Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.ifrs.org)

13 September 2013

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Exposure Draft of Leases

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on this Exposure Draft (ED). Our responses to the questions raised in your Invitation to Comment are set out in the Appendix for your consideration.

Dual accounting model

We commend the IASB's significant efforts to reach out to constituents and respond to the many views expressed. However, we note that constituents in our jurisdiction have expressed significant concerns about the dual accounting model proposed for both lessees and lessors to the point where there is generally a lack of support for those proposals. Concerns have been expressed at the lack of an underlying conceptual basis and complexity of the proposals. It is unclear whether the proposal would improve comparability or reduce the number of adjustments that financial statement users make to reported financial information. Our constituents also expressed concerns that the added complexity and costs of applying the proposal would outweigh any improvements to financial reporting.

Specifically, we note that the dual model for leases is inconsistent with the Board's initial objective of introducing a single lease accounting model and in recognizing the assets and liabilities that arise from lease contracts. For Type B leases, the amortization of the right-of-use asset in each period is, in effect, a balancing figure to achieve a straight-line expense in profit or loss, and combines a financing cost and amortisation of the right-of-use asset. We question whether the subsequent measurement of the right-of-use asset under Type B reflects the pattern of its consumption and how it provides relevant information for users to calculate meaningful ratios based on carrying amounts of such right-of-use assets. We also are concerned at the lack of consistency between the proposals for lessors and lessees of Type B leases, which in effect creates three accounting models for leases, rather than two, in addition to the practical expedient for short term leases.

We believe that the inclusion of a dual measurement approach in the ED is a compromise attempt to fix a valid concern that the right-of-use model is not appropriate for all the arrangements within the current scope of the proposals. In our view, this concern has not been sufficiently addressed by these proposals and instead unnecessary complexity has been introduced by attempting to force the right-of-use model through the lessee's statement of financial position, regardless of the nature of the lease. Our position on this fundamental issue is as follows:

We continue to support the right-of-use model for those leases which contain a significant financing component (described in the ED as Type A leases, but subject to modifying the qualifying criteria discussed below). However, we do not support the use of the right-of-use model for lessors or lessees of leases which fall outside this categorization. As articulated in paragraph BC73(ii) of the ED, when the lessee is expected to consume an insignificant amount of the economic benefits embedded in the underlying asset, the lease does not represent a transfer of a significant portion of the underlying asset (i.e. Type B). In such cases, the lessor's view is that they are not primarily in the business of providing finance to lessees. Instead, their aim is to generate cash flows from the underlying asset on an ongoing basis by managing the asset over a period typically longer than any one lease term. We agree with the Board's conclusion that accounting for such a lease by recognizing the lease payments received as rental income over the lease term would appropriately reflect the lessor's business model and we believe that a mirrored accounting treatment should be applied to the lessee. This is because in our view the reasons cited in support of the treatment of accounting for such a lease by recognizing the lease payments received as rental income over the lease term would equally apply to lessees of such leases.

Therefore, we consider that a leasing arrangement which does not contain a significant financing element (i.e. broadly Type B but subject to modifying the qualifying criteria discussed below) should not be included within the scope of right-of-use model in the final standard. Instead, we consider that such leases should be accounted for in accordance with the requirements described in paragraph 93-97 for lessors, appropriately mirrored for lessees.

Lease classification

We are of the view that the classification model in the proposed standard will create unnecessary complexity in the accounting for leases. Under the proposals, leases may be classified differently based on whether the underlying asset is property or non-property. This delineation will create significantly different measurements and presentations in the comprehensive income and cash flow statements for leases that are economically similar.

We believe that the way a lease is classified should be the same for all underlying assets, regardless of their nature. The criteria for classifying a lease to be included in the scope of the right-of-use model in the standard should be based on the significance of the level of consumption of benefits of the underlying assets as is currently proposed for Type A leases (including those leases which contain a purchase option that the lessee has a significant economic incentive to exercise). This would make the Type B classification test redundant.

We understand that one of the reasons for introducing the Type B classification was that the right-of-use model would prove unnecessarily complex for lessors of property, so far as 'selling profit' and residual value calculations are concerned. However, we consider that, instead of the Type B classification criteria for property, it would be sufficient relief for lessors to exclude leases from the right-of-use model if underlying asset is an investment property which falls within the scope of IAS 40 and is carried at fair value.

This simplified approach to lease classification can be summarized as follows, as a replacement of paragraphs 28-30 and 34-35 of the ED:

> **A lease shall be recognized by lessors and lessees under the right-of-use model unless one or more of the following criteria are met:**
> **(a) the lease is a short term lease (as defined in xxx);**
> **(b) the underlying asset is an investment property carried by the entity at fair value under IAS 40 *Investment Property*;**
> **(c) the lease term is not for a significant part of the total economic life of the underlying asset; and/or**
> **(d) the present value of the lease payments is not significant relative to the fair value of the underlying asset at the commencement date.**

As mentioned above, we consider that any lease which meets any of the above criteria and does not contain a purchase option as described in paragraph 31, should be accounted for in accordance with the requirements described in paragraph 93-97 for lessors, appropriately mirrored for lessees.

We would support continuing to refer to the leases accounted for under the right-of-use model as 'finance leases' and to those which fall outside this model as 'operating leases'. Although the new requirements would in effect move the dividing line between these two types, such that far more leases currently classified as operating leases, would be accounted for as finance leases under the right-of-use model, we consider that users will find it useful to continue with the same terminology for the two types, as the basic accounting model for each type will not have changed.

We believe our classification proposal would significantly reduce the complexity surrounding the new standard, while still achieving the Boards objective of including significant financing liabilities on the lessee's statement of financial position.

Complexity of the proposals for lessors under the right-of-use model

Concerns have been raised by constituents regarding the proposals being overly complex, particularly for the measurement of the residual asset under lessor accounting for Type A leases. It is difficult to rationalize the accretion of the residual asset conceptually. To simplify, we suggest that the lessors derecognize the carrying amount of the underlying asset and allocate that amount between the portion related to the right to use granted to the lessee (i.e. the cost of 'sales') and the portion that is retained (i.e. the residual asset). The amount allocated to the residual asset would be the residual amount of the carrying value of underlying asset after deducting the amount of lease receivable which would be measured as the present value of the lease payments to be received during the lease term plus any initial direct costs incurred by the lessor less any profit relating to the lease recognized at the commencement date. No depreciation would be charged on the residual asset until after the end of the lease term.

Cost of the proposals compared to the benefits

Constituents in our jurisdiction expressed concerns as to whether the benefits of the proposals as drafted in the ED will outweigh the costs. The cost burden primarily arises from complying with the proposals in the year of transition, specifically capturing information for potentially a large volume of leases, and from the ongoing cost of the proposals due to the need to estimate discount rates, reassess the lease terms, variable payments and impairments and maintain significantly expanded asset registers. Some constituents have commented that better disclosures under the current standard (IAS 17) would be sufficient without having to implement all of the proposed changes.

We consider that our recommendations above for simplifying the classification criteria and requiring the lessee accounting to mirror the lessor accounting in respect of Type B leases will significantly address those concerns. However, if such simplifications cannot be introduced at this stage in the project, then we agree with our constituents that the benefits of these proposals do not outweigh the costs and we would not support their finalization in their current form.

If you have any questions regarding the matters raised in our submission, please contact Winnie Chan, our Associate Director of Standard Setting at winniechan@hkicpa.org.hk.

Yours faithfully,

Simon Riley
Director, Standard Setting

SR/WC

Encl.

Hong Kong Institute of CPAs

Comment on IASB Exposure Draft of Leases

Question 1: Identifying a lease

This revised Exposure Draft defines a lease as 'a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. An entity would determine whether a contract contains a lease by assessing whether:

(a) fulfilment of the contract depends on the use of an identified asset; and

(b) the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.

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? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

In principle, we agree with the proposed definition of a lease and the criteria that an entity would determine whether a contract contains a lease. They are generally consistent with the requirements in IFRIC 4. However, we believe that the boards need to provide further guidance to assist preparers in applying the definition to their lease contracts and to draw between leases and service contracts.

Right to control the use of an identified asset

We believe that it would be judgmental under the new proposals to identify whether an arrangement is or contains a lease, particularly it may be difficult to assess 'control' when the asset is not in the physical possession of and is not directly managed by the lessee. The Board should consider adding more guidance on the assessment of control, which could be developed from the new revenue recognition standard to be finalized in the third quarter of 2013.

The ED does not specifically exclude transactions that automatically transfer title of the underlying asset to the customer at the end of the lease term. Nor does it provide guidance on whether or when such transactions would transfer control of the underlying asset to the customer. Therefore, it is not clear whether such transactions are or are not within the proposal's scope.

Identifying a Specified Asset

We have concerns with the impact of substitution rights on the identification of the specified asset. We agree that substantive substitution rights should be considered when evaluating whether an arrangement relates to a specified asset. This analysis will be critical for determining whether arrangements for certain items (e.g., office equipment) are considered a service or a lease. However, the proposal is unclear as to when substitution rights are considered substantive. Paragraph 9 mentioned that a supplier's right to substitute an asset is not substantive whenever customer consent is required. It is not clear what is the level of consent would make the substitute's right become not substantive as often some form of consent will be required whenever a supplier wishes to enter a customer's premises to service or replace an asset. The boards should clarify or provide additional guidance for evaluating when substitution rights are considered nonsubstantive as a result of a barrier to exercise the substitution right.

Ability to direct the use

Paragraph 13 of the ED indicates a customer's ability to direct the use of an identified asset would be demonstrated by its ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from the asset's use throughout the term of the contract. However, the proposal is not clear how entities would determine which party is responsible for individual decisions contained in a mutually agreed upon contract. Nor does the proposal provide guidance on how to consider arrangements that include significant decisions that are jointly agreed to by the customer and supplier prior to lease commencement (i.e. in the contract) whilst other significant decisions are made during the lease term. We believe application guidance such as how to identify and weight significant decisions would be helpful.

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 agree that the recognition, measurement and presentation of expenses and cash flows arising from a lease should differ depending on whether the lease is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. However, our constituents do not agree with the dual model as drafted in the ED which is conceptually and operationally insufficiently developed.

We are concerned that there is not a conceptual basis for the current accounting model for Type B leases (most property leases), as in order to generate a straight-line expense profile, the subsequent measurement of the ROU asset is measured simply as a balancing figure, which is inconsistent with the measurement of other non-financial assets which are measured on a cost basis. We also question how the pattern of consumption as reflected in Type B provides relevant information for users to calculate meaningful ratios.

Our constituents who are lessees of large portfolios of leases (such as retailers and fast-food restaurant chains) are also concerned at the cost and effort involved in determining discount rates and applying discounting concepts on a lease by lease basis and do not consider the benefits outweigh the efforts, particularly for leases which do not contain a significant financing component, such as the Type B leases. The depth of feeling on this issue was such that some constituents in our jurisdiction requested that if the Boards insisted that the balance sheet must be grossed up for all lease commitments, then in their view the lease liability should be measured at each reporting date at the non-discounted amount of the lease payments for the minimum period during which the lessee does not have any right to cancel the lease, with an equal and opposite asset. They felt that this was information which they could extract from their reporting systems with minimal effort, as it was factual. By contrast, their concern with applying an incremental borrowing rate used by the lessee to discount the PV of the lease payments is that it is judgmental and is not comparable from one entity to the next. For example, an entity with a strong credit profile may have a lower borrowing rate and hence end up with a higher lease liability and asset amounts when compared with a company with a lower credit rating in the same transaction. Computing such discounted amounts on a lease by lease basis would be excessively time-consuming for companies with large portfolios of individual leases, with no perceived benefit for the user of the financial statements in light of the lease expense being recognized on a straight-line basis. It is also not clear, in particular for a cash rich company with no outstanding debts, how they should determine an appropriate discount rate.

The lack of conceptual merit for Type B leases is further evidenced by the boards' decision to require the presentation or disclosure of lease liabilities arising from Type A leases separately from lease liabilities arising from Type B leases. Under the ED, 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 is required to recognize a financial liability measured at amortised cost. A requirement to provide additional disclosures to enable users to reconcile amounts between the income statement (operating expense) and the balance sheet (lease obligation) is indicative of a move in the wrong direction.

In addition, we believe accounting for the current proposals would be operationally complex. The proposals not only retain the current dual-classification approach but also introduce a new bright line based on the nature of the underlying leased asset – property versus other than property. As a result, leases with similar economics will be accounted for differently solely due to the nature of the underlying asset (e.g. why is a building with a 30-year life different to a ship with a 30-year life?). Moreover, the proposals include new concepts and a judgmental threshold that are not defined or thoroughly explained in the proposals (e.g. use of majority of the useful life and substantially all the fair value criteria for lease classification in paragraph 30), which will add greater complexity for users, preparers and auditors.

We agree that, fundamentally, there are two types of leases, namely (i) leases where the lessee consumes more than an insignificant portion of the economic benefits embedded in the underlying asset where asset financing is essentially provided to the lessee; and (ii) leases where the lessee consumes only an insignificant portion of the economic benefits embedded in the underlying asset and the lessor prices the lease such that it generates a return on the investment only. The accounting and presentation should therefore reflect the different economics of these different types of leases.

We recommend that the final standard require lessees to account for all leases with a significant financing component under a single-model approach that reflects a lease as financing the purchase of a right to use asset (i.e. broadly consistent with the accounting for Type A leases in the proposal). The underlying concept in the ED is that a lessee would account for a lease as the acquisition of a right to use an underlying asset and the lessor would account for a lease as the transfer of that right-of-use in exchange for a commitment from the lessee to make lease payments. We would agree with paragraph 31 of the ED that the 'Type A' classification should extend to those leases which contain a purchase option, if the lessee has a significant economic incentive to exercise that option (subject to our comments on this new terminology set out in our response to question 5), as we consider this indicative of the lease containing a significant financing component.

For those leasing arrangements that are executory in nature without any significant financing component (consistent with Type B leases in the proposal), we consider that they should be excluded from the scope of the right-of-use model and should not be recognized on the lessee's statement of financial position. In other words, the accounting treatment for these non-financing leases should mirror the accounting treatment set out in paragraphs 93-97 of the ED for lessors for the following reasons:

We use a retail company in Hong Kong as an example: It is generally not the intention of retailers to own the properties in which their retail outlets are located nor to manage the risks associated with property investment. Instead, a retailer will enter a tenancy agreement with a fixed term of between one to three years, typically for a unit within a shopping mall. Rental payments are typically paid evenly over the term of the lease to match the period during which they are permitted to occupy the unit. As a lessee of a retail property in Hong Kong, there is limited capacity to influence or control the leased property. In fact, it is quite common that there are certain restrictions imposed by lessors, for example, covering the nature of business conducted and requirements on fit-out and renovation. In addition, for a leased retail outlet in a shopping mall, the lessor has the responsibility to properly manage the quality of the mall and stores within it as well as the tenant mix to attract traffic.

On this basis we agree with the Board's conclusion as articulated in paragraph BC73(ii) that accounting for Type B leases by recognizing the lease payments received as rental income over the lease term would appropriately reflect such a lessor's business model and we believe that the Boards should mirror this accounting treatment for lessees (i.e. to recognize the cost as a periodic operating expense, no different to other periodic costs such as payroll, cleaning services, off-site storage facilities, security etc.). In accordance with the principles in IAS 37, such leases are executory in nature and should only be provided for when the contract is onerous. Our proposal that the accounting for lessees of such Type B leases should mirror the accounting treatment set out in paragraphs 93-97 of the ED for lessor is entirely consistent with those principles in IAS 37 and is well understood by both preparers and users of financial statements.

In our response to Question 4 we provide further details of our proposals in respect of simplifying the classification tests, to identify which leases should fall under the right-to-use model and which should be treated as executory in nature.

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 broadly agree with the proposed lessor accounting for Type A leases where the lessor would account for a partial disposal of the underlying asset, in the same way that the lessee would account of the acquisition of the ROU asset. However, we consider that the model itself is complex and costly for entities to apply, particularly for the measurement of the residual asset. We understand from constituents in the shipping industry, for example, that they have significant concerns on determining the fair value of the residual assets given the significant fluctuation of Baltic Index in recent years. In addition, the residual value that is assessed under the ED is different from current practice. Currently, it is rather simple to determine the residual value of vessels as they are usually estimated based on its value as scrap. However, under the ED, the fair value would be assessed on the portion that is not leased out. This will create additional valuation challenges. In addition, in principle we do not support accretion and recognition of interest income on the residual asset as it is difficult to rationalize conceptually and also it is inconsistent with how other non-financial assets (e.g. PPE and inventory) are accounted for under IFRS.

To simplify, we suggest that a cost approach should be adopted where lessors derecognize the carrying amount of the underlying asset and allocate that amount between the portion related to the right to use granted to the lessee (i.e. the cost of "sales") and the portion that is retained (i.e. the residual asset). The amount allocated to the residual asset would be the residual amount of the carrying value of underlying asset after the amount of lease receivable being measured as the present value of the lease payments to be received during the lease term plus any initial direct costs incurred by the lessor less any profit relating to the lease recognized at the commencement date. No depreciation would be charged on the residual asset until after the end of the lease term.

In respect of Type B leases, we agree with the proposed accounting treatment set out in paragraphs 93-97 of the ED. However, as discussed more fully in our response to question 4 below, we believe that the classification tests can be simplified, such that this accounting treatment is available whenever the underlying asset is an item of investment property carried at fair value under IAS 40.

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?

Our constituents disagree with the notion that the nature of the underlying leased asset is an appropriate proxy to determine which accounting model to apply. This approach will result in economically similar transactions being accounted for differently solely due to the definition of property. It is not clear whether the boards intended for certain structures that are attached to land or property, or buried under land, to be considered property assets or non-property assets under the proposal. For example, certain assets such as cell towers and wind farms, which are attached to property and cannot be removed and/or used separately without incurring significant cost, would most likely be considered 'other than property' under the proposal. Other assets such as ships, railcars, and storage containers also have characteristics similar to that of a building, in that use of the asset may not result in the significant consumption of the economic benefits embedded in the underlying asset.

The boards acknowledge in BC51 that although a classification approach that is based on the nature of the underlying asset would make the classification proposals much simpler, it would not always result in conclusions that are consistent with the consumption principle. We are concerned that the proposed requirements will create diversity in practice. In addition, delineating leases based on the whether the underlying asset is property will add complexity in terms of defining and interpreting what is considered property.

Further complexity arises from this delineation being the first step in the classification and then introducing 'unless' exceptions which differ depending on whether the underlying asset is property or non property. We found that constituents found this further level of detail particularly hard to grasp.

In our view, when evaluating lease terms as part of the lease classification, the approach applied should be consistent for leases of property and non-property. We consider that there is no conceptual basis for the proposed difference in the classification criteria that is based on the *remaining* economic life of the underlying asset in the case of *property* and the *total* economic life of the underlying asset in the case of *non-property assets*. Comparing the lease term of leases of assets other than property to the 'total' economic life of the underlying asset (rather than the 'remaining' economic life) may result in leases of certain older non-property assets being classified as Type B leases.

For example, a two-year lease of an aircraft would likely be insignificant to the total economic life of the aircraft. Therefore, regardless of the age of the aircraft at the lease commencement date (i.e. even very late in the economic life of the asset), such a lease would be classified as Type B. However, a two year lease of a building near the end of its economic life may result in the lease being classified as Type A because the lease term would be compared to the remaining economic life of the building. We agree with the Alternative View of two IASB members as discussed in paragraph AV5 that it is arbitrary and unnecessarily complex to have different criteria for assessing the lease term when classifying leases. The boards should decide on the use of one metric, either the 'remaining useful' life of the asset or the 'total useful' life of the asset, for performing the evaluation.

We believe that the way a lease is classified should be the same for all underlying assets, regardless of their nature, and that the criteria for classifying a lease to be included in the scope of the right-of-use model in the standard should be based on the significance of the level of consumption of benefits of the underlying assets as currently proposed for Type A leases. This would introduce greater conceptual consistency into the proposals and it would also simplify the proposals as it would make the Type B classification test redundant.

We understand that one of the reasons for introducing the Type B classification was that the right-of-use model would prove unnecessarily complex for lessors of property, particularly property that consists of many smaller units, such as a shopping mall, where each unit may be the subject of a separate tenancy, so far as day one 'selling profits' and residual value calculations are concerned. However, we consider that, instead of the Type B classification criteria for property, it would be sufficient relief for lessors to exclude leases from the right-of-use model if the lease is of an investment property (or part of an investment property) which falls within the scope of IAS 40 and is carried at fair value.

This simplified approach to lease classification can be summarized as follows, as a replacement of paragraphs 28-30 and 34-35 of the ED:

A lease shall be recognized by lessors and lessees under the right-of-use model unless one or more of the following criteria are met:

(a) the lease is a short term lease (as defined in xxx);

(b) the underlying asset is an investment property carried by the entity at fair value under IAS 40 *Investment Property*;

(c) the lease term is not for a significant part of the total economic life of the underlying asset; and/or

(d) the present value of the lease payments is not significant relative to the fair value of the underlying asset at the commencement date.

As mentioned in our responses to questions 2 and 3, we consider that any lease which meets any of the above criteria and does not contain a purchase option as described in paragraph 31, should be accounted for in accordance with the requirements described in paragraph 93-97 for lessors, appropriately mirrored for lessees.

We would support continuing to refer to the leases accounted for under the right-of-use model as 'finance leases' and to those which fall outside this model as 'operating leases'. Although the new requirements would in effect move the dividing line between these two types (from 'substantially all' to 'more than insignificant'), such that far more leases currently classified as operating leases would be accounted for as finance leases under the right-of-use model, we consider that users will find it useful to continue with the same terminology for the two types, as the basic accounting model for each type will not have changed.

.

We believe our classification proposal would significantly reduce the complexity surrounding the new standard, while still achieving the Boards objective of including significant financing liabilities on the lessee's statement of financial position.

In addition, though the ED does not define nor prescribe a threshold for 'insignificant', we note that IE7 of the Illustrative Example suggests that 16.6% and 27.8% of economic life and FV, respectively, would not be deemed to be insignificant. We suggest that the Boards should develop examples on other than clear-cut scenarios to help constituents apply the principle-based proposals as intended and to prevent constituents from misinterpreting the benchmark.

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?

We welcome that the Board has accepted our previous recommendation that the lease term should not be based on the longest term more likely than not to occur, as was suggested in the 2010 ED. We agree with the proposal on lease term which would be determined at the lease commencement date based on the non-cancellable period of the lease, together with the periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option.

However, under the proposals, a new threshold for including renewal periods and excluding termination periods would be introduced – 'significant economic incentive'. It is not clear whether the concept of 'significant economic incentive' would provide a threshold that is similar to the concepts of 'reasonably certain' in IAS 17. We consider the boards should provide some guidance on whether the differences in terminology between 'significant economic incentive' and 'reasonably certain' will result in different outcomes to prevent inconsistent application.

In addition, we agree with the analysis of economic factors developed by the Board in paragraph B5. However, as the proposed approach requires the lease term to be determined from the perspective of a lessee, we are concerned with how lessors would consider the relevant factors when determining whether the lessee has an economic incentive to exercise an option. We recommend presenting the analysis of economic factors as application guidance and provide illustrative examples for each type of factor to help both the lessee and lessor to assess whether there is a significant economic incentive for a lessee to exercise or not exercise renewal or termination option.

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?

We agree that when measuring the lease obligation and right-of-use asset, the lease payments should include those payments that are fixed or which are, in-substance, fixed. We support the inclusion of variable payments based on an index or rate. We welcome the IASB's decision to exclude usage and performance-based variable lease payments from the measurement of the lease liability and lease receivable as we do not consider that such payments, which are contingent on future events, meet the definition of a "present obligation" of the lessee. We also consider that to include such amounts which are dependent on trading conditions in the future in the measurement of an asset which will be amortised over the whole period of the lease would significantly distort the expenses reported each period. We believe 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.

In addition, we are concerned that the notion of 'in-substance fixed payments' is not clearly articulated in the ED. The application of this notion in the ED is mostly based on the illustrative examples. Furthermore, these examples could be interpreted that the intended scope of 'in-substance fixed payments' is limited to price floor. We believe that examples cannot replace principles-based requirements and may be interpreted in different ways. We suggest that the boards should provide a principle to identify in-substance fixed payments.

Paragraph 72 of the ED proposes that when a lessor reflects an expectation of other variable lease payments in the rate that it charges the lessee and those variable lease payments are not included in the lease receivable, the lessor would adjust the residual asset on initial recognition. In subsequent periods, that adjustment would be unwound and a portion of the carrying amount of the residual asset would be transferred to profit or loss. We are concerned that applying these requirements in practice could be difficult. 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 and provide additional guidance on how to apply the reassessment requirements when the lessor's discount rate includes an expectation of variable lease payments, together with a clear worked example.

Question 7: Transition

Paragraphs C2–C22 state that a lessee and a lessor would recognise and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

Are there any additional transition issues the boards should consider? If yes, what are they and why?

While we are generally supportive of the transition guidance within the ED, we are concerned about the possibility of differences between the transition provisions of the proposed leases standard and the final revenue recognition standard. As lessors may have arrangements that fall within both the proposed revenue recognition standard and the proposed leases standard, there would be implementation challenges for the adoption of the two standards if the transition provisions (e.g. cumulative effect transition alternative) are not consistent. Therefore, we recommend that the transition provisions for the final leases standard be consistent with the transition provisions of the forthcoming revenue standard.

Question 8: Disclosure

Paragraphs 58–67 and 98–109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised in the statement of financial position; and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

Generally, we consider that the disclosure requirements are excessive. We have concerns that if the new accounting model is providing the information that users need, it is difficult to understand why the disclosure burden is increased when compared to existing IFRSs. As mentioned in Q2, we note that a number of disclosures require information to be segregated between Type A and Type B leases. A requirement to provide additional disclosures to enable users to reconcile amounts between the income statement and the balance sheet might be indicative of a move in the wrong direction for the proposed dual-accounting model.

We consider that our proposal for simplifying the accounting model for lessees and the classification test, as set out in our responses to question 2 and 4 above, would result in a considerable reduction in the amount of information that would need to be disclosed, particularly by lessees, as the accounting models adopted by the lessee would generally be understandable to the users of the financial statements, with the main change being only that the right-of-use (a.k.a. finance lease) accounting model would capture a greater number of leases than is the case under IAS 17.

The ED proposes that the requirement to disclose maturity analyses in accordance with paragraphs 39(a) and (b) of IFRS 7 would not apply to lessees and that instead in accordance with paragraph 67 of the ED the lessee would be required to disclose a maturity analysis by annual time bands for a minimum of the first 5 years and a total for the remaining years. It is unclear why a lessee would be required to disclose a more detailed maturity analysis for lease liabilities and lease receivables compared to the maturity analysis for other financial liabilities and financial assets under existing IFRSs. This requirement also effectively encourages the preparer to provide this information in a separate note from the liquidity risk disclosure required by IFRS 7.

We do not support the approach taken to the disclosure of this information. In our view, the on-balance sheet lease liabilities should be analysed together with other financial liabilities in the maturity table required under IFRS 7.39. In addition, in respect of the remaining leases (i.e. those without a significant financing component) which under our proposals above would be accounted for in accordance with paragraphs 93-97 (as mirrored for lessees), we consider that lessees should be required to include the non-cancellable contractual commitments under these leases as additional line-item information in the liquidity risk analysis, in a similar way to the requirement in IFRS 7.B11B to include all loan commitments and in IFRS 7.B11C(c) to include the maximum amount of an issued financial guarantee, irrespective of whether this amount has been provided for under IAS 39.47. This disclosure requirement could also usefully include the requirements currently found in IFRIC 4.15(b), which require disclosure of committed payments for services as well as lease components, when the lessee concludes it is impracticable to separate the payments. In this way, gross contractual cash outflows which represent liquidity risk are grouped together in appropriate time bands, providing useful information to the user who wishes to assess the entity's exposure to liquidity risk and its ability to manage it.

In addition, the boards should consider making the roll forward disclosure requirements for Type A right-of-use assets consistent with the requirements of IAS 16, IAS 38 and IAS 40.

Additionally, the boards should clarify the presentation requirements for short-term lease payments, variable lease payments, and payments for non-lease components.

Question 9, 10 and 11 in the ED are for FASB only

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

The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.

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 agree that a right-of-use asset of an underlying investment property should be measured in accordance with IAS 40. However, we have concerns on the determination of the fair value of a ROU asset. Currently, the guidance in IAS 40 is usually applied only to an interest in investment property held under a finance lease which typically would not include variable lease payments or unrecognized optional lease payments. We suggest the IASB develop practical application guidance for preparers to determine the fair value of ROU assets.

~ End ~