The Corporate Reporting Users' Forum

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Dear Ms Knubley

Discussion Paper: Preliminary Views on Leases

The Corporate Reporting Users' Forum (CRUF) welcomes the opportunity to comment on the Discussion Paper (DP) on Preliminary Views on Leases. As investment professionals, we place great importance on being able to compare and contrast the profitability and balance sheet information reported by companies as these are important to our work on valuation. Lease accounting is one area where users currently have to adjust their analysis and restate reported information and thus we welcome a review. We have not sought to explore, except in passing, the intellectual debate surrounding whether a lease contract is any different in nature from a service contract as we agree that leases are a large enough discrete class of contract that deserve their own standard.

Our letter is a summary of the main areas of discussion amongst CRUF participants in Europe, Australia and the US. Overall we felt the DP is heading in the right direction, creating a single accounting framework for leases which will be simpler and more understandable than the current standard. As a general observation we continue to be disappointed by the focus on the balance sheet with little attention paid to the disclosures and reconciliations needed for the P&L and Cash Flow statements that are needed by users when considering the future prospects of the business. We assume that further consideration of disclosure will wait until there is an Exposure Draft but we would like to make clear that we believe that this will be the area which will get our greatest focus.

We would have preferred to see an analysis of lessor accounting as well as lessee accounting. We do accept that lessee accounting, of the two, is the area where operational and financial metrics can be the most distorted in practice and is the key reason why leasing is on the IASB's agenda and should not be delayed by lessor accounting. Having said that, lessor accounting is important and we believe that getting the right answer for lessees must reflect the right answer for a lessor too as the accounting should be symmetrical. For a simple whole life lease, the lessee will employ a capital asset to generate operating profit whilst the lessor will have a financial asset which gives an interest return on the total value of that capital asset plus compensation for depreciation in the value of the asset to a residual value. We would like to see these costs, allowing for differing views on appropriate interest rate assumptions, the same in both sets of accounts. Furthermore, in the current difficult economic environment, lessors are facing significant issues regarding residual values which are likely to be materially impacted.

Current disclosure regarding such residual value exposures is inadequate for users to make an assessment of the risks and this issue needs to be addressed urgently.

In general we are agreed that, for lessees, the use of simple leases for equipment employed directly for operational reasons is purely a financing decision. In such circumstances, we believe that the reason for the use of a lease to acquire an asset should be that management believe it provides the lowest marginal risk adjusted after tax cost of capital for financing the business. The decision should never be driven by presentation and we would prefer that the accounts showed the operating assets and financing liabilities categorised and treated the same whether leasing or debt were used. Irrespective of how an entity finances its assets, the entity essentially owns the assets as they generate economic benefit from the use of those assets. We therefore support treatment of leased assets in line with their underlying nature.

Whilst we finally concluded that the Rights of Use approach was an acceptable pragmatic solution, some of us believe the Whole Asset approach was too readily discarded by the Board and we would recommend a fuller discussion of the issues, particularly when considering symmetry with lessor accounting. The lessor has the total capital value of the leased asset earning income from the lessee, whatever the lease term, so implicitly the interest cost borne by the lessee actually reflects the value of the whole asset, rather than the unwinding of the discount rate implicit in the lease obligation. If this is accepted, on a comprehensive view, the balance sheet should reflect a capital value that is consistent with the charge passing through the P&L. This can only be the case if the whole asset is capitalised and the return of the asset at the end of the lease term is seen as a repayment of lease principal. Assuming the Rights of Use approach is retained then we all agreed that disclosure should be adequate for users to approximately restate operating metrics uniformly whether the asset was bought or leased.

One key area that we debated was whether it was appropriate to disaggregate leases between “short term vs long term”. We were all of the view that the expense associated with any asset employed by the business should be operating in nature but we accept that the hire of a car over a week for a business trip overseas is different to leasing cars for a sales force. We were uncomfortable with any “bright line” rule that simply relied on a measure of duration to determine capitalisation as we generally recommend avoidance of rules. We hope that the materiality concept will allow management to ignore any incidental lease contracts and account for them as executory contracts, expensing as incurred as is the case today. If such leases are material in aggregate, then capitalisation as for any other lease would seem to be appropriate. We tried to construct a principle for P&L categorisation in answer to question 12 that would allow a rental expense category to be used for “qualifying short term contracts” which are those where leased assets are not utilised "necessarily, repetitively or consistently for the operations of the enterprise to function internally or deliver goods and services to customers" We believe that this would allow rental treatment for short term car hire or plant used to install equipment in a factory but would ensure that fleets of vehicles are correctly dealt with for logistics companies and airplanes for airlines. Supporters of the Whole Asset approach would use the same rule to determine when to capitalise the asset or alternatively deal with it using an executory model.

Leases of land and buildings was also an area that was extensively debated and for many was the key reason for accepting a Rights of Use approach as the asset at the end of the lease term will still have significant value that the lessee has no rights over. It is worth noting that many users already restate the accounts of companies with significant direct property ownership into the "OpCo / PropCo" model treating all land and buildings as non-operating investments and charging rent to the operations so that they compare these businesses with those which rent their premises. P&L treatment of these payments as rent would be consistent with this approach as opposed to disaggregating between the unwinding of the discount rate and a residual "depreciation" which does not reflect a true decline in the value of the underlying asset.

The other major area of debate was contingent payments where many in CRUF believe one of several boundaries between service contracts and asset leases lies. Essentially a lessor who accepts payment based on future events (sales, profits, utilisation rates etc.) is accepting operating risk and this element of the liability should not be capitalised. We believe that in most cases there should be evidence of different charging rates based on either a fixed rent or a contingent rent. Where this is the case, we were generally of the view that the full fixed rate payment should be used to calculate the right of use asset / lease liability and any subsequent variation taken through P&L in the period where the payment was made.

The implications for the Financial Statement Presentation project (FSP) are also significant as we want to see the liability as a financing obligation and not "through the eyes of management" or as portrayed in ToolCo.

Following this letter is an appendix where we have answered each of the questions in the Discussion Paper.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB and FASB.

CRUF participants come from all around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

We sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum (www.CRUF.com) and not as representatives of our respective organizations. The views expressed are those of individual CRUF participants and do not necessarily reflect the views of the respective organizations where we are employed.

The Corporate Reporting Users' Forum

The participants in the Forum that have specifically endorsed this response are listed below.

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Appendix

Chapter 2: Scope of lease accounting standard
Question 1
The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach? If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

We agree with this decision on the basis that it will be easy to implement, require little restatement of historical models used by the user community and low cost. We do agree that many service contracts have characteristics that are similar to leases and we are concerned that this will create opportunity for companies to structure transactions in a manner which minimises liabilities on their balance sheets and distorts economic reality. We encourage the boards to address this issue when possible as practice evolves and when time permits. We think that the boundary for a service contract depends on which entity utilises the physical asset.

Question 2
Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

We like the conceptual purity of removing assets from operating capital if they are not used necessarily for the delivery of operational output to ensure users can calculate comparable and meaningful returns on invested operating capital (or net operating assets). However we believe the application of a materiality threshold, which should remove the need to capitalise many of these assets, and the need to ensure that aggregate liabilities are correctly stated means that not permitting exemptions is the appropriate decision. We have argued on several occasions that options and exemptions and should not be permitted. Furthermore we would not give the exemption based on a management approach regarding non-core. If there are material leases, we are of the view that they must be core – if not why are shareholders incurring the cost? Regarding short term leases, we agree that a car hired for 1 week that is held over a period end should not be capitalised in full (as would be the case with the whole asset approach) but we believe that such examples will be immaterial. Where there is repeated use of short life leases (e.g. construction equipment for a construction company) we would suggest that these should be capitalised as they are used necessarily for the operations of the business and are a material cost. We do highlight alternative P&L presentation in the answer to Q 12.

Chapter 3: Approach to lessee accounting
Question 3
Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

We agree with this analysis for the rights and obligations. Many of us believe that there is a liability to deliver the asset at the end of the lease period and that this asset should be recognised as it is available for delivery to discharge the obligation. This equates to the "whole asset" approach which you discuss in Appendix C and discard (perhaps a little too readily).

Question 4
The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:
(a) an asset representing its right to use the leased item for the lease term (the right-of-use asset)
(b) a liability for its obligation to pay rentals.
Appendix C describes some possible accounting approaches that were rejected by the boards.
Do you support the proposed approach?
If you support an alternative approach, please describe the approach and explain why you support it.

We are divided on this matter but have concluded that the rights of use for assets and the obligation to pay rentals for liabilities is better than the current approach and is an acceptable representation of the assets and liabilities arising from a simple lease contract.

Those of us that expressed reservations do so on the basis that the assets could be materially different to those where the entity has chosen to purchase the asset instead of leasing it. This will reduce the comparability between businesses with similar operational models but where a financing decision is different. Ideally two airlines with identical routes, pricing, load factors, and costs should produce identical operating margins and identical ROCEs (ROICs). The proposals in this DP will not result in this outcome and users will need to continue to make significant adjustments to accounts to compare the operational performance of management. We do accept that leases provide greater optionality and are generally lower risk [although even this generalisation is not always true] than owned assets financed through secured debt but believe that this difference could be highlighted in notes rather than modifying the operational metrics users rely on. Clearly, in our view, the "Whole Asset" approach we refer to in Q. 3 would address this issue.

Question 5
The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:
(a) a single right-of-use asset that includes rights acquired under options
(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.
Do you support this proposed approach? If not, why?

We agree that assessing rights and obligations and consolidating each into a single value is appropriate. This is adequate for users and has the benefit of less subjectivity than any disaggregation process would require. Were the "Whole Asset" approach to be used, there would be no need to disaggregate either on the asset side, albeit that a separation of the liability between contractual cash obligations and asset return obligations might give useful further information to credit analysts.

Chapter 4: Initial measurement
Question 6
Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate?
If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

We agree that this is the simplest default discount rate at which to value the obligation as the alternative form of finance would have been debt and we accept the description of the difficulty that is faced by lessees in determining the actual interest rate priced in by the lessor as it is not typically disclosed within the contract. It is worth noting that there are companies without debt finance, who may still use leasing due to convenience or simply due to inability to access the asset except through leasing (e.g. retail premises), and it is unclear whether it is possible to determine a marginal borrowing rate with any accuracy (e.g. should they get a quote from the bank or look at the rate of interest foregone if cash balances are utilised). In addition, leasing can be the cheapest after tax form of financing for a business because the lessor has security over the asset and clearly has greater protection in bankruptcy than incremental bank finance. We believe that further guidance may be required, possibly with a default to use an estimate of the implicit rate that reflects security for the lessor.

Question 7
Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost?
If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

We agree that the initial measurement should be cost for the same reasons noted in the paper and in addition we see little merit on businesses generating day one gains or losses when entering into such contracts.

Chapter 5: Subsequent measurement
Question 8
The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset.
Do you agree with this proposed approach?
If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

We should be treating the asset like regular PPE with capex, depreciation implications and obsolescence built in. The lease obligation should be similarly treated on this amortised cost approach.

Question 9
Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

We think it highly unlikely that many preparers would opt for such an election, were it to be allowed. Nevertheless, we do not believe that the option should be available on the grounds that it would reduce comparability and might mislead users regarding performance if gains were taken to income when the relevant operating entity had financial difficulties. We would note that we have consistently argued against any options being allowed in GAAP as we value comparability highly.

Question 10
Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons.
If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows?
Please explain your reasons.

We do not believe that this annual revision is necessary as it would reduce comparability to debt financed companies who in the main do not elect to measure their financial liabilities at fair value. Furthermore we highlighted in the answer to Q. 9 that we are uncomfortable with booking gains or losses that may reflect the changing credit risk of the lessee which cannot be realised. Most businesses will have a large number of leases running at any given moment in time with new leases taken out regularly. This will mean that the liability will represent a blended average rate for leasing. Given our earlier comments in Q 6, where we highlighted the difficulty in arriving at a "correct" rate, such a blended average, with relative stability over time reflecting the normal renewal rate, will not represent a challenge for users to interpret.

Question 11
In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities.
Do you agree with the proposed approach taken by the boards?
If you disagree, please explain why.

Given that the IASB & FASB have announced that they are in the process of a complete overhaul of IAS39, we think it is appropriate to specify accounting for leases within this DP if only to frame the debate for IAS39. We hope that the revised IAS 39 will not contradict the conclusions for this leases DP as we do regard these obligations as financial in nature.

Question 12
Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement.

Would you support this approach? If so, for which leases? Please explain your reasons.

We highlight two areas where we believe that "depreciation" is not the appropriate description for the decrease in the value of the right-of-use asset in order to ensure comparability with similar businesses that have made different financing or operational choices:

- *Short term contracts, such as car hire for business trips are clearly different in nature to car hire of a fleet for sales representatives. It would be useful to reflect costs differently within the P&L. We would not define short term contracts by reference to a bright line period but would use a principle. Qualifying short term contracts are those where leased assets are not utilised "necessarily, repetitively* ***or*** *consistently for the operations of the enterprise to function internally or deliver goods and services to customers". We accept that this may introduce some subjectivity but believe that this is less concerning as the asset and liability will be fully reflected on the balance sheet and we are therefore only allowing this subjectivity to arise within P&L line items. We believe that typical examples will include items which are more likely to overlap with service provision in other businesses (e.g. lease a car vs. use taxis on a business trip, lease crane vs. hire team to install plant & machinery). Such charges for leases should be clearly analysed so users can make an assessment of the appropriateness of such charges. We believe that this is a sensible compromise for prepares who might reasonably think it is expensive to split the cost of a CU 500 car hire contract between depreciation and finance costs.*

- *Lease payments for assets which would not normally be depreciated if owned where the payment largely reflects a "financial" return to the lessor rather than compensation for the decline in the value of an asset. This will typically be limited to leases of land and some buildings.*

Outside these areas, the concern we have is that for any lease the expense will fall into two components – the "unwinding" interest on the liability and the operating cost, which over the life of the lease usually equates to the principal repayments and does usually equal depreciation. We note this is typically not the case for land or buildings relative to the true diminution in value of the underlying asset over the lease term.
We believe that the implied portfolio asset value regardless of right of use or whole asset should be amortised on a useful life basis and captured through the income statement as the depreciation for the use of a portfolio of assets. The change in the NPV of the year over year present value of the leases is the capital expenditure assuming it is a positive change. If the change is negative then there is an impairment or obsolescence/write down This means the reported rental is broken into a operating component (depreciation) and a financing component (interest cost on the corresponding liability).

Chapter 6: Leases with options
Question 13
The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term.
Do you support the proposed approach?
If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Before answering the question, we would like to mention again that a Whole Asset approach would have rendered this complex issue, which creates structuring opportunities, obsolete. The optionality of leases with ability to return the asset at various times with guaranteed exit prices could then have been disclosed.

If we accept the Rights of Use approach, we agree that the most likely lease term is the most appropriate as the alternative in most cases is an outcome that may be impossible. We would be keen to see disclosure that enables users to assess whether management are consistently under/over-estimating the most likely duration of the lease term. We would like to see changes in liability as a result of a change in estimate clearly flagged in the note which reconciles opening to closing balances. We would also be interested to know what the liability would be if all leases were expected to last until their maximum or minimum lease terms as this would enable users to understand the range of potential outcomes. We believe equity investors will tend to focus on the maximum lease term as being closer to the ownership model ensuring comparability of similar businesses, whilst many fixed income investors will focus on the minimum lease term to understand the unavoidable liability in the event of financial difficulty. This additional disclosure would also mitigate the shortcomings highlighted in the paper that a 5 year lease with an option to extend for 3 years might look the same as an 8 year lease albeit that the value of the option might inflate the right of use asset in the contractually shorter lease.

Our most significant reservation is the ability to structure leases to reduce the liability. As an example, a 3 year lease with an option to extend in year 3 by a further 6, 7 or 8 years might, at initial assessment have a probability assigned to the 4 possible alternatives of 26.5% for 3 years and, 24.5% for each of the other options and as a result the liabilities would be materially underestimated (albeit that in year 3 there would be a significant step up in the liability and asset). We suggest that consideration is given whether the best term is the first possible expiry where the cumulative probabilities rise to >50%.

We would also highlight that the value of the option may be very material for some assets, such as airplanes, where residual values are very volatile over the economic cycle. We do not think that this can be ignored and we would like to see some analysis that gives clarity to users regarding the implications of this approach with real back-tested examples rather than this theoretical discussion paper.

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Question 14

The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset.

Do you support the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

As for Q. 13 we agree with the approach but would seek good disclosure as there would be significant scope to "manage" earnings. We do believe that reassessing the lease term would be beneficial for users as this is likely to be an important signalling mechanism for understanding changes in management views regarding plans for the business – a wholesale reduction in expected lease terms might indicate uncertainty about trading prospects or plans to purchase assets in future with either outcome being important for users to understand.

The changes in the portfolio of leases should correspond to the changes in the units of revenue generators (e.g. implied capitalised leased assets for airlines increasing should indicate either an increase in the number of planes or old leases replaced with newer leases.)

Question 15

The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease.

Do you agree with the proposed approach?

If you disagree with the proposed approach, please describe what alternative approach you would support and why.

We agree but similar comments regarding disclosure and the value of the option would also apply.

Chapter 7: Contingent rentals and residual value guarantees

Contingent rentals

Question 16

The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements.

Do you support the proposed approach?

If you disagree with the proposed approach, what alternative approach would you recommend and why?

There were a range of views within CRUF on this issue. Some agreed that the liability should reflect contingent payments in order to reflect the real substance of the economic situation albeit that the legal form of the contract may not be crystallised until the contingent event has occurred. Examples where this may be the case are revenue related rents at shopping centres where a material part of the rent may *be contingent on sales but where sales are inherently predictable across such a large number of tenants so that the aggregate rents are only slightly higher than fixed rent tenancies.*

Others believed that any leasing contract where payments depended on future performance (sales, profits, asset utilisation) is materially different to a simple lease where the alternative is usually to buy the asset. In the latter case the lessee retains the full responsibility for utilising the asset to generate the full economic rent available. With contingencies, the lessor has effectively taken some of the business risk from the lessee and this risk transfer may be material if a significant proportion of the expected payments are based on a future event. At some point in this risk transfer process is the transition from an asset lease to a service contract, which would not be capitalised.

The accounting would be more straightforward if there were evidence of a full fixed rent equivalent deal available as an alternative to the contingent rent as this could be used to define the right of use asset with variations from this base rent taken to P&L as they occur. We suggest the board pursues this further to construct a principle relevant to all contingent rental payments.

Question 17
The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes.
Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

Noting our reservations to the proposal in Q16, we agree that, if all estimated contingent rentals are included, the IASB's probability weighted outcome is likely to be the most appropriate as we believe that the most frequent contingent liabilities are those where the obligation varies proportionately to sales or profits. These contingencies do not lend themselves to an approach focussed on determining the most probable outcome as each possible outcome may, in reality, have <1% chance of occurring. We would observe that the example used in the DP for 3 different sales outcomes is meaningless as these imaginary outcomes only reflect intervals along a continuum and by definition represent arbitrary points which could be determined by management in a manner which manipulates the end result. We would note that where sales are expected to occur in a normal distribution with low skew, the two results will be the same and we would anticipate management could reasonably use their budgeted sales as a proxy provided the auditors are happy that the skew in results historically is unlikely to change the probability weighted estimate materially.

We have asked that maximum and minimum lease payments are disclosed where lease duration is uncertain. Where these payments are contingent, we would not seek equivalent disclosure (as theoretically sales related rents could have no upward limit) but would like to see sensitivities to key assumptions where such leases are material (e.g. 1% CAGR in sales in premises subject to sales related rents would result in obligations which are CU XXm higher).

Sensitivities here do not yield an increase in the actual obligation at the measurement date. They are important only for forecasting purposes, so analysts can do scenario analysis and determine that the assets will grow a certain amount if the revenues do so.

Question 18
The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease.
Do you support the proposed approach? Please explain your reasons.

The key advantage to this methodology is the objective determination of some critical variables and greater comparability between companies with similar lease contracts. We would generally expect these variables to be important for both the probability weighted outcomes and for the most probable outcomes as current indices and rates are often taken as representative of the future as well. Auditors are unlikely to accept future expectations that are materially different to observable inputs. We would highlight however that current indices are often not the best indicators of the future (inflation is a good example where long run inflation expectations derived from index linked bond prices can be materially divergent from current levels of CPI or RPI).

We therefore do not believe that this rule should be mandated particularly as re-measurements would create significant restatement "noise", whilst a management assessment of the most probable outcome or their range of forecasts for probability assessments might have more information value.

Question 19
The boards tentatively decided to require re-measurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments.
Do you support the proposed approach? If not, please explain why.

Ultimately the answer to this question is contingent on the decision whether to capitalise contingent rentals in the first place. We did not fully conclude on this as we argued that there is a boundary between a service contract and an asset lease contract as risks transfer. Our optimal solution was to capitalise the full fixed rent alternative and take variations to P&L in the year that the payment was made. It follows that variations in full fixed rent equivalents would need to be monitored and reflected as a change in the value of the asset.

Question 20
The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:
(a) recognise any change in the liability in profit or loss
(b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.
Which of these two approaches do you support? Please explain your reasons.
If you support neither approach, please describe any alternative approach you would prefer and why.

We would prefer to see the change in the liability automatically applied to the right-of-use asset as an adjustment in the value of the asset as the business would be utilising an asset that is more valuable with the benefit experienced at the same time that the cost is incurred. An example of this would be sales related rents – as forecasts for future sales rise / fall and the liability rises / falls, we would prefer to see the asset rise / fall in value such that the charge for the utilisation of the asset rises / falls at the same time that the higher / lower sales are recognised in income. This is ideally a function of the change in the full fixed rent equivalent.

Residual value guarantees

Question 21

The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives.
Do you agree with the proposed approach?
If not, what alternative approach would you recommend and why?

We agree that the treatment as a contingency is appropriate although we would differentiate these by showing what the maximum and minimum residual value guarantee payments might be as these will have contractual limitations (unlike sales related rents where theoretically the obligation can be infinite).
Our comments in response to Q 16 are also relevant regarding risk transfer. We would highlight the fact that such residual value guarantees given by a lessee make the transaction even closer to a "purchase by use of credit" as the lessee bears the risk of the asset losing value faster than originally assumed. We would suggest treating the issue similar to an impairment test of owned assets.

Chapter 8: Presentation

Question 22

Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons.
What additional information would separate presentation provide?

The key thing we would like to see is the obligation shown as part of financing. If material, we would like to see the liability shown as a separate item on the face of the statement of financial position (it is sufficiently different in nature to other liabilities to justify separation) or if not material, we would be happy to have disclosure confined to the notes which expand on "Other financial obligations" on the face of the statement. We would always expect the obligation to be separately disclosed somewhere. If a "through the eyes of management" approach is adopted and management determine the obligation is operational, they should explain in detail why they believe that the lease obligation is not a form of finance for the business and such a liability should be shown on the face of the statement of financial position so that users can readily adjust numbers.

We should also have disclosure of the related deferred tax effect of the lease related debt.

Question 23
This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position. How should the right-of-use asset be presented in the statement of financial position? Please explain your reasons. What additional disclosures (if any) do you think are necessary under each of the approaches?

We prefer to see such assets accounted for on the basis of the nature of the leased item as tangible assets and we agree with the board that they are sufficiently different that they should be disclosed separately and not subsumed within the owned asset notes. Broadly speaking we agree with the conclusions in the DP regarding income statement categorisations where these should match the equivalent treatment for owned assets (depreciation / amortisation) and debt financing (interest), notwithstanding our earlier comments where we did agree that certain payments should be treated as "rental expense". (Q. 12).

We should also have disclosure of the related deferred tax effect of the lease related assets and depreciation.

Chapter 9: Other lessee issues
Question 24
Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

We believe the Board needs to consider in detail the treatment of the lease related taxes effects – current, temporary and deferred. Outside of the taxation effect, we are not aware of any other issues that need to be considered from a user perspective other than more disclosure in the footnotes to further describe the types of leases the lessee has entered into.

As we have stated in the previous responses, companies sometimes use leases instead of outright purchasing the assets for a number of reasons. Many of them under US GAAP are based on tax related issues. For example, some companies enter into lease contracts where there is a special tax treatment embedded into the lease. Under current rules, these "synthetic tax leases" are treated as operating leases and recorded off balance sheet and in essence all they represent are leases with added tax benefits. Under a synthetic lease, the lessee retains the tax advantages of ownership. Because the transaction places significant benefits, burdens and control of ownership with the corporate user, the user is regarded as the tax owner of the property and is eligible for the accelerated depreciation and interest deductions contained in the lease payments. It is clear from a tax perspective, these leases, should be capitalized and treated as if owned as they are under US tax laws.

The Corporate Reporting Users' Forum

Chapter 10: Lessor accounting

Question 25

Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

Yes as there is a symmetric obligation from the lessee who has recognised the liability.

Question 26

This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) de-recognition of the leased item by the lessor or (b) recognition of a performance obligation by the lessor. Which of these two approaches do you support? Please explain your reasons.

We believe that the most useful treatment is de-recognition of the leased item with the asset transferred to the lessee shown as a financial receivable whilst the residual value of the asset (which based on this DP has never been transferred) shown as a separately identified asset. We do not believe that grossing up the assets will provide meaningful information to users. We also note that the Whole Asset approach is also simpler for lessors.

Question 27

Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

The revenue recognition project should provide the framework to this matter and we believe that such a debate is probably best left until then. For the purposes of this DP, we do agree that it makes sense that there should be no day one gains on the inception of a lease where the lessor is not the manufacturer. Where the lessor is the manufacturer, provided that transfer pricing between the manufacturing and the financing arms is appropriately treated, we believe that profit may be recognised on the inception of the contract. In both cases revenue should probably be recognised; where no profit / loss is recognised cost of sales will equal sales.

Question 28

Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

We believe that lessors of property should apply the same accounting as for any other asset from a balance sheet perspective. The key difference will be that the assessment of the residual value is likely to form a very material part of the accounting. We would favour a fair value based approach for this such that the value of the building should be the present value of rents plus the residual value. We would also point out that we accepted that non-depreciating assets should be treated differently to depreciating assets with payments by lessors treated as a rental expense. Symmetry here would indicate that the lease receipts should be shown as rental income unless it is deemed that some are payment for a decline in the value of the building (e.g. logistics sheds may have an average 15 year life vs. CBD offices *which might have maintenance requirements that are expected to extend useful life indefinitely) in which case part of the rents should be allocated to revenue to compensate for impairment.*

Question 29
Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

We believe the Board needs to consider in detail the treatment of the lease related tax effects – current, temporary and deferred.