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Staff Paper

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Project **Leases**

Topic **Comment letter summary — main issues**

Purpose of this paper

1. This paper summarises the feedback received in response to the boards' exposure draft *Leases* (ED), which was published for public comment in August 2010.

2. Before and after the publication of the ED, both IASB and FASB project staff and board members have reached out to several thousand organisations and professionals to explain the proposals and to obtain feedback. Detailed feedback about these activities to date was provided during the October 2010 Board meeting (Agenda Paper 15). These activities included:

   (a) seven roundtables in London, Hong Kong, Chicago and Norwalk held in December 2010 and January 2011. These were attended by representatives from over 80 interested parties and included one roundtable focused on private and not for profit entities;

   (b) fifteen preparer workshops in London, Tokyo, Seoul, Melbourne, São Paulo, Toronto and Norwalk held in November and December 2010 and attended by representatives from over 90 organisations;

   (c) outreach meetings in which the staff and boards met globally with over 1500 organisations in over 200 meetings since publication of the ED.

In doing so we have engaged with around 2300 individuals, including over 500 users. These meetings included:

   (i) presentations during accounting conferences;

   (ii) keynote presentations at industry forums;

   (iii) investor calls; and

   (iv) meetings with individual organisations or groups;

(d) preparer questionnaires completed by over 250 lessors and over 400 lessees relating to their use of leases;

(e) project webcasts and podcasts which each attracted between 500 and 1000 participants; and

(f) publication of articles in professional journals and on the IASB and FASB websites.

3. The project pages on the boards' websites contain further details about these activities.

4. The summary feedback included in this paper is based on the staff's preliminary analysis of respondents' comment letters as well as on feedback received from these outreach activities undertaken by board and staff members.

5. A detailed analysis of feedback received on specific proposals in the ED will be presented to the boards when redeliberations on those proposals begin. This paper does not include any staff recommendations and the boards will not be asked to make any technical decisions at this meeting.

6. This paper should be read in conjunction with agenda paper 5B / FASB memo 124, which proposes a plan to achieve the boards' stated objective of issuing a joint leases standard for US GAAP and IFRSs during 2011.

Overview of the comment letters

7. The four-month comment period on the exposure draft ended on 15 December 2010. As of 12 January 2011, the boards have received 760 comment letters. Appendix A provides a summary by type of respondent and geographical region.

8. The response rate to this ED was very high, firstly because many entities are involved, either as a lessee or lessor, in lease transactions. Consequently, it is not surprising that a diverse range of industries are well represented in the responses, including retail, financial services, real estate, transportation, power and utilities, tourism and hospitality. Some of the concerns raised by those respondents were specific to their industry (eg interpreting whether a specific contract is a lease or a service arrangement), but many concerns expressed were shared by respondents from a range of different industries.

9. The relevance of the proposals—in terms of their application across industries and geographical regions —is also evident from the high response rate from preparers as well as from the substantial number of responses from auditors, accounting professional bodies, national standard-setters, industry organisations and other interested parties including academics. Although responses from users were limited, board members and staff focused much of their outreach efforts on those groups to ensure that their views could be included in the boards' redeliberations on the project.

10. The very high response rate can be attributed to the leases project being an IFRS-US GAAP convergence project. This has also resulted in the comment letters being received from a geographically diverse range of respondents. In addition to the responses received from the FASB's constituents and the IASB's constituents from jurisdictions that have been using IFRSs since 2005 (such as Europe and Australia), responses were also received from:

    (a) jurisdictions that are adopting IFRSs for the first time in 2010 or 2011, including Brazil, Canada and South Korea, or have that have plans to adopt IFRSs from 2012, such as India; and

(b) other jurisdictions that are in the process of making a decision on whether to adopt IFRSs in the future, including Japan.

Structure of the paper

11. The comment letters summary is presented as follows:
    - (a) Overall views (paragraphs 12-18)
    - (b) User views (paragraphs 19-35)
        - (i) Simple lease – lessee accounting
        - (ii) Simple lease – lessor accounting
        - (iii) Complex features
    - (c) Summary of feedback on the main elements of the proposals (paragraphs 36-58)
    - (d) Lessee right-of-use model (Questions 1 and 3) (paragraphs 59-83)
        - (i) Recognition of a right-of-use asset and a liability to make lease payments
        - (ii) Pattern of profit or loss recognition
        - (iii) Short-term leases
    - (e) Lessor accounting model (Questions 2 and 3) (paragraphs 84-104)
        - (i) 'Hybrid' model
        - (ii) Derecognition approach
        - (iii) Performance obligation approach
        - (iv) Short-term leases
    - (f) Definition of a lease (Questions 4-6) (paragraphs 105-132)
        - (i) Differentiation between service and lease contracts
        - (ii) Contracts containing service and lease components
        - (iii) Scope exclusions
    - (g) Complex features (Questions 7-11) (paragraphs 133-178)

(i) Lease term

(ii) Purchase options

(iii) Lease payments

(iv) Reassessment

(v) Sale and leaseback

(h) Presentation (Question 12-14) (paragraphs 179-194)

(i) Disclosures (Question 15) (paragraphs 195-204)

(j) Effective date and transition (Question 16) (paragraphs 205-213)

(k) Benefits and costs (Question 17) (paragraphs 214-217)

(l) Other matters (Question 18) (paragraphs 218-227)

(i) Private companies that apply US GAAP

(ii) Discounting

(iii) Accounting between inception and commencement of a lease

(iv) Areas where additional guidance is requested

(m) Appendix – Comment letters demographic information

Overall views

12. Most respondents supported the boards' efforts in jointly developing a single, comprehensive and converged lease accounting model for US GAAP and IFRSs.

13. There was general support for the boards' efforts to address criticisms of the current 'bright-lines' that exist in the current lease accounting guidance and the objective of improving information provided to users of the financial statements by providing greater transparency and comparability. In this regard, most respondents supported the recognition of lease obligations and related assets on the lessee's statement of financial position.

14. However, significant concerns were expressed relating to the:
    (a) complexity and cost of implementing the proposals, specifically the initial and subsequent measurement of lease assets and liabilities;
    (b) reduced comparability arising from the level of estimation and judgement required by the proposals (eg determination of lease term and calculation of variable lease payments);
    (c) definition of a lease, and whether all arrangements meeting the proposed definition should be accounted for in accordance with the proposals; and
    (d) direction and objectives of the proposals on lessor accounting.

15. These concerns included observations on the interaction between these issues, the risk of creating new bright-lines to replace existing bright-lines and the pervasive implications that simplifying the guidance on these matters would have on the overall proposals.

16. Many respondents and participants in round tables and workshops urged the boards to focus on providing a high quality standard, rather than focusing on meeting specific project time lines. They communicated that significant changes are needed to the ED if the boards are to proceed with a comprehensive standard on leases.

17. A number of respondents also recommended that further field-testing should be performed on elements of the proposals, assessing the cost/benefit of changes that the boards may make in the final standard, specifically relating to:
    (a) the criteria for differentiating between a service and a lease;
    (b) revisions to the current lessor accounting model; and
    (c) which elements of lease contracts should be recognised rather than disclosed.

18. Finally, several respondents applauded the boards and staffs for their efforts to reach out and engage with preparers, users and auditors, specifically after the publication of the ED.

User views

19. Although comment letters from users have been received, the staff obtained a considerable amount of additional feedback from users during their outreach activities. A summary of this feedback has been included below:

Simple lease—lessee accounting

20. Almost all users already make adjustments to capitalise operating leases on the statement of financial position and so they support the right-of-use model in principle. Some think that this would provide better information than the broad assumptions used today (eg those that apply multiples to disclosed lease payments may use numbers such as 6 to 8, which are often carried over from past calculations that may not accurately reflect an entity's lease term or discount rate). This is particularly important for users when calculating leverage ratios because operating leases are taken into account when assessing leverage.

21. However, some users say that they will still adjust the statement of financial position if a right-of-use model is implemented because they support a whole asset approach, or because they want to measure liabilities or assets that would result from cash flows over the life of an entity (on a going concern basis). Other users commented that they would find improved information on entities' long-term contract commitments useful, regardless of whether they arise from leases or from other contractual arrangements.

22. At present, some users separate rental expense on operating leases into an interest and a depreciation component and therefore support the proposal to that effect which was included in the ED. However, they do not calculate the interest expense from a mortgage-type liability; instead, they split the straight-line rent expense that has already been recorded. This does not have the same profit or loss effect as the proposals would. Other users prefer all expense to be treated as rental expense, with many users commenting that they see lease cash flows as operating, not financing, in nature. The users that support interest plus amortisation expense support the proposals in the ED because they agree that the lease is a source of financing of the right-of-use asset.

23. Some users do not make adjustments to the amounts recognised in the profit or loss for operating leases and are they are therefore concerned about the proposed approach which results in a higher lease expenses in earlier periods compared to later periods.

Simple lease—lessor accounting

24. Many users did not report any adjustments being made to current lessors' accounting. Users are still considering the proposed lessor approach. To date, reactions have been mixed, with some users preferring two different approaches, while some are calling for a single approach consistent with lessee accounting. Those who support a dual approach think that it makes sense because there are two different business models associated with leasing. When asked about statement of financial position and profit or loss treatment for specific scenarios, almost all users that we met with supported different approaches to the underlying asset, depending on the characteristics of the lease.

25. As in the case of lessee comments, some users prefer profit or loss to be more similar to actual cash flows. Many users are uncomfortable with the lessor recognising higher lease expenses in earlier periods compared to later periods, although some users said they supported the removal of straight-line rents because, in the past, they think that some lessors have manipulated rents to achieve the highest possible GAAP income.

26. This profit or loss pattern proposed was a particular concern with long-term property leases as it suggests that most of the economic value of the lease is gained early in the lease which some users in their view do not think reflect the economics of the transactions. This distortion is further magnified the longer the lease term. Some users asked for these property leases to be scoped out entirely.

27. In their analysis, users focus on exposure to residual assets and the impairment analysis of the underlying asset of the lessor and they note that this is not disclosed in current accounting.

28. Users are also often very interested in the residual value of the asset. Almost all users commented that, if the derecognition model is to be used, the residual asset should be accreted or measured at fair value so that entire income can be recognised over the lease term and not be deferred until the end of the lease.

Complex features

29. Users had mixed views on the treatment of complex features. They have not had significant information in the past about variable lease payments or options to extend or cancel leases, unlike the information that the proposed model would provide. They welcome better access to this information, but disagree on how best to provide it.

30. Some think that estimates are a part of business and that including them in measurement, similar to other accounting estimates, provides the best possible information on the statement of financial position, as long as users can understand the assumptions that were made about these features (ie via disclosure). They argue that statement of financial position presentation and footnote disclosure have different weights and that footnotes are not audited as robustly.

31. Users also cited the difference in timeliness of information provided in the financial statements and information provided in the notes. They identified that information presented in the financial statements is usually available earlier (typically in an earnings release) that information included in footnote disclosures.

32. Others would prefer to see only the minimum contractual on the statement of financial position and see additional, detailed information disclosed about options to renew or cancel and contingent lease payments in the footnotes, because of the uncertainly in estimating such amounts. Some industry-focused users (eg retail) are particularly uncomfortable with including optional lease terms in the statement of financial position, because they think that options to extend are negotiated to provide the lessee with flexibility and do not represent obligations of the lessee.

33. Some think that economic compulsion should be reflected in the recognition of renewal terms. Those users did not think that an expectation of renewal without some economic incentive to do so (eg the existence of significant leasehold improvements) is enough.

34. Many users did not think that performance-based and usage-based contingencies were liabilities and thought that only index-based contingencies should be recognised. Some users did think that accounting should reflect constructive obligations and support expected value measurement, which could be on a portfolio, rather than lease-by-lease basis.

35. When asked about leases with 100 per cent contingent lease payments (eg based on sales), users also had mixed reactions. Some want to estimate these amounts themselves and think that management is too biased or uses too much judgement in making future estimates. Others think that management has the best information about the future contingent lease payments linked to sales and would like those amounts to be included in the statement of financial position, as long as users can understand how the amounts are calculated when looking at the notes.

Summary of feedback on the main elements of the proposals

Lessee right-of-use model

36. Many respondents expressed support for recognising a right-of-use asset and a liability to make lease payments as a result of a contract that meets the definition of a lease, although some respondents struggled with applying one model to all leases (eg because of concerns about viewing all lease contracts as defined in the ED, such as real estate leases, as a financing of a right-of-use asset).

37. However, there were mixed views on the pattern of profit or loss recognition for lessees with:

    (a) some respondents, specifically those from accounting firms and standard-setter respondents supporting the proposals in the ED; and

    (b) Other respondents, specifically those from the leasing industry, some users and preparers, supporting an annuity-based or mortgage-based amortisation of the right-of-use asset to create a straight-line profit or loss pattern similar to current operating lease accounting.

38. Almost all respondents supported providing a simplified lessee accounting approach for short-term leases. However, many of them proposed that this simplified approach should be consistent with current operating lease accounting, rather than the approach proposed in the ED.

Lessor accounting model

39. Many respondents observed that the lessor accounting proposals in the ED were less developed than those for lessee accounting. They believe that the boards need to perform significant additional work as part of their due process, including field-testing, before finalising any amendments to lessor accounting.

40. A significant number of respondents questioned whether the lessor accounting proposals were an improvement to current financial reporting, noting that the:

    (a) current lessor accounting model is not 'broken'.

    (b) cost / benefits of any proposed changes should be carefully evaluated and considered because the financial reporting outcomes may not be significantly different from the application of current US GAAP or IFRS.

    (c) complexity of lessor accounting is increased, rather than simplified.

41. Consequently, respondents offered a variety of proposals for the path forward for lessor accounting, with significant support expressed for developing a:

    (a) single lessor accounting model, consistent with the lessee accounting model; or

    (b) lessor accounting model that would be consistent with the *Revenue from Contracts with Customers* exposure draft (the Revenue Recognition ED); or

    (c) business model approach to lessor accounting that would more closely reflects the economics of lease transactions (which may lead to retaining, or substantively retaining, the guidance in current IFRS/US GAAP).

42. Overall, respondents had mixed views on whether the boards should proceed with:

(a) proposals to change the lessee accounting model, acknowledging that the main objective of the proposals should focus on lessee accounting, and address lessor accounting later; or

(b) a complete project analysing both lessee and lessor accounting because only by looking at both together can the boards resolve issues about proposals relating to either lessee or lessor accounting.

Definition of a lease

43. The majority of respondents recommended that the boards need to perform additional work to develop the definition of a lease in the ED because the definition is based on interpretations in IFRS and US GAAP to address a very narrow set of circumstances rather than the broad range of contracts that may be affected by the ED. They suggested that the definition should be narrowed and they identified examples in which the assessment of whether a contract should be accounted for as a lease or a service is difficult.

44. Many respondents agreed with the principle of separating the service and lease components of a contract but were concerned that when the service and lease components are not distinct, both lessees and lessors are required (always in the FASB ED, and for (a) lessees and (b) lessors applying the performance obligation approach in the IASB ED) to apply lease accounting to the combined contract.

45. The majority of respondents:

(a) commented that if the boards appropriately defined a leases contract in the Leases project and appropriately defined a sale in the Revenue recognition project that additional guidance on distinguishing a lease from a purchase or sale contract would not be needed; and

(b) supported the scope proposed in the ED, although significant concerns were raised relating to the:

(i) requests by the US real estate industry to enable them to apply guidance similar to IAS 40 *Investment Property*; and

(ii) proposal to scope out leases of intangible assets.

Lease term

46. Almost all respondents disagreed with the definition of the lease term as the longest possible term that is more likely than not to occur.

47. As an alternative to the proposals in the ED, many respondents supported either:

(a) increasing the threshold for taking into account options to renewal from ‘longest possible lease term that is more likely than not to occur’ to either ‘reasonably assured’ (current US GAAP), or ‘reasonably certain’ (current IFRSs), with respondents noting that current practice generally works well, or ‘virtually certain’ (which would nearly equate to including only contractual minimum lease payments); or

(b) the Alternative View to reflect options to cancel and extend leases in measurement of lease assets and liabilities only when the lease contract includes incentives for the lessee or lessor to exercise the options.

Lease payments

48. Many respondents disagreed with the proposal to estimate lease payments, term option penalties and residual value guarantees using an expected outcome technique. These respondents commented that estimating variable lease payments would:

(a) be costly and challenging to reliably estimate; and

(b) create significant volatility in profit or loss.

49. Users supported additional disclosure relating to contingent lease payments but were mixed in their views on whether amounts recognised in the financial statements should reflect:

(a) only contractual minimum lease payments (allowing users to apply their own judgement to estimate contingent lease payments, based on disclosures of non-contractual lease payments);

(b) in-substance contractual lease payments; or

(c) the proposals in the ED (noting that management estimates are useful and would not prevent users from making further revisions from management estimates, based on information disclosed in the notes).

50. Many respondents suggested alternative approaches such as:

(a) those proposed in the Alternative View, which advocated including only contingent lease payments based upon indices or rates and excluding contingent lease payments that vary with usage or performance (noting that similar guidance in current US GAAP works well in practice);

(b) including only those contingent lease payments which that are outside of an entity's control and are therefore unavoidable; or

(c) changing the estimation approach from 'expected value' to an alternative estimation technique (eg to be consistent with the threshold for recognising options to renew or cancel leases).

Other matters

Purchase options

51. Respondents had mixed views on the proposal to only account for purchase options when they are exercised. Some respondents agreed with the proposals, although others proposed that the accounting for purchase options should be consistent with the accounting for options to cancel or extend a lease.

Sale and leaseback

52. Many respondents are concerned that the threshold for recognising a transaction as a sale and leaseback is set too high and is inconsistent with the Revenue recognition ED.

Presentation

53. Many respondents proposed that entities should be allowed to apply judgement in determining which leases line items should be presented separately in the income statement or statement of financial position, rather than being required to do so.

Disclosures

54. Respondents expressed concern about balancing the objective of providing useful information to users with the burden created for preparers by requiring potentially voluminous, boiler-plate disclosures.

Transition

55. Many respondents recommended permitting, but not requiring, entities to apply the guidance on a fully retrospective basis, specifically as a way of overcoming the profit or loss 'front-loading' effect of the simplified retrospective transition approach proposed in the ED.

Effective date

56. Many respondents recommended an extended lead-time before entities are required to apply the proposals. This is because of the:
    (a) significant burden of assessing a significant number of contracts to determine whether they meet the definition of a lease, and
    (b) complexity of the requirements for recognition and measurement for those contracts that meet the definition of a lease.

Private companies that apply US GAAP

57. Feedback from private companies that apply US GAAP was consistent with the feedback from public companies. This included support for the proposals to be applied consistently by both public and private companies that apply US GAAP and concerns with the complexity and cost of implementing the proposals. However, private companies that apply US GAAP requested that the effective date be later than for public companies applying US GAAP.

Other

58. Additional concerns were noted relating to:

    (a) discount rates;

    (b) accounting for transactions (eg build-to-suit leases) between the inception and commencement dates; and

    (c) other issues that respondents highlighted should be addressed in the final standard.

Lessee right-of-use model (Questions 1 and 3)

Recognition of a right-of-use asset and a liability to make lease payments

Support for the proposals

59. Many respondents agreed with the proposals in the ED for recognising a right-of-use asset, together with a liability to make lease payments, when a contract meets the definition of a lease, noting this proposal is consistent with the boards' main objectives for the Leases project and with the adjustments that are currently made by users.

60. These respondents believed that recognition has the benefit of:

    (a) eliminating the existing bright-line tests between finance and operating leases that currently create the structuring of off-balance sheet arrangements; and

(b) consistency with the adjustments currently being made by users such as rating agencies.

61. However, these respondents had concerns with issues relating to the recognition of these assets and liabilities. These concerns included how the definition of leases gives rise to these assets and liabilities and also the proposals for measuring and recognising components of the lease contract. These issues are discussed below.

Concerns relating to the proposals

62. Many respondents expressed some level of concern with the proposals relating to whether:

(a) one lessee accounting model can be applied to all lease contracts (eg retailers and the hotel industry in particular do not think the proposed model reflects their business activities);

(b) all leases should be considered as being similar to financing the acquisition of an asset, rather than being operational in nature;

(c) the boards have clearly articulated why a lease contract should be accounted for in a manner that is different to the accounting for executory contracts (eg employment and utility contracts); or

(d) the boards' objectives could be better achieved through either revising the bright-lines that exist in present lease accounting standards or else through enhancing disclosures.

63. Some of these respondents were also concerned that the proposals would change lessees' business behaviour. When asked, some lessees indicated that if the proposals were finalised, they might buy some assets rather than lease them. Others indicated that they enter into the lease for specific economic reasons (cash flows and flexibility), and that they would not change their behaviour because of the proposed changes to the accounting for leases.

64. Other respondents expressed concern about the measurement approach proposed for the right-of-use asset and the liability to make lease payments. They noted that lessees with a strong credit profile will recognise a larger liability because of the lower incremental borrowing cost that they will apply to discount future lease payments. However, lessees with a strong credit profile would probably have lower lease payments overall, and would also recognise less interest expense over the lease term.

Suggested approaches

65. In relation to the measurement of assets and liabilities arising from lease contracts, respondents suggested that:

(a) the amount capitalised by the lessee as a right-of-use asset should be capped at the fair value of the underlying asset (eg for 100-year land lease where the total lease payments may exceed the fair value of the land).

(b) additional guidance is needed when lease payments are denominated in a foreign currency and on whether changes in foreign exchange rates should lead to the adjustment of the right-of-use asset rather than be recognised in profit or loss (eg in the airline industry where leases are typically denominated in USD).

(c) the right-of-use asset should always, or alternatively, never, be permitted to be revalued in order to enhance comparability.

Pattern of profit or loss recognition

Support for the proposals

66. Almost all respondents supported the proposal to discount the liability to make lease payments using the effective interest method, noting it to be consistent with the measurement of financial liabilities.

67. However, respondents had mixed views on the boards' rationale that the combined pattern of profit or loss recognition for the right-of-use asset and the liability to make lease payments should be consistent with the pattern that would arise from financing an acquisition of the underlying asset, with:

    (a) Some respondents, specifically those from accounting firms and standard-setters supported the proposals in the ED; and

    (b) others, specifically the leasing industry, some users and preparers, supported applying annuity-based or a mortgage-based, amortisation of the right-of-use asset. Under this approach, the combination of amortisation and interest expense would be recognised on a straight-line basis, resulting in a profit or loss pattern for lease expense, similar to current operating lease accounting.

Concerns relating to the proposals

68. The respondents that disagreed with the profit or loss recognition pattern proposed in the ED noted that the proposals create:

    (a) higher lease expenses in earlier than later periods for all current operating leases;

    (b) significant deferred tax assets for lessees;

    (c) inconsistency with the accounting for purchasing the underlying asset with finance, because a purchase is unlikely to be 100 per cent debt financed; and

    (d) further divergence from the cash payments made for the lease contract (eg the expense recognised by a lessee in the final year of a lease is very different to the expense recognised by the same lessee in the first year of a replacement lease).

69. Concerns were also raised relating to the nature of the items recognised in profit or loss. A minority of respondents, including many users, believe that the expense recognised represents rental expense, rather than a combination of amortisation and interest expense or that the allocation of expense between amortisation and interest expense should vary, depending on the nature of the underlying lease asset.

70. Regulated industries and governmental contractors (particularly US based) raised concerns with the effect that the proposed profit or loss pattern and line item classifications might have on their ability to recover costs (eg interest expense may have different cost recovery attributes to rental expense).

Suggested approaches

71. Many respondents noted that the boards acknowledge that a lessee's asset and liability are linked upon initial measurement and believe that this linkage should continue to be reflected in subsequent measurement. This is because the right-of-use asset and the liability to make future lease payments are components of the same contract. Unlike a transaction to finance the acquisition of an asset, the right-of-use asset cannot exist in isolation without the lease payment obligation.

72. As a result, these respondents believe that lessees should amortise a right-of-use asset on an annuity-basis or mortgage-basis so that in the case of leases with even rental payments, absent the effects of impairments, revaluations and initial direct costs, these assets and liabilities will remain equal throughout the lease term.

73. Users also expressed support for a profit or loss pattern that is closer to the current straight-line approach applied in the present operating lease model. This is because they view it as a closer approximation to cash flows relating to the lease contract. However, users did not generally indicate any current concerns at present about the profit or loss pattern recognised by lessees for existing finance lease contracts, the pattern of which is consistent with the proposals in the ED.

Short-term leases

Support for the proposals

74. Almost all respondents supported the boards' efforts to provide a simplification for short-term lessee accounting.

75. Some of these respondents noted that the risk profile of a short-term lease would result in a lessor demanding a premium and minimise the risk of lessees structuring short-term arrangements to take advantage of the simplification.

Concerns relating to the proposals

76. However, some of the respondents observed that the requirement to discount short-term leases is not considered to be a significant time or cost driver for preparers in implementing the proposals. Instead the burden relates to the costs of identifying, tracking and recognising a potentially significant number of short-term leases. Consequently, they do not think that the proposed simplification meets the boards' objective.

77. A few respondents were concerned that providing a simplified short-term lessee accounting approach replaces one bright-line between operating and finance leases with another bright-line between short-term and long-term leases. Consequently, the proposal would create structuring opportunities, specifically if the simplification could be elected on a lease-by-lease basis, and would create an unnecessary exception to underlying principles.

Suggested approaches—simplified short-term lease accounting

78. Many respondents encouraged the boards to align the lessee simplification proposals with the lessor proposals. As a result, for short-term leases (as defined in the ED), a lessee would not recognise an asset or a liability. Instead the lessee would effectively apply the operating lease accounting treatment that exists in current IFRSs/US GAAP, with guidance requested to be provided on how the lessee's profit or loss on short-term leases should be:

    (a) recognised (ie straight line basis?); and

(b) presented (ie amortisation, interest or rental expense?).

79. A few respondents also requested that the scope of the simplification should be amended, for example to include contracts with a lease term of less than 24 or 36 months or where the ‘short-term’ assessment is made in the context of the useful life of the underlying asset. These respondents noted that this would address concerns relating to having to recognise assets and liabilities for many low-value equipment and short-term property leases.

80. Some respondents also suggested that the simplification should be required, or subject to an accounting policy election that would apply to all short-term leases, rather than being elected on a lease-by-lease basis. They believe this would promote comparability.

Suggested approaches—alternatives to simplified short-term lease accounting

81. As an alternative to providing a simplified approach to short-term lease accounting, a minority of respondents proposed that the boards could provide increased relief for preparers by providing additional guidance relating to the materiality of contracts that would be required to be accounted for in accordance with the standard.

82. This additional guidance could:

(a) require a materiality assessment to focus only on materiality of the statement of financial position if the profit and loss pattern was on a straight-line basis, rather than in accordance with the approach proposed in the ED.

(b) require capitalisation of a right-of-use asset only if the underlying asset would be capitalised if it was purchased, based on capitalisation thresholds and disclosure of that capitalisation threshold.

83. Another alternative identified by respondents was to refine the definition of a lease so that a simplification for short-term leases would not be required. For example, by defining a lease as requiring that the right to use the underlying asset must be conveyed for a specified period of time that exceeds 12 months.

Lessor accounting model (Questions 2 and 3)

Multiple approaches to lessor accounting

Support for the proposals

84. A minority of respondents supported the concepts underpinning the proposed lessor accounting model noting that the approach is:

    (a) reasonably consistent with the present lessor accounting models in IFRS and US GAAP which are generally well understood and recognises the different business models employed by lessors; and

    (b) appropriately based upon an assessment of whether the lessor retains exposure to significant risks or benefits rather than on a control approach.

Concerns relating to the proposals

85. However, almost all respondents expressed concerns relating to the proposed approach to lessor accounting, stating that the proposals:

    (a) do not represent an improvement compared to the current lessor accounting model, because they do not better reflect the different economics of different lease transactions (eg time value of money, lease income, residual value and tax effects) and because they create additional complexity (eg the number of potential lessor accounting models);

    (b) are inconsistent with requiring only one right-of-use approach for lessees (eg problems arise with inconsistency between treatment of intercompany leases);

    (c) highlight uncertainty in identifying the nature of the lessor's performance obligation; and

(d) focus on an assessment of risks and benefits and should be consistent with the control concepts that are embodied in the proposed definition of a lease and the principles of recent board proposals, specifically the Revenue recognition ED.

86. The majority of respondents, including a number of workshop participants, also identified problems in the guidance provided on determining whether, for a specific transaction, the performance obligation or derecognition approach should be applied. These respondents were concerned that the proposals:

(a) may imply that the performance obligation would be the default approach and that the derecognition approach would apply only when the residual interest held by the lessor is very insignificant;

(b) lead to preparers defaulting to using the performance obligation approach where operating lease accounting had previously been applied and the DR approach when finance lease accounting had been applied;

(c) create a new bright-line and increase complexity and subjectivity for lessors in determining which approach to apply;

(d) do not focus sufficiently on the lessor's business model or its exposure to credit and asset risk; and

(e) may reduce comparability with similar transactions accounted for in a different manner.

87. A few respondents also requested that additional guidance should be provided on whether:

(a) reassessment of a decision to apply the performance obligation or derecognition approach should be required when significant events occur after inception of the lease; or

(b) when a lease contract includes two underlying assets, for example land and a building, one approach can be applied to one underlying asset (eg performance obligation for the land) and a separate approach for the other underlying asset (eg derecognition for the building).

Derecognition approach

Support for the proposals

88. Almost all of those supporting the derecognition approach believe it to be conceptually consistent with the right-of-use lessee accounting model because it reflects a view that the lease contract is transferring existing rights from the lessor to the lessee at commencement of the lease.

89. Specific support for the derecognition approach came from a number of national standard-setters, some of the accounting firms and some lessor industry groups (eg for equipment, where the underlying contract has limited service components and the lessee consumes a significant portion of the benefit of the equipment during the term of the lease contract). There was strong geographical support from Europe and Asia.

Concerns relating to the proposals

90. The majority of respondents expressed some level of concern with the proposed derecognition approach, including:

    (a) derecognition of part of the underlying asset by the lessor is misleading if the lessor retains legal title to the underlying asset;

    (b) neither the lessee nor the lessor recognise the underlying physical asset;

    (c) the approach is not suitable for certain types of leases (eg a two-year lease of a floor in a building or a lease with significant service components); and

    (d) it moves the accounting for direct finance, leveraged and sales-type leases further away from the economics (eg tax implications) of the transaction.

91. Many respondents also expressed concerns relating to the proposal to 'freeze', rather than to accrete the carrying amount of the underlying asset that is reclassified as a residual asset at the date of commencement of the lease. These respondents noted that:

(a) lessors attribute significant importance to the residual asset and that the fair value of the residual interest is of significant interest to users;

(b) delaying recognition changes in the value of the residual asset until the end of the lease term is inconsistent with how lessors negotiate lease contracts;

(c) the proposals are inconsistent with the requirement to measure the residual asset at fair value of at transition; and

(d) lessors (specifically those in IFRS jurisdictions) should be required or allowed to measure the residual asset at fair value, either through profit or loss or other comprehensive income (eg if the lessor applies the revaluation model to the class of property, plant and equipment to which the underlying asset belongs).

92. A few respondents also identified concerns that:

(a) guidance is required to address the situation in which the present value of the future lease payments exceeds the fair value of the underlying asset (eg a lease of land). In this situation, would the residual asset be measured at zero?

(b) additional guidance is required for remeasuring assets and liabilities as a result of a reassessment event, specifically because the residual interest is not accreted over the lease term.

(c) the proposed methodology for determining the amount of the asset to be derecognised might not always faithfully depict the transaction and changes should be made to the proposed derecognition formula.

(d) the derecognition approach may provide implementation challenges for entities bound by Sharia law.

Performance obligation approach

Support for the proposals

93. Respondents supporting the performance obligation approach noted that recognition of lease income over the lease period, rather than at commencement of the lease, is more appropriate for some transactions where the lessor's performance obligation is not considered satisfied at commencement (eg a two-year lease of a floor in a building or a lease with significant service components).

94. As a result, there was significant support for the performance obligation approach from the real estate industry (in situations where a fair value model is currently not applied to a leased investment property) and from lessors who believe that their contracts are an inseparable bundle of an underlying asset and a significant service component (eg for equipment leases in which the contracts embed required maintenance services). Specific geographic support for the performance obligation approach came from the US.

Concerns relating to the proposals

95. Many respondents expressed concerns about the proposed performance obligation approach. The most significant of these were that the performance obligation approach:

    (a) is conceptually inconsistent with the lessee right-of-use model because the existence of a remaining performance obligation implies that the lessor still has to perform under a contract, even though the lessee has recognised the asset it has received under the contract and its obligation to pay for that asset.

    (b) results in a more aggressive profit recognition than the derecognition approach or existing IFRSs/US GAAP in some situations;

    (c) is not an improvement upon current accounting guidance for operating leases;

(d) leads to uncertainty in how an impairment analysis should be assessed and whether cash flows would be double counted when assessing the recoverability of the underlying asset and the lessor receivable; and

(e) is inconsistent with the Revenue recognition ED, specifically because a lessor recognises a receivable is even though the performance obligation has not been satisfied.

Suggested approaches – support for a single lessor approach

96. Many respondents recommended that the boards continue to develop their thinking about lessor accounting with the objective of identifying a single lessor approach. These respondents commented that a single approach should be consistent with the:

(a) approach developed for lessees; and

(b) principles for defining a lease, specifically whether the focus should be on a physical underlying asset or on the rights associated with an underlying asset.

97. Some respondents supported further development of a multiple-approach model to lessor accounting, because they do not believe a single model can appropriately depict all of the very different business models of lessors. They requested that the boards:

(a) provide more application guidance to assist entities in determining which approach should be applied. This need was highlighted during the workshops when preparers were identifying different approaches to be applied to what seemed to them to be economically similar transactions.

(b) focus more on reflecting the economics of the different lessor business models (eg exposure to asset and credit risk, implications of taxes).

(c) start with the current lessor accounting model in US GAAP and IFRSs but replace perceived bright-lines with clear principles.

98. A number of respondents supporting either a single or multiple approaches to lessor accounting recommended that the boards seek consistency with the *Revenue recognition* project, either through:

    (a) the timing of when a single model identifies and recognises lessor performance obligations and associated profit or loss; or

    (b) basing the criteria for determining which multiple approaches should be applied on control, rather than risks and benefits criteria.

99. Other respondents noted that the current guidance in IFRSs and US GAAP is not 'broken' and that the proposals in the ED are either not an improvement or not enough of an improvement to justify the costs of implementation. These respondents did not support changing lessor accounting, at least in the near term, noting that:

    (a) the symmetry between the lessor and lessee accounting is not necessary (for instance, it rarely exists in other accounting transactions eg revenue);

    (b) the boards should finalise other related projects (eg revenue and, for US GAAP respondents, investment properties) before addressing lessor accounting; and

    (c) accounting for subleases could be addressed either by providing specific guidance (eg requiring all sub-leases to be accounted for using a derecognition approach) or through disclosure.

100. However, many respondents were concerned with the possible issues that may arise if lessee accounting was addressed separately from lessor accounting.

Leveraged leases

101. Many respondents agreed that a separate accounting model for leveraged leases should not be provided. These respondents believe that reducing the number of ways in which a lessor can account for a lease transaction and eliminating special purpose rules, especially those that create divergence between IFRSs and US GAAP, will improve the understandability of lease accounting for users.

102. However, a minority of respondents were supportive of maintaining a separate approach for leveraged leases, noting that the current guidance in US GAAP provides a good representation of the economics of these transactions.

103. A number of respondents proposed a potential compromise approach whereby grandfathering provisions are provided for the accounting for those leverage leases existing at the date of transition to the new standard.

Short-term leases

104. Almost all respondents supported the boards' simplification proposals for short-term lessor accounting, although some concerns, similar to those discussed in respect of the proposals for short-term lessee accounting were also expressed (eg structuring concerns and whether the simplification should be elective or required).

Definition of a lease (Questions 4 – 6)

Differentiation of service and lease contracts

Support for the proposals

105. The majority of respondents supported maintaining a definition of a lease that is:

(a) consistent across IFRS and US GAAP; and

(b) based on some of the underlying principles included in current IFRSs and US GAAP.

Concerns relating to the proposals

106. The majority of respondents believe that the boards need to perform additional work to develop the definition of the lease in the ED. They observe that the definition and supporting guidance in the ED:

(a) was based on interpretations in IFRS and US GAAP to address a narrow set of circumstances and that it is inappropriate to carry-forward this guidance to the broad range of contracts that may be affected by the ED;

(b) does not provide a clear rationale for why leases should be accounted for differently from executory contracts;

(c) is not based on an underlying principle (eg whether the asset subject to a lease is a right to an asset or an underlying tangible asset) that is consistently applied through the ED for both lessees and lessors; and

(d) will be subject to additional stress and structuring focus because of the significant difference in accounting for a contract as a service or a lease as proposed in the ED, with the definition creating a new bright-line.

107. The majority of respondents were concerned that the definition of a lease was too broad and would scope in contracts that were perceived to be service contracts. Specifically, they noted concerns as to whether it is appropriate for the customer to recognise an unconditional obligation to make lease payments and the lessor to recognise an unconditional right to receive lease payments, when these payments are fully contingent on providing future services.

108. Comment letter respondents and participants in the workshops identified a number of examples where the assessment of whether a contract should be accounted for as a lease or a service is challenging and where the conclusions under the proposals may not be intuitive. These include:

(a) time-charter arrangements in the shipping industry;

(b) multiple elements of outsourcing contracts;

(c) ‘non-core’ assets (eg photocopiers and computers), although the majority acknowledged the difficulties identified by the boards in seeking to define non-core;

(d) season tickets for sporting events;

(e) wet leases in the aircraft industry;

(f) oil rigs in the energy industry; and

(g) power purchase agreements (eg when renewable energy credits are involved or pricing is stated in the contract but varies over time).

109. Respondents also identified a number of issues arising in current practice with applying the criteria in the ED for determining whether a lease exists. These issues relate to:

(a) the *specified asset* criterion

(i) unnecessary focus on the asset (eg registration number) being explicitly identified in the contract, leading to structuring opportunities, rather than on the control of the asset.

(ii) lack of clarity in identifying the unit of account (eg whether it can be a component of an underlying physical asset such as a space/capacity on a telecommunications cable, a pool of assets such as a group of rail cars or whether it should be aligned with other accounting guidance (eg on property, plant and equipment)).

(b) interpreting the *conveying the right to control the use* criterion

(i) ’ability or right to operate’ in situations when the lessee is directing, but relying on individuals from the lessor or a third party to operate the right-of-use asset (eg time charters in the shipping industry or wet leases in the aircraft industry where performance is dependent on crew provided by the lessor).

(ii) 'output' and whether it should be based on physical or economic outputs (eg when, in addition to electricity, renewable energy credits (RECs) are an output from a wind farm and have significant economic value).

(iii) 'contractually fixed per unit of output' in situations when pricing is stated in the contract but subject to an inflation factor or a fixed escalation clause, is different in different periods (eg because of seasonality, on/off-peak pricing or different amounts in different years of the contract), is a stated amount that varies with the volume of output or is determined based upon an index (eg a commodity price index).

(iv) 'current market price' and whether this requires a liquid spot market to exist.

Suggested approaches – lease definition

110. Common themes suggested by respondents for the next steps that the boards should take in defining a lease were as follows:

(a) develop an underlying principle for the definition of a lease which explains:

(i) why lease contracts are different from executory contracts;

(ii) the relationship between a lease contract and an underlying physical asset (ie is the leased item the entire, or a portion of an underlying physical asset or a right);

(iii) the significance of a right to use, or right to access capacity of the underlying asset rather than the right to output or consumption of the underlying asset; and

(iv) whether the intent and business model of either the lessee or the lessor should affect whether a contracts is a lease.

(b) focus on the principles of what constitutes the underlying asset in the lease contract and consequently the relative significance of whether the underlying physical asset is:

  (i) available to be separately purchased (eg some asset components or portions of land may not be available for separate purchase by the lessee).

  (ii) consumed by the lessee during the lease term (eg investment property which may not depreciate in value over the lease term).

  (iii) leased for a period that is significant in the context of its useful life (eg two-year lease of a new aircraft).

  (iv) fungible and interchangeable and whether the lessor has the ability to replace the asset and continue to perform under the contract, regardless of whether substitution 'rarely occurs in practice' (eg outsourcing contracts).

  (v) exclusively available for use by the lessee during the lease term.

  (vi) conveying any economic benefit to the lessee without the provision of services that are included in the contract or considered a delivery mechanism for a service (eg digital television set-up boxes and modems/routers for providing internet service).

(c) clarify the current criteria applied to determine whether a contract is a lease by:

  (i) reviewing any guidance that was not carried forward from the existing IFRSs and US GAAP lease definition and clarifying the rationale for not doing so; and

  (ii) providing further application guidance to address the current practice issues identified in paragraph 109.

(d) consider whether, if the definition of a lease contract captures fewer contracts than at present, the boards should as part of another project consider the enhanced disclosure of service contract commitments.

Distinguishing a lease from a purchase or sale contract

Support for the proposals

111. There was little support for providing additional guidance on distinguishing a lease from a purchase or sale contract if the boards make improvements to the definition of a lease.

Concerns relating to the proposals

112. The majority of respondents commented that if the boards appropriately define a leases contract in the *Leases* project and a sale in the Revenue recognition project, then the additional guidance on distinguishing a lease from a purchase or sale contract would be unnecessary and, consequently, the complexity created by that guidance and the existence of multiple definitions of a sale would be avoided.

113. These respondents stated that if these terms are appropriately defined then contracts would either be accounted for in the final standard on *Leases* or *Revenue recognition*, noting that the guidance in the ED was developed by the boards when the model proposed that lessors would always apply the performance obligation approach.

114. These respondents believe appropriately defining a sale and a lease would address a concern that in-substance purchase or in-substance sale contracts would be scoped out of Leases but would not meet the criteria to be accounted for in accordance with Revenue recognition project, considering that transactions that are not sales should be accounted for in accordance with guidance in the final standard on *Leases*.

115. Many respondents also expressed concerns with the introduction of the term ‘trivial’ in distinguishing a lease from a purchase or sale contract, noting that the:

(a) term trivial is not defined; and

(b) boards have not explained how trivial aligns with other terms used in the ED such as 'insignificant' or ‘minor’.

116. A few respondents commented that if the boards retain guidance on distinguishing a lease from a purchase or sale contract that this should focus on control, rather than a combination of risks and benefits and control. This could include:

(a) the notion that a bargain purchase option or transfer of title at the end of the lease term indicate that control has transferred from the lessee to the lessor; and

(b) alignment with the guidance in IFRIC 12 *Service Concession Arrangements* for identifying where a grantor has control of infrastructure assets (within IFRSs).

Suggested approaches

117. The majority of respondents proposed that guidance on distinguishing a lease from a purchase or sale contract should not be brought forward into the final standard on Leases as this issue should be addressed through the development of a clear definition of a lease.

Contracts containing service and lease components

Support for the proposals

118. Many respondents agreed with the principle of separating the service and lease components of a contract and for using the Revenue recognition ED as the basis for identifying service components.

119. Respondents were generally split on whether they supported the FASB views not to separate (expressed in paragraph BC52 of the ED) or the IASB views to separate (as expressed in paragraph BC53 of the ED) for lessors applying the derecognition approach. However, respondents encouraged the boards to reach a converged view.

Concerns relating to the proposals

120. Many interested parties, specifically in the US, expressed concerns both in their comment letters and during workshop and roundtable events with the proposals. These concerns included whether it was the intent of the boards that the following, which may not be distinct components of a contracts, be included as lease payments:

(a) common area maintenance (CAM), insurance and property taxes (eg in real estate leases); or

(b) executory costs (which are currently scoped out of the definition of lease payments that exists in US GAAP).

121. Some respondents also identified conceptual concerns with the proposals, questioning whether:

(a) it is appropriate for a lessee to apply the guidance in the Revenue recognition ED to identify and separately account for service components when the lessee is receiving, rather than providing, the services.

(b) the right-of-use asset and lease liability are overstated when service components are non-distinct.

122. It was also apparent during workshops that many lessee participants think that it is practically difficult to allocate between the service and lease components in a contract. Specific concerns were noticed by time-charterers in the shipping industry and lessees of oil rigs where the contract rates are market-driven, rather than being based on a split between lease and service. Most lessor workshop participants believed that they would be able to separately measure the service and lease components in a contract.

Suggested approaches

123. Respondents proposed alternative approaches to accounting for contracts that contain both service and lease components. These approaches included suggesting:

(a) carrying forward guidance similar to current US into the Leases standard to define lease payments and clarify that payments for services and executory costs, including CAM, insurance and taxes should be excluded.

(b) that the boards switch the focus to whether the underlying leased asset, rather than the services component, is distinct.

(c) assessing on a quantitative (eg relative fair value basis) and/or qualitative basis (eg assessing the service component relative to the amount of the benefit of the underlying asset that is consumed by the lessee) which component of the contract is the most predominant and accounting for the whole contract accordingly (eg a season ticket for sporting events would be considered a service in its entirety).

(d) including all mandatory services in the liability and right-of-use asset calculations. If a service is optional, the service component should be excluded from the liability (eg if a copier requires monthly maintenance, rather than it being optional, it would be included in the lease liability).

Scope exclusions

Support for the proposals

124. Almost all respondents supported the proposed exclusions to the scope of the ED, with the exception of intangible assets.

125. Specifically, there was significant support for excluding lessors that measure their investment property at fair value in accordance with IAS 40 *Investment Property* from the proposals. The real estate industry in IFRS reporting jurisdictions expressed a strong belief that the fair value model in IAS 40 provides users with useful information.

126. However, the support for the exclusion of intangible assets was mixed, although the majority of respondents did agree with the decision for the reasons the boards had explained in BC36.

Concerns relating to the proposals

127. A minority of respondents, especially those involved in the pharmaceutical and outsourcing industries, expressed concerns with the proposal to exclude intangible assets from the scope of the proposals, commenting that:

(a) it is inconsistent with the proposals in the Revenue recognition ED which provide guidance on the sale of intellectual property.

(b) practical application concerns may exist when accounting for a lease contract relating to both tangible and intangible underlying assets (eg a lease of IT software and hardware or a property with a gaming licence).

128. A minority of respondents also identified concerns with the proposed scope relating to investment properties, commenting on the:

(a) need to incorporate into US GAAP guidance consistent with the scope and fair value measurement guidance in IAS 40;

(b) lack of comparability that may occur depending on whether an entity makes an accounting policy election in accordance with IAS 40 to measure investment properties on a fair value, rather than cost basis; and

(c) importance of the boards exposing for comment full consequential amendments to IAS 40 prior to finalisation of a Leases standard.

Suggested approaches

129. A few respondents suggested clarifying the scope of the proposals relating to whether the standard should apply when the underlying asset in the contract is:

(a) anything other than an item, or portion, of property, plant and equipment;

(b) an item of inventory (eg fuel and spare parts);

(c) a financial asset;

(d) accounted for in accordance with IFRIC 12; and

(e) timber (because of the specific guidance that exists in ASC Topic 905).

130. Some respondents also suggested that if specified underlying assets are excluded from the standard, guidance should be provided on whether the accounting can be analogised to the new Leases standard (eg when a contract relating to an intangible asset was accounted for as a lease in accordance with current IFRS).

131. In relation to the proposed IAS 40 scope exclusion, respondents suggested that the:

(a) FASB develop guidance on an accelerated basis that replicates IAS 40;

(b) scope exclusion should apply to all investment property accounted for in accordance with IAS 40, regardless of whether the cost or fair value model is applied, if the fair value of the investment property is disclosed;

(c) lease of assets other than investment properties be excluded from the scope of the standard if they are accounted for using a fair value model; and

(d) boards consider excluding all property leases (for both lessees and lessors) from the standard.

132. A few respondents also made suggestions to clarify the scope exclusion relating to minerals, oil, natural gas and similar non-regenerative resources.

Complex features (Questions 7 – 11)

Lease term

Support for the proposals

133. Many respondents agreed with the boards that options to cancel and extend leases affect the economics of lease contracts and supported a consistent approach for applying the lease term definition to both lessees and lessors.

134. Many of these respondents agreed with the views of the boards that, although having some conceptual merit, accounting separately for renewal and other options embedded in a lease contract would be overly complex and burdensome. However, a minority of respondents continue to support an approach of separately accounting for some, if not all of these options, with measurement either on a fair value or intrinsic value basis.

Concerns relating to the proposals

135. Almost all respondents disagreed with the definition of the lease term as the longest possible term that is more likely than not to occur.

136. Many respondents, especially preparers and auditors, expressed concerns with, and demonstrated in workshops, the cost of complying with the proposals. They commented that determining lease term as defined in the ED would:

(a) be very time-consuming because the current functionality of IT accounting systems and nature of the estimation required would lead to a manually-intensive process with inputs to the estimation process required from many senior organisation members;

(b) lead to unreliable estimates at the contract level. For example, the retail industry noted that within a portfolio, some retails stores are likely to underperform and, consequently, the leases will not be renewed. However significant challenges exist in identifying which individual stores are likely to underperform.

(c) decrease comparability due to the difficulty of estimations (eg in assessing lease terms associated with rigs in the energy industry, factors such as drilling success, the quality of associated service, commodity prices and weather will all affect renewal assessments).

(d) place a challenging burden on lessors to estimate the behaviour of lessees.

(e) create significant estimation uncertainty when a lease term goes beyond the period of an entity’s business plan, acknowledged in IAS 36 *Impairment of Assets* as a period not exceeding 5 years, (eg long-term property leases) or when the lease relates to a start-up activity.

(f) add complexity and cost to the audit process.

137. Many respondents acknowledged the boards’ concerns relating to the structuring risks associated with options to cancel and extend leases. However, these respondents discouraged the boards from defining lease terms purely to avoid structuring arguing that:

(a) as noted in the Alternative View, options provide flexibility (eg the hotel and retail industries are concerned that the reduced leverage they gain by entering into contracts with variable rents will not be appropriately reflected under the proposed lease term definition);

(b) a 5 year lease with an option for a further 5 years should not be accounted for as a 10 year lease if the option is expected to be exercised because the economics are different between the two lease contracts; and

(c) option flexibility would be reflected in contractual minimum lease payments (eg a lessor would demand a premium if the lessee wanted to structure a lease contract in a way that reduces the lease term).

138. The majority of respondents also expressed concerns relating to the consistency of the lease term proposals with the boards’ conceptual frameworks. These respondents argued that:

(a) options to cancel and extend leases do not create financial liabilities for lessees and assets for lessors because the lease payments are contractually avoidable and consequently do not meet the definition of a liability or an asset until the options are exercised.

(b) for lessees, these options are not a liability as future payments are at their discretion (ie within their control), will only occur in conditions that are favourable to the lessee and their recognition is inconsistent with how other IFRSs and US GAAP treat unavoidable firm commitments.

(c) for lessors, the receivable for lease payments will only arise as a result of a future action taken by another party (ie they are outside of the lessors' control) and written options are generally viewed as liabilities rather than assets.

(d) counter-intuitive outcomes arise with the lessee reporting a higher liability and the lessor a higher receivable in situations where the lessee has the benefit of optionality. Similarly, if an option is not exercised, a lessee would get a significant one-off gain and a lessor a significant one-off loss that do not reflect the economics of the lease contract.

(e) recognition of assets and liabilities when the lease payments in option periods are at fair market value is inappropriate.

139. Some respondents also commented on the commercial aspect of options to cancel and extend leases. These respondents pointed out that:

(a) decisions to renew leases are usually taken near to the end of the contractual lease term;

(b) business plans rarely consider actions to be taken beyond the first break point in a lease; and

(c) options to cancel and extend leases are frequently not exercised, but instead are used as a renegotiation tool by both lessees and lessors at the end of the contractual lease term.

140. Many respondents and workshop participants questioned the practical application of the proposals, querying how the lease term would be determined in situations when a lease contract includes:

(a) month-to-month renewal terms/open-ended/'pay-as-you-go' contracts (eg construction equipment such as scaffolding);

(b) a right of first refusal, or statutory right for the lessee to renew at the end of the lease term (eg tenancy agreements in some European countries);

(c) 'evergreen' statutory or implicit renewal terms (eg in some Asian jurisdictions, tenants have an infinite right to renew that may be outside of statute or the terms of the contract);

(d) options relating to different underlying assets (eg an option relating to a different floor in a building);

(e) terms permitting cancellation by either the lessee and/or the lessor; or

(f) purchase options (eg when they are not considered to be bargain purchase options).

141. A few respondents also noted that because financial statements are generally prepared on a going concern focus, then it could be argued that assumptions for lease terms should be broader than just focusing on renewals included in lease contracts. This is because there is no significant economic difference between an entity that has corporate headquarters, and will need those headquarters for an infinite period of time, and an entity that has either an option to extend at market rates or the ability to relocate to a similar office at the end of the current lease term. These respondents encouraged the boards to consider whether the objective of the lease term definition is to focus on:

(a) contractual future lease cash flows;

(b) estimating all future lease cash flows; or

(c) in-substance contractual future lease cash flows.

Suggested approaches - support for a higher recognition threshold

142. As an alternative to the proposals in the ED, many respondents supported either:

(a) increasing the threshold for taking into account options to renew from 'longest possible lease term that is more likely than not to occur' to either 'reasonably assured' (current US GAAP), 'reasonably certain' (current IFRS), with respondents noting that current practice generally works well, or 'virtually certain' (which would be close to just including contractual minimum lease payments); or

(b) the Alternative View to reflect options to cancel and extend leases in the measurement of lease assets and liabilities only when the lease contract includes incentives for the lessee or lessor to exercise the options. This would include qualitative indicators such as the:

(i) customisation and specialised nature of the underlying asset;

(ii) existence of leasehold improvements; and

(iii) penalties payable on cancellation of the lease.

143. If the boards were to pursue one of the alternative approaches above to defining the lease term, a number of respondents were supportive of providing additional disclosure, by type of contract, of renewal periods and minimum lease payments in those renewal periods.

144. A few respondents (especially preparers) also suggested that if the boards were to proceed with the lease term definition in the ED that entities should be:

(a) permitted to assess the longest possible lease term that is more likely than not to occur on a portfolio, rather than lease contract basis. However, although users indicated that this approach may be acceptable, significant concerns were raised regarding whether a portfolio approach would be auditable; or

(b) required to apply a 'best estimate' approach to determining the lease term.

Purchase options

Support for the proposals

145. Respondents had mixed views on the proposal to only account for purchase options when they are exercised. Some respondents agreed with the proposal that a purchase option should not be accounted for as a purchase until a future event, the exercise of the option, has occurred.

Concerns relating to the proposals

146. However, other respondents disagreed with the proposal to only account for purchase options only when they are exercised. Instead, they proposed that the accounting for purchase options should be consistent with the accounting for options to cancel or extend a lease.

147. These respondents argued that this approach would recognise that:

    (a) purchase options are in substance the same as ongoing renewal options and so should be accounted for in a similar manner;

    (b) bargain purchase options should be recognised;

    (c) avoid establishing a distinction between leases and in-substance purchases/sales that lead to a bright-line similar to the current operating/finance lease distinction which the boards are seeking to eliminate.

Suggested approaches

148. Some respondents suggested that the accounting for purchase options should be consistent with the proposals for renewal assumptions. These respondents supported extending the accounting discussed in paragraph 142 to the accounting for purchase options.

149. In expressing these views, many respondents supported consistency in the measurement approach and probability estimate techniques used between the measurements of different components of a leases contract.

150. Respondents also noted that this approach should lead to a lease transaction that meets the criteria for a sale in the Revenue recognition ED being accounted for as a sale and all other transactions being accounted for in accordance with the Leases ED.

Lease payments

Support for the proposals

151. Consistent with the responses to the proposals for lease term, respondents agreed with the boards' observations that excluding all contingent lease payments may create structuring opportunities.

152. However, respondents encouraged the boards to balance anti-abuse objectives with an approach that was operational in practice, noting that contracts that may concern the boards (eg 100% contingent arrangements with no contractual minimum lease payments):

(a) are rare in practice;

(b) could only be entered into with the payment of a significant premium to lessors; and

(c) should potentially be considered service, rather than lease contracts.

153. Many respondents were supportive of the boards' proposals for measuring:

(a) residual value guarantees, noting that they should be included as they are unconditional rights and obligations where only the amount is contingent; and

(b) option penalties, noting that estimation assumptions should be consistent with the entity's determination of the lease term.

154. Almost all respondents supported the requirement that lessors should only include payments that can be measured reliably, agreeing with the consistency in the Revenue recognition ED.

155. A few respondents also expressed support for not separating contingent lease payments between different categories, noting that this approach may be operationally complex.

Concerns relating to the proposals

156. Almost all respondents disagreed with the proposals to recognise contingent lease payments on an expected value basis. Many of these concerns were consistent with those raised on the proposed definition of the lease term.

157. Specifically, many respondents, especially preparers and auditors, expressed concerns with, and demonstrated in workshops, the cost of complying with the proposals for estimating lease payments for many of the reasons described in paragraph 136. Respondents also expressed concerns with the stress that the proposal put upon the definitions of assets and liabilities and the profit or loss volatility that would be created.

158. Many respondents were also concerned with the application of an expected value approach to determining lease payments, noting that it would require judgemental probability weightings to be applied to already judgemental estimates of lease payments.

159. These respondents also questioned whether a reliability threshold, similar to that included for lessors, should also be applied by lessees, consistent with other guidance in US GAAP and IFRS.

160. For example, these respondents noted significant concerns with the reliability of contingent lease payment estimates and the risk of manipulation of long term estimates (eg estimates of future sales of a retail store with a 2 year minimum lease period but an expected lease term of 20 years because of the existence of options to extend, will depend on external factors such as the macro-economy, competition, performance of the mall that are difficult to predict over an extended period).

161. Many respondents expressed concerns relating to the proposals for measuring lease payments that depend on future performance or usage. These respondents commented that:

(a) the obligation to make these payments only exists when a future economic event (ie future use or future performance) occurs.

(b) performance-related payments are economically structured to provide a sharing of future risks between the lessee and lessor (eg in the retail industry, leases for store space in a mall may involve a minimum lease payment plus a payment based on future sales to incentivise the performance of the mall owner (lessor)).

(c) a mismatch would be created between income and expenses (eg when a retailer has lease payments that are contingent on sales). In these situations, the lease payments are considered a commission and should be recognised consistently with the underlying sales.

(d) these payments are within the control of the lessee and do not represent a present obligation because they are dependent on a future event that is yet to occur (although some expressed concerns as to whether performance based payments are within, or outside, the control of the lessee).

(e) contingent payments based on usage are akin to renewal options.

(f) recognition of revenue by lessors for these lease payments would be inconsistent with the Revenue recognition ED.

Suggested approaches

162. As an alternative to the proposals in the ED, many respondents supported either of the following approaches:

(a) include a minimum threshold that must be met before contingent lease payments can be included in lease assets and liabilities, eg ‘reasonably assured/certain’, ‘virtually certain’;

(b) use a ‘best estimate basis’ instead of an ‘expected outcome’ approach;

(c) the Alternative View to include only contingent lease payments based upon indices or rates and exclude contingent lease payments that vary with usage or performance (which is largely consistent with current US GAAP which and which many respondents think works well in practice); or

(d) accounting only for those contingent lease payments which are outside of an entity’s control and therefore unavoidable.

163. Respondents also suggested that the boards consider additional guidance relating to:

(a) principles for identifying contingent lease payments that are in substance disguised minimum rental payments;

(b) which indices and rates should be used to measure contingent lease payments, expressing support for the use of spot, rather than forward rates;

(c) leases rentals that vary because of changes in tax legislation and rates;

(d) the extent of disclosures of reported contingent lease payments;

(e) residual value guarantees with third parties, noting that these should be accounted for on a basis consistent with residual value guarantees with the lessor; and

(f) the interaction of the proposals with current embedded derivative guidance.

Reassessment

Support for the proposals

164. A minority of respondents expressed support for the requirement for lessees and lessors to remeasure assets and liabilities arising under a lease when significant changes occur. These respondents commented that this would provide users with up-to-date management estimates.

165. However, there would be more support for requiring reassessment if the threshold for recognising options to extend and cancel leases were to be increased in accordance with the respondents' suggestions in paragraph 142.

Concerns relating to the proposals

166. Many respondents and workshop participants expressed concerns similar to those in paragraph 136(a) relating to the cost of performing reassessments and questioned whether these were exceeded by the benefits for users. Additionally respondents cited the increased difficulty in complying with the reassessment requirements when faced with interim or quarterly reporting requirements.

167. Respondents also identified practical application challenges with the proposals relating to:

    (a) allocating reassessment changes between prior, current and future accounting periods;

    (b) proving that no significant change has occurred, with many commenting that preparers are likely to have to perform all of the reassessment work that would be required to record a reassessment transaction.

Suggested approaches

168. Many respondents proposed that if the requirement to reassess based upon significant change is retained, then examples of indicators of significant change should be provided, consistent with those provided in the accounting guidance for asset impairments. They also suggested that reassessment would only be required if a triggering event occurred or, at a minimum, on an annual basis.

169. The majority of respondents also requested additional guidance on allocating changes between past, present and future reporting periods or else suggested that all changes should be recognised in the current reporting period.

Sale and leaseback

Support for the proposals

170. Almost all respondents agree with analysing a sale and leaseback arrangement firstly to determine whether the transfer of the underlying asset qualifies as a sale and secondly in the context of the guidance on accounting for leases.

171. Many respondents also agreed that if the transfer of the underlying asset does not qualify as a sale that the transferor should account for the contract as a financing.

Concerns relating to the proposals

172. Many respondents are concerned that the threshold for recognising a transaction as a sale and leaseback is set too high and is inconsistent with the Revenue recognition ED. For example in many equipment vendor leasing situations, the lessee buys the underlying asset (because of the discounted price they obtain as a result of their larger purchasing power) but then sell it to the lessor and lease it back. These transactions may not meet the criteria to be accounted for as a sale and leaseback.

173. As a consequence many transactions that are currently accounted for as a sale and leaseback will not meet the proposed criteria and will be accounted for as a financing.

174. These concerns relating to the proposals for the sale threshold are discussed in the responses above in the section 'Distinguishing a lease from a purchase or sale contract' which starts in paragraph 115.

175. Many respondents also questioned whether, in a transaction that meets the sale and leaseback criteria, a transferee should be required to apply the performance obligation approach if the lessor model was appropriately defined. These respondents noted that there may be situations where a modified derecognition approach would provide more useful information.

176. Some respondents also expressed concerns with how the proposed approach aligns with the boards' views on whether the leased asset is considered to be a right or a physical underlying asset.

Suggested approaches

177. Consistent with the suggested approaches for distinguishing a lease from a purchase or sale contract, many respondents propose that the control-based guidance in the boards' project on Revenue recognition (and not risks and benefits criteria) be applied to determine whether the transfer of the underlying asset qualifies as a sale.

178. Some respondents also expressed support for the:

(a) partial asset approach described in BC161 of the ED.

(b) transferee recognising profit or loss on the sale and leaseback transaction over the lease term, rather than on an up-front basis.

Presentation (Question 12 – 14)

Support for the proposals

179. Many respondents supported the boards' objectives to provide a clear presentation of the affects of lease accounting on the financial statements, separately identifying assets, liabilities, income, expenses and cash flows relating to lease contracts.

180. Users were specifically supportive of presentation enabling a comparison of the total profit or loss and cash flows associated with leases.

Concerns and suggested approaches – general

181. Many respondents expressed concerns with the requirements for separately presenting a number of line items on the face of the financial statements relating to lease contracts, believing these requirements 'clutter' the statement of financial position, statement of comprehensive income and statement of cash flows.

182. Instead, many respondents recommended that entities be permitted to apply judgment in determining whether items should be presented on the face of the financial statements or within the notes.

183. Many IFRS interested parties expressed support for permitting application of the guidance in IAS 1 *Presentation of Financial Statements* (or the *Financial Statements Presentation* project) to assist entities in determining whether items relating to lease contracts should be presented separately on the face of the financial statements or disclosed separately in the notes to the financial statements, rather than prescribing the guidance in specific standards.

Concerns and suggested approaches – Statement of financial position

184. The majority of respondents agree that the right-of-use asset should be presented according to the nature of the underlying leased item, that is, included within property, plant and equipment or investment properties rather than, as some propose, a separate intangible asset. Financial services entities were specifically supportive of this presentation, noting regulatory capital concerns with a requirement to classify the right-of-use asset as an intangible, rather than tangible asset.

185. Many respondents disagreed with the requirement to separately distinguish assets and liabilities arising from sub-leases on the face of the statement of financial position, believing that entities should be required to apply judgement to determine whether this information should be provided on the face of the statement of financial position or in the notes.

186. Respondents expressed mixed views on the proposals for presenting:

    (a) assets and liabilities relating to the performance obligation approach on a net basis, with some commenting that the presentation of sub-totals on the face of financial statements may be confusing to users and others preferring a gross presentation; and

    (b) residual assets arising under the derecognition approach within PP&E, rather than as a financial asset.

187. A few respondents requested additional guidance on the presentation of amounts between current and non-current.

Concerns and suggested approaches – statement of comprehensive income

188. Respondents were mixed in their views on the proposal for lessees to recognise separately amortisation and interest expenses, rather than present just a single lease expense and classify it as lease/rental expense. They noted that the proposals would lead to all lease/rental expense being excluded from EBITDA.

189. Specifically a number of users expressed support for maintaining the terms lease/rental income (lessors) and lease/rental expense (lessees) when presenting lease items in profit or loss, or at the very least presenting or disclosing the total amount of lease income and expense in one place, either in the financial statements or the notes.

190. A few respondents were also concerned with the effect that the proposed profit or loss presentation would have on:

   (a) key performance metrics and ratios (eg effect on the interest margin for the financial sector); and

   (b) consistency with the approach for recovery or reimbursement of lease expenses (eg the US regulated utilities industry where the recoverability of lease expenses through rates is presented within operating expenses and government contracts where interest expense may be recovered on a different basis to rent expenses).

191. Respondents who supported lessors applying the performance obligation approach:

   (a) viewed that lease income should be presented as revenue, rather than interest income in some situations; and

   (b) had mixed views on whether profit or loss relating to the performance obligation approach should be presented on a 'linked' or 'gross' basis.

Concerns and suggested approaches – statement of cash flows

192. The majority of respondents were concerned with the requirements for lessees to present all lease payments as financing activities. These respondents commented that this presentation was:

(a) not reflective of the economics of certain lease transactions which are not always considered to be financing activities (eg retailers perceive leases of store space to be operating in nature and some equipment lessees may view payments as being investing activities, similar to the acquisition of the underlying asset); and

(b) inconsistent with current guidance in US GAAP and general practice under IFRSs that requires presentation of only the principal portion of borrowing payments as a financing activity and interest paid as operating, rather than financing cash flows.

193. The majority of respondents agreed with the proposal to present cash receipts from lease payments as operating activities in the statement of cash flows. However, a few respondents questioned whether lessors should classify the repayment of principal lease payments consistently with the classification of other loans receivable (eg as investing or operating, depending on the lessor operations).

194. However, respondents were generally supportive of providing more prescriptive guidance on the presentation of cash flows and separately presenting cash flows relating to leases to enhance comparability.

Disclosures (Question 15)

Support for the proposals

195. Almost all of the respondents supported the objective of requiring lessees and lessors to disclose quantitative and qualitative information that:

    (a) identifies and explains the amounts recognised in the financial statements arising from leases; and

    (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows.

196. These respondents were also supportive of the requirement for entities to use judgement to determine the level of detail required to satisfy the disclosure requirements.

197. Many respondents also expressed support for disclosures relating to;

    (a) potential purchase and renewal options;

    (b) presentation of contingent lease payments separately from required minimum lease payments;

    (c) discount rate assumptions;

    (d) future lease commitments; and

    (e) residual assets (lessors only).

198. Users also welcomed the proposals for lessees to disclose a reconciliation of opening and closing balances of right-of-use assets and liabilities to make lease payments.

Concerns relating to the proposals

199. Many respondents, and specifically preparers, expressed concerns that the requirements such as the proposed roll-forwards create an 'information overload' that would be burdensome to comply with and result in boilerplate disclosures.

200. These respondents noted that auditors would generally require ‘more’ rather than ‘less’ disclosure and were concerned with the cost / benefit of providing detailed disclosures relating to subjective estimates such as lease terms and contingent lease payments.

201. Other common concerns identified by respondents included:

(a) a perceived duplication and inconsistency with the maturity analysis requirements of IFRS 7 *Financial Instruments: Disclosures*;

(b) requirements to disclose commercially sensitive information (eg renewal assumptions relating to ongoing contract renewal renegotiations); and

(c) the usefulness of detailed analysis of subjective estimations that are included in the measurement of lease assets and liabilities.

Suggested approaches

202. Many respondents requested that the boards make an explicit statement to the effect that the disclosures listed should not be regarded as mandatory in all situations and that entities should apply materiality judgements in determining the extent to which disclosures are required.

203. Some respondents also noted that if the simplifications to the measurement model proposed by a number of respondents are reflected in the final standard, then the disclosure requirements would likely become less complex and more operational.

204. Additional requests relating to disclosures came from:

(a) regulators, requesting that the final standard include disclosure examples (eg showing the level of aggregation/disaggregation that entities should apply);

(b) preparers, especially those currently reporting in accordance with US GAAP, requesting clarification of the extent of disclosures that are required in interim or quarterly financial statements; and

(c) some users requesting disclosure of the fair value of residual assets.

Effective date and transition (Question 16)

Support for the proposals

205. Almost all respondents supported the proposal not to require entities to apply a fully retrospective approach on transition because of the cost and complexity for some preparers.

206. Respondents were also supportive of the approach of the boards in seeking input on effective dates for the final guidance jointly with the effective dates of other significant projects.

Concerns relating to the proposals

207. Many respondents identified concerns with the profit or loss ‘front-loading’ effect of the proposed simplified retrospective transition approach proposed in the ED, as identified in the Alternative View.

208. Users preferred a requirement to apply a fully retrospective transition approach. They were concerned with the usefulness of information that would be provided under the simplified retrospective transition approach, identifying comparability concerns:

    (a) between entities, if entities are permitted, but not required, to apply a fully retrospective transition approach, noting that this may allow entities to chose a transition approach that provides them with a favoured financial reporting outcome; and

    (b) between new and existing leases within an entity because the pre-transition period of existing leases is not considered in their post-transition accounting.

209. Some respondents also identified specific concerns for lessors, identifying that the proposed transition guidance results in the:

(a) residual asset value being a larger percentage of the value of the underlying asset, potentially meaning that on transition, leases would be more likely accounted for under the performance obligation, rather than derecognition, approach.

(b) residual interest for lessors using the derecognition approach being accounted for at fair value at transition, thereby reducing the income recognised on realising the residual interest.

Suggested approaches

210. The majority of respondents supported permitting, but not requiring, entities to fully retrospectively apply the guidance, specifically as a way of overcoming the profit or loss ‘front-loading’ effect of the proposed simplified retrospective transition approach. These respondents noted that additional guidance would be needed for the extent of hindsight that should be applied on transition.

211. Other suggested approaches for transitions included:

(a) grandfathering provisions for existing finance and/or leveraged leases or for identifying whether a contract meets the definition of a lease (consistent with those included in current US GAAP);

(b) requiring fully retrospective transition, noting an expectation that users will be requesting the retrospective information regardless of whether or not is included in the financial statements and that this may be simpler to prepare if the measurement proposals in the ED are simplified in the final standard;

(c) modified simplified retrospective transition approached;

(d) providing an exception for leases with a remaining term of 12 months or less at the effective date; and

(e) allowing prospective application.

212. Respondents also identified situations, such as the following, where additional transition guidance is required:

(a) Contracts considered as purchases, sales or leases in accordance with previous US GAAP and IFRSs, but not in accordance with the ED.

(b) Sale and leaseback transactions that meet the current criteria in IFRSs/US GAAP but will not meet the criteria in the ED and deferred gains on arrangements that continue to be considered as sale and leaseback transactions.

(c) Leveraged, sub-leases and build-to-suit leases.

(d) Clarification on what date a lessor should evaluate on transition whether to apply the performance obligation or derecognition approach.

(e) Treatment of prepaid and accrued amounts.

213. Although respondents were not asked for views on the effective date, some requested allowing extended lead-time before the effective date of the standard due to the complexity of the proposals and perceived high cost of implementation. These cost and complexity concerns specifically related to the need to assess a significant number of contracts to determine whether they meet the definition of a lease, and for those contracts that meet the lease definition, the requirement for recognition and measurement of complex features of lease contracts.

Benefits and costs (Question 17)

214. Almost all respondents questioned the cost / benefit of the proposals, perceiving them to be too far-reaching in scope, overly complex and resulting in financial reporting which would not achieve the objective of comparability between entities.

215. In addition to the perceived administrative burden for preparers to comply with the proposals, respondents had broader cost concerns relating to the;

(a) affect of the proposals on the behaviour of lessees and implications on the leasing business;

(b) economic impacts of the proposals at this point in the business cycle;

(c) effects on debt covenants and regulatory capital metrics due to the implications upon key financial ratios/performance indicators (eg leverage and capital ratios, EBITDA metrics and operating margins);

(d) need to restructure employee compensation;

(e) inconsistency with the requirements of taxation authorities;

(f) education of investors and key stakeholders;

(g) implications on preparer’s IT systems, controls and processes (including compliance with Sarbanes-Oxley for the US constituents); and

(h) professional fees associated with applying the proposals (eg legal, valuation, taxation, accounting and audit fees).

216. Respondents also noted that the cost-benefit analysis in the ED focused primarily on the lessee, rather than the lessor proposals.

217. A number of examples were provided in comment letters and in materials presented in workshops of the estimated costs of complying with the requirements.

Other comments (Question 18)

Private companies that apply US GAAP

218. Feedback from private companies that apply US GAAP was generally consistent with the feedback from public companies.

219. Many participants proposed that there should not be any differences between the final standard and the guidance that these entities should apply, noting, as

discussed above, that the final standard should be less complex than the proposals in the ED.

220. However, the majority of participants and attendees at the private company roundtable supported a delayed effective date for private companies that apply US GAAP. It was noted that this would provide significant cost savings, allowing private companies that apply US GAAP to adopt system and broader implementation strategies based on feedback from the adoption by larger public entities.

221. Other specific issues identified by private companies that apply US GAAP included concerns that the:

(a) application of the 'distinct profit margin' criteria to identify distinct service components in a lease contract is not applicable to not-for-profit or public sector entities.

(b) treatment of intercompany leases may be inconsistent between counter-parties and that application to the terms of related party leases would be challenging.

Discounting

222. The majority of respondents, many of those we met with during our outreach and a significant number of workshop participants identified concerns with the proposals for lessees to apply their incremental borrowing rate to present value the lease payment liability when the rate the lessor charges the lessee cannot be readily determined. Specifically, respondents believed that:

(a) use of a lessee's incremental borrowing rate would reduce comparability because of the sensitivity of the measurement of substantial future lease payments to the assumptions of an entity's discount rate;

(b) it is unrealistic to assume that an acquisition of the underlying asset will always be financed with 100% debt, rather than a combination of debt and equity; and

(c) inconsistencies with other accounting standards exist relating to adjustment of discount rates during the lease term (eg accounting for pensions, insurance, decommissioning or financial instruments).

223. Respondents specifically identified concerns with determining the lessees incremental borrowing rate in specific situations, for example when;

(a) the lease is in a subsidiary entity, and a group conducts all of its financing at a consolidated group/corporate level;

(b) credit curves are unavailable (eg private companies that apply US GAAP);

(c) significant lease renewal options exist;

(d) financing may not be available if the lease is for a relatively small proportion of the economic life of the underlying asset or for a low value underlying asset;

(e) determining the 'yield on property' (eg for lessees of commercial real estate);

(f) the market for the underlying asset is very volatile (eg daily rates for offshore drilling rigs); or

(g) applying the transition requirements (eg should the discount rate (i) take into account the effect of the lease on borrowing rates, or (ii) assume that the underlying asset is purchased?).

224. Respondents suggested using the following to determine the discount rate to be applied:

(a) one readily available rate (eg a risk free rate that approximates the lease term) throughout the duration of the lease (unless the rate is linked to an underlying index) to enhance comparability;

(b) an alternative internally developed discount rate (eg weighted average cost of capital, internal rate of return or a rate consistent with that used to capitalise interest); or

(c) a group, rather than entity specific rate.

Accounting between inception and commencement of a lease

225. Additional guidance was also requested relating to contracts with a significant time period between the inception and commencement of a lease (eg in the aircraft industry). This includes requests for guidance on:

(a) whether the commencement, rather than inception date should be the appropriate point for recognition and measurement;

(b) calculation of the incremental borrowing rate to be applied and how the time value of money should be reflected;

(c) build-to-suit leases;

(d) accounting for initial direct costs; and

(e) changes in assumptions (eg contingent lease payments, lease term and factors that would change an assessment of whether the performance obligation or derecognition approach should be applied).

Areas where additional guidance is requested

226. A number of additional comments were received, specifically relating to:

(a) requests that the boards provide additional application guidance to illustrate how a number of areas in the ED should be applied;

(b) the lack of exposure of consequential amendments to other standards, specifically IAS 40 and the accounting for business combinations; and

(c) drafting comments.

227. Respondents also requested additional guidance on a range of issues, most notably relating to matters that are currently specifically addressed in US GAAP or IFRS interpretative literature, including:

(a) leasehold improvements;

(b) lease incentives (including key money and rent-free periods);

(c) build-to-suit leases;

(d) lease contract modifications and extinguishments, including the need to perform additional reassessments of the accounting leases;

(e) lessee obligations to restore, or remove specific improvements made to, the underlying asset at the end of the lease term;

(f) application of impairment requirements, including interaction with guidance on exiting activities;

(g) returnable lease deposits; and

(h) cross cutting issues such as:

(i) accounting for initial direct costs, including the allocation between service and lease components of a contract;

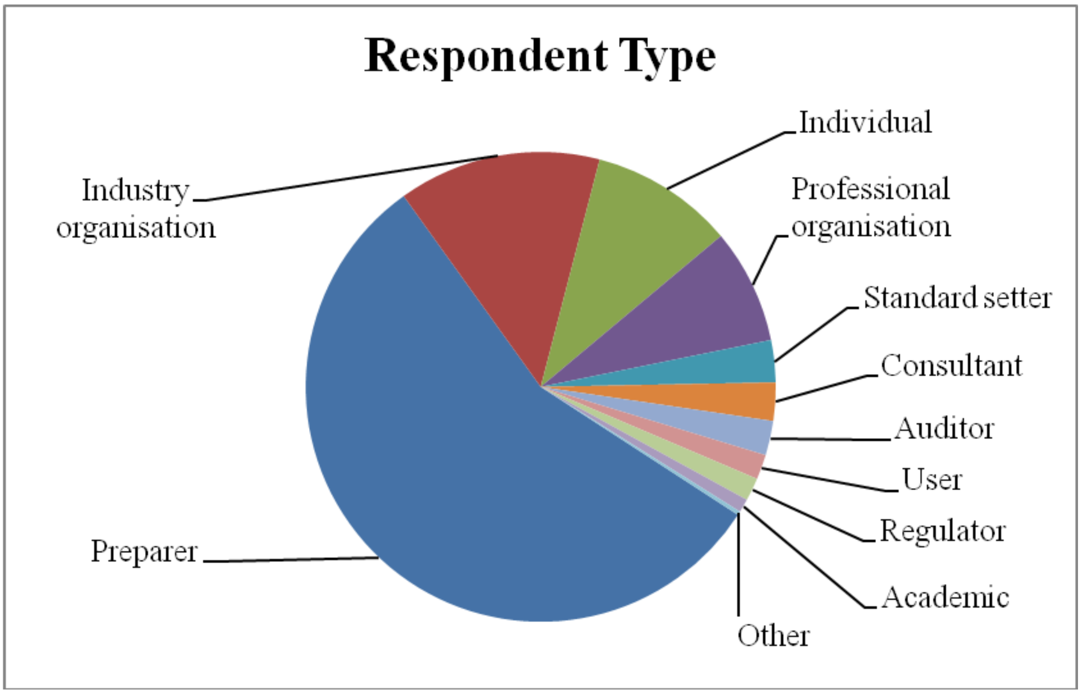
(ii) the consistency of the definition of lease payments and a contract with the Revenue recognition ED;

(iii) interaction with the boards' proposals on hedge accounting.

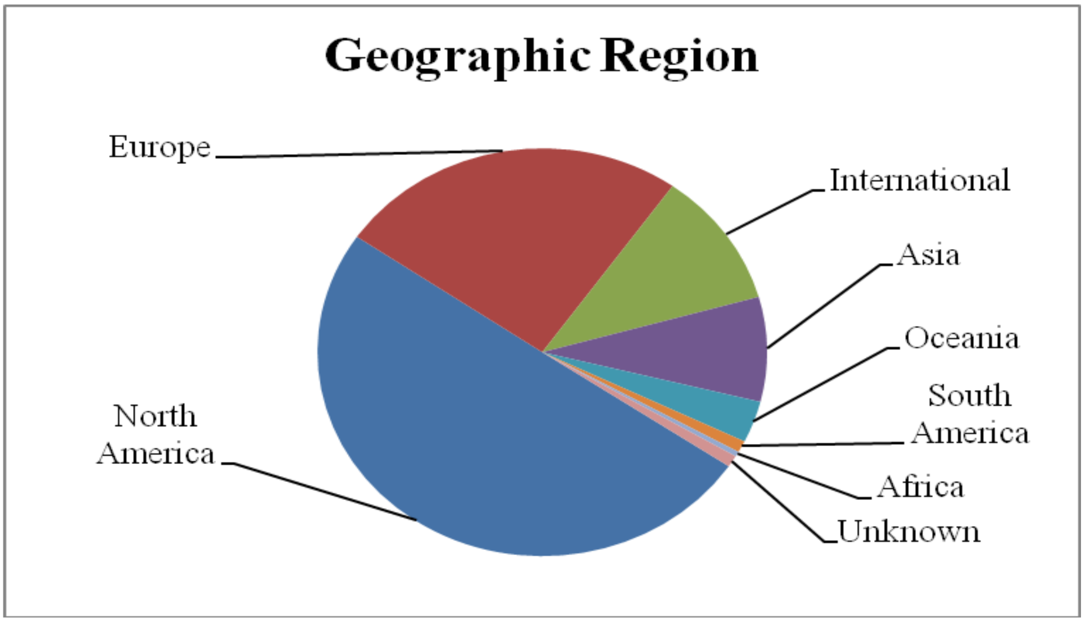
Appendix – Comment letters demographic information

A1. The following is a summary of 760 comment letters received as of 12 January 2011.

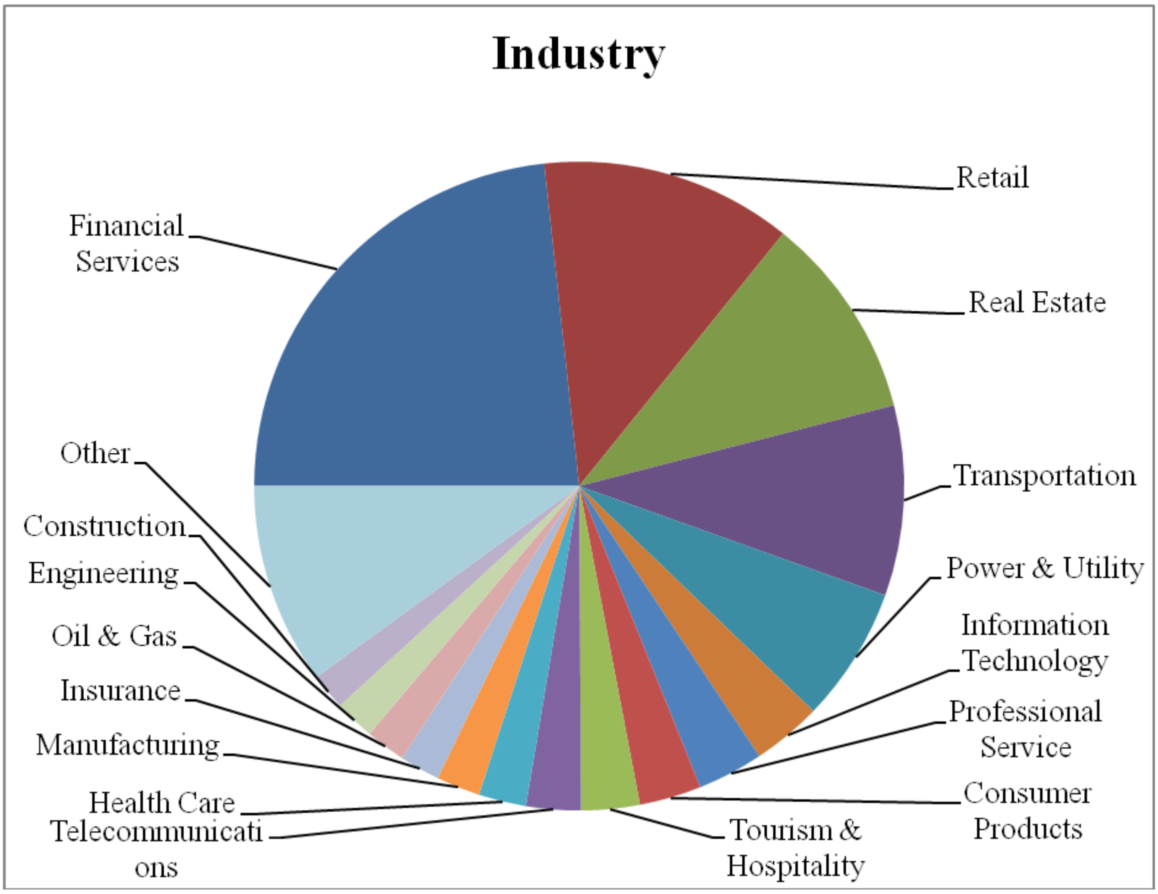
A2. This pie chart illustrates the comment letters by respondent type:



A3. This pie chart illustrates the comment letters by geographic region:



A4. This pie chart illustrates the comment letters by industry:



NOTE: Not all respondents (e.g. auditors or individuals) are associated with an industry group.