well as illustrated examples for subleases.

Impairment

With regard to lessees in Type B leases, we believe that there is a lack of clarity as to how to approach the impairment test, and a risk of unintended consequences as a result. For example, given the inherent ambiguity in the proposals as to whether a Type B lease is a financing transaction, it would be helpful for the ED to include an explicit statement as to whether when performing impairment testing for Type B leases a lessee should exclude the lease liability from the carrying amount of a CGU that includes an ROU asset arising from a Type B lease.

In addition, the Type B lessee model may be prone to impairment charges as the ROU asset is measured as a balancing figure, which may result in less amortisation in earlier periods. Similarly, we note that impairment may arise simply due to the fact that the discount rates used for impairment testing may be different than the rate determined in accordance with the lease proposals. Lastly, in the event an impairment loss is recognised, it is unclear if the loss can subsequently be reversed.

With regard to lessors in Type A leases, we believe impairment testing for the residual asset will be challenging in practice. For example, the lessor may not have sufficient information about the condition of assets in possession of lessees at each reporting date. This may be a particular issue when the lessor has a high volume of small assets. Although operating lessors face similar issues today, we believe the impairment test will be more onerous, and the effort required less proportionate, to test the carrying amount of the residual asset. Similar to lessees, it is also not clear if impairment losses once recognised can be reversed if circumstances were to change.

Short-term leases

We support the proposal to provide relief for short-term leases and agree with the proposed definition of a short-term lease. However, as noted in the body of our letter, we would also support a revised version of the relief in which it would apply to leases that on commencement have a lease term of one year or less. While this would place additional pressure on the determination of lease term for some leases, it would reduce the costs associated with applying the right-of-use model to leases that give rise to short-term receivables and payables. This approach would also be consistent with the guidance in the new revenue recognition standard not to account for the time value of money on contracts with customers when payment is expected within 12 months of performance. In addition, we recommend that the expense recognition pattern for lessees not be limited to a straight-line basis. Instead, we propose similar recognition criteria for lessees to that of lessors – i.e. expense to be recognised either on a straight-line basis or another systematic basis if that basis is more representative of the pattern of benefits produced by the underlying asset.

Leases acquired in a business combination

Generally, we support the proposal to add a new recognition and measurement exception to IFRS 3 for leases acquired in a business combination. However, because U.S. GAAP does not include a requirement for component depreciation (unlike IFRS), we do not support the proposed changes to U.S. GAAP on measurement of assets and liabilities arising from leases in which the acquiree is a lessor. We believe the FASB should retain the requirement in existing U.S. GAAP to recognise lease-related intangibles separately when the acquiree is a lessor.

We are concerned that it is unclear how an acquirer should measure an acquired residual asset in a Type A lease. For example, paragraph B45C of IFRS 3 does not appear to envisage any kind of adjustment for expected variable lease payments, even if the acquirer factors an expectation of future lease payments into the discount rate it uses to calculate the initial carrying amount of the lease receivable.

Further, it is not clear how the acquirer should measure an acquired residual asset after initial recognition. For example, should the carrying amount of an acquired residual asset be accreted over the lease term, even though there was no discounting of the initial carrying amount? If so, what discount rate should be used? Should the acquirer adjust the carrying amount of the

residual asset in accordance with paragraph B20 of the proposals if there are variable lease payments?

We recommend that the Boards develop additional guidance on accounting for acquired residual assets. As part of this process, the Boards should evaluate the costs and benefits of the proposed approach to measurement of an acquired residual asset and an alternative approach under which the acquirer would estimate the residual value of the underlying asset and discount it at the rate used to discount the lease payments.

Repairs and maintenance

We are concerned that the ED contains insufficient guidance on accounting for leases of 'big-ticket' assets in which there is a legal or regulatory requirement for periodic major maintenance of the underlying asset. Such arrangements are common in the airline industry and in some other sectors, and there is diversity in practice at present.

Specific issues that arise in such leases include:

- whether cash flows identified as 'maintenance payments' in the lease are lease payments or a separate component of the arrangement;

- the circumstances in which a lessee or lessor should recognise the costs of a completed major maintenance event as an asset (or component of an asset); and

- the treatment of arrangements in which either the lessee or lessor may be required to make a payment if the actual cost of a maintenance event is higher or lower than expected.

We recommend that the Boards take advantage of the proposed introduction of a new lease accounting standard to improve the consistency of accounting in this important practice area.

Illustrative examples

We have the following observations and concerns about the illustrative examples provided by the Boards:

- We believe the facts provided in Example 2 are incomplete for the purposes of reaching the conclusion that the contract does not contain a lease because the facts are insufficient to evaluate the criterion in paragraph 19(a) of the ED.

- Whilst we agree with the conclusion in Example 3, we believe it is difficult to distinguish this arrangement in economic substance from the arrangement in Example 2. In addition, we believe there are not enough facts provided to reach the conclusion about separate components for both the lessee and lessor.

- We disagree with the analysis of Example 5B as we believe there is not a substantive difference between the facts in that example and those in Example 5A. We view the supplier's right to make decisions about operations as an insignificant activity in the context of an arrangement in which the purchaser takes substantially all of the asset's output, particularly in light of the existence of industry-approved operating practices, and the fact that the customer is involved in the plant's maintenance plan.

- Examples 17A and 17B do not provide very useful information because the 'in-substance fixed payments' are actually explicitly fixed payments.

- In Example 17C, it would seem more appropriate for the lessee to determine which alternative represents a significant economic incentive and then to record its lease liability and right-of-use asset based on that rather than automatically defaulting to the lowest amount.

- The analysis of Example 23 states that, "The terms and conditions of the transaction are such that Buyer obtains control of the land in accordance with the requirements for determining when a performance obligation is satisfied in [draft] IFRS X *Revenue from Contracts with Customers*." However, paragraph 112 requires only that the leaseback not provide the transferor with the ability to direct the use of and obtain substantially all of the remaining benefits from the asset to recognise a sale. The Boards need to either clarify paragraph 112 or conform the analysis of Example 23 to the current draft requirements of that paragraph.

Other comments

We have the following other observations and concerns about the proposals.

- We are concerned that the proposals are unclear whether the right-of-use asset and the lessor's residual asset are intangible assets or tangible assets. The mixed requirements are unhelpful in determining an important distinction for debt covenants and other important ratios, including those required by regulators. We believe for pragmatic reasons that the lessee's right-of-use asset and the lessor's residual asset should be classified as property, plant and equipment, when that is the nature of the underlying asset. We believe the right-of-use and residual assets would form a separate class of asset, so revaluation should be permitted under IFRSs even if 'owned' assets were not also revalued.

- The Boards should not eliminate existing IFRS and U.S. GAAP guidance that will continue to provide relevant guidance for issues that may arise under the final standard. Examples of situations for which there is existing authoritative guidance that may continue to be relevant after the issuance of a final standard include, but are not limited to:

  – accounting for interests in residual values of leased assets not owned by the investor;

- amortisation period for leasehold improvements;
- whether a lessee should capitalise costs (such as interest and amortisation) incurred during construction of an asset;
- accounting for maintenance deposits;
- whether a sublease results in a substantive termination of the head lease for accounting purposes;
- loss recognition on subleases; and
- lessee purchase of leased assets during the lease term.

- The Boards should clarify whether lessee payments of lessor debt and other in-kind payments are included in the definition of lease payments.
- The Boards should clarify whether residual value guarantees from related entities of the lessee are considered lessee guarantees, and if so, how they should be accounted for.