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Re: Exposure Draft Leases (ED/2010/9, File Reference No. 1850-100)

Grant Thornton International Ltd and its U.S. member firm, Grant Thornton LLP, appreciate the opportunity to jointly comment on the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) Exposure Draft, *Leases* (the ED or Leases ED).

General

We continue to support the Boards' efforts to improve lease accounting with a principles-based and conceptually consistent accounting model. However, although we acknowledge and welcome the progress made since publication of the Discussion Paper in 2008, we think that considerable work remains to be done. In particular, we believe the Boards should reconsider the ED's proposals on:

- the distinction between a sale and a lease,
- the measurement provisions for the lessee right-of-use model,
- lessor accounting generally, and
- sale and leaseback transactions.

Our main comments and views are as follows.

We are concerned that many of the ED's proposals are conceptually inconsistent with the proposals in the Boards' Exposure Draft, *Revenue from Contracts with Customers* (the Revenue ED), complex, and often tending toward rules instead of principles. A primary criticism of the current lease accounting model is that there is a bright line between an operating and a finance (capital) lease where a small change in judgment could have a significant impact on the accounting. The proposed model has similar issues with the distinction between a service and a lease, the distinction between a sale and a lease, the accounting for option periods, and the

distinction between the derecognition approach and the performance obligation approach for the lessor. We are concerned that these distinctions will lead to complexity, diversity in application, and, inevitably, the structuring of contracts.

We note that the Boards have developed a new concept of a “whole contract” to explain some of the features of the ED’s proposals. We believe that the concept requires further development at the current time. The recognition and measurement issues are connected with difficult topics, such as the appropriate accounting for executory contracts and appropriate discount rates. The pattern of revenue and expense recognition from executory contracts is a key element of both this project and the Revenue ED, yet at the conclusions appear to differ. The issue of discount rates affects several current projects. The issues are complicated and we believe that all constituents would benefit from additional development of the related concepts either in the standards or in the Conceptual Framework.

Lessee accounting

Scope of right-of-use model

Leases are very flexible instruments, the terms and economic effects of which vary enormously. The economic substance of leases differs accordingly, as does the conceptual analysis of the related rights and obligations of the parties. Broadly, existing GAAP and IFRS classify a lease either as a sale or purchase of the underlying asset, or as an executory (service) contract. The ED proposes that leases are classified either as a sale or purchase of the underlying asset, or as the sale or purchase of a “right-of-use” asset.

We believe more work is needed to assess whether the ED’s classification scheme adequately reflects the diversity of lease arrangements and business models. We agree that there is a role for a right-of-use model but are concerned that the ED extends this model to leases for which it is not appropriate. Specifically:

- We believe the proposed criteria in paragraph 8(a) to classify a lease as a sale or purchase of the underlying asset are too restrictive. We would favor criteria to classify a lease as a sale or purchase that are robust and consistent with the Revenue ED. This could in turn require some revisions to the proposed criteria in the Revenue ED, and additional guidance on how they might be applied to a lease. Leases that cover the substantially all of the economic life of the underlying asset, for example, should most likely be classified as a sale or purchase.
- We believe that leases that are in-substance services should be accounted for as executory contracts. In our view, multiple-element contracts that involve the use of a specific asset that is incidental to provision of a service should be classified as service contracts in their entirety. We also suggest that short-term leases of longer-lived assets might be better viewed as service contracts. We acknowledge, however, that more guidance would be required to determine the classification of contracts as service contracts or leases.
- We think the right-of-use model is most appropriate for contracts that finance the consumption by the lessee of part of the economic benefits of the underlying asset (i.e., that finance the temporary control of that asset).

Mechanics of right-of-use model

We believe that the proposed right-of-use model needs additional work to ensure that its results reflect the economic substance of the types of leases to which it applies. In particular:

- We are concerned at the “front-loading” of the lessee’s total rental expense that arises as a consequence of measuring the liability using the effective interest method (although this concern would be reduced if the scope of the right-of-use model was refined, as discussed above).
- We do not think the lessee’s right-of-use asset and liability should include option periods. We are not convinced that rentals during an unexercised future option period are present obligations arising from past events.
- We disagree with the ED’s proposed treatment of contingent rentals. In our view, contingent rentals are not present obligations if the lessee is able to decide the outcome of the contingency. We also suggest the Boards should consider whether other contingent rentals should be included in the lessee’s obligation and right-of-use asset only when the amounts can be reasonably estimated (using criteria similar to those in the Revenue ED in relation to variable consideration). Some contingent rental arrangements give rise to embedded derivatives that must be separated in accordance with IAS 39, *Financial Instruments: Recognition and Measurement*. The IAS 39 guidance in this area might need to be enhanced in view of the increased significance of this issue.
- We disagree with some aspects of the proposals on purchase options. We believe these proposals would result in too many options being ignored until exercised. We agree that options to purchase the underlying asset at market value should be accounted for as a purchase only when exercised. Bargain purchase options should be evaluated at inception to determine whether an in-substance sale has occurred. Options that may appreciate in value and options coupled with above-market rents could require separate accounting (which would need to be developed in view of the lack of current guidance in IFRS for options over nonfinancial items.)
- We think that more work is needed on how existing requirements on impairment in IAS 36, *Impairment of Assets* and the revaluation model in IAS 16, *Property, Plant and Equipment*, would apply to a right-of-use asset. The right-of-use asset is a new type of asset and may present special challenges in recognition and measurement. We think that addressing these areas would also significantly reduce the need for periodic reassessment. This would in turn reduce complexity and avoid certain counterintuitive patterns of expense recognition.

Treatment of embedded service elements

We believe that the proposal to recognize a right-of-use asset and a related obligation for nondistinct services could lead to undesirable consequences (in particular, this could result in the asset being stated at an amount higher than the underlying asset’s fair value).

Lessor accounting

Some of our comments relating to lessee accounting also apply to the lessor, in particular:

- the distinction between a lease and a sale or purchase,
- option periods,
- contingent rentals (although we note that, in contrast to the lessee accounting proposals, a reliable measurement threshold is included in relation to contingent rentals for the lessor), and
- purchase options.

Our other main comments on the lessor accounting proposals follow.

Performance obligation model

The proposed performance obligation model differs from the approach for licensing agreements (i.e., rights-of-use) in the Revenue ED. We would prefer a consistent model in both EDs. The proposed performance obligation approach in this ED requires separation of performance obligations into lease obligations and service obligations. The lease obligations, receivable, and the underlying asset are recognized separately but combined into a net figure on the statement of financial position, while the service contract assets and performance obligations are recognized net. We would prefer a consistent approach to accounting for performance obligations, preferably one that does not require separation of the contractual cash flows into lease performance obligations and service performance obligations.

Derecognition model

We question why the ED proposes a “significant risks or benefits” test to determine which accounting model should be applied by lessors (performance obligation or derecognition). We view the proposed derecognition model as a partial sale approach and believe that the criteria for derecognition should be consistent with the Revenue ED. We also believe that many transactions to which the derecognition model applies in accordance with the ED should be classified as a sale of the underlying asset (see our comment above under “Scope of right-of-use model”). This classification could reduce or eliminate the need for the derecognition model.

Use of a fair value model by lessors

The IASB has proposed that revenue from investment property measured under the fair value model in IAS 40, *Investment Property*, should be recorded on a straight-line basis. In our view, this accounting model (fair valuation and straight-line rental income) could deliver useful information for other types of assets held by a lessor to earn rentals. Such a model could be less complex than either of the proposed lessor models in the ED.

Sale and leaseback

We do not agree with the proposed criteria for determining whether a contract is a sale or a lease in the ED and therefore do not agree with using the criteria for determining whether there has been a sale of the underlying asset in a sale and leaseback transaction. We believe that the definition of a sale (or purchase) should be based on a robust and consistent definition of control in both the Revenue ED and the Leases ED.

We also would like to request that the Boards provide additional guidance on how to account for a transaction as a financing. We believe that financings in the form of a sale and leaseback would pose additional measurement, presentation, and disclosure issues that are not addressed in current IFRS.

Invitation to comment questions

Question 1: Lessees

- a) **Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?**

We agree in principle with the concept of the lessee recognizing a right-of-use asset and lease obligation for some leases, but believe that the model still requires additional work in order to ensure that the results reflect the economic substance of lease transactions. The right-of-use asset is a new type of asset and could present special challenges in recognition and measurement.

We believe that the economic substance of all leases, and therefore the nature of the related rights and obligations, is not always the same. When the substance of a transaction is a financing transaction and the asset is likely to be the subject of a single lease prior to disposal by either the lessee or the lessor, recognition of a purchase and sale would be appropriate. When the transaction reflects the shorter term use of a long-lived asset, including but not limited to real estate, we believe that the substance of the right-of-use asset may differ and pose different measurement issues on initial recognition and subsequent measurement.

- b) **Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?**

We agree that a lessee should recognize amortization of the right-of-use asset when the lease is of a type that gives rise to this type of asset. If the lease is in substance a purchase of the underlying asset the lessee (purchaser) should recognize amortization of the underlying asset.

We have a concern that the application of the effective interest method to the associated lease liability when the lease is not a purchase of the underlying asset results in front-loading of the lessee's expense recognition. We find this outcome somewhat counterintuitive and are not convinced that it provides the most relevant information for users. We suggest that the Boards examine alternative methods of measuring the right-of-use asset and liability that would avoid this outcome.

Question 2: Lessors

- a) **Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?**

We do not agree with using a risks and benefits model for determining whether a partial sale has occurred while using control as the criteria for determining when a sale has occurred (similar to the Revenue ED). We favor a model based on a robust and consistent definition of control at the commencement of the lease. We believe that the proposed criteria for classification of a lease as a sale of an asset are too restrictive and that a robust model of control would classify many of the transactions that would be accounted for under the derecognition approach as sales. Many of the indicators used to describe when the lessor would apply the derecognition approach, such as a residual value guarantee or a lease term that includes a significant amount of the economic life of the underlying asset, may also be indicators that the lessee has obtained more than temporary control of the underlying asset and therefore the transaction should be accounted for as a sale.

- b) **Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?**

The proposal for the performance obligation approach differs from the performance obligation approach proposed for licensing agreements (a lease of an intangible asset) in the Revenue ED. We are in favor of a single approach for recognizing performance obligations in the Leases ED that is consistent with the Revenue ED.

The proposed performance obligation approach in this ED requires separation of performance obligations into lease obligations and service obligations. The lease obligations, receivable, and underlying asset are recognized separately but combined into a net figure on the statement of financial position, while the service contract assets and performance obligations are recognized net. We would prefer a consistent approach to accounting for performance obligations, preferably one that does not require separation of the contractual cash flows into lease performance obligations and service performance obligations. This would greatly reduce the complexity of the final standard without compromising the information provided to users of the financial statements.

We think that derecognition of the underlying asset is appropriate only when the lease is an in-substance sale. Accordingly, we do not support the ED's derecognition model (which we would characterize as a partial sale model) for leases in which the lessor retains control of the underlying asset. However, we also believe that the ED's proposed criteria for classifying a lease as a sale are too restrictive. Revised for recognition of a sale that include situations where the lease term is for the economic life of the underlying asset or the

presence of a residual value guarantee could significantly reduce or eliminate the need for the derecognition approach. Ideally, the Revenue ED would incorporate an improved definition of a sale and indicators of control that would facilitate an assessment of whether a lease contract gives rise to an in-substance sale of the underlying asset.

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

We are not aware of any conceptual arguments that would justify a separate approach for lessors with leveraged leases.

Question 3: Short-term leases

This exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is 12 months or less:

- a) **At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in the income statement over the lease term (paragraph 64).**
- b) **At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors would continue to recognize the underlying asset in accordance with other Topics and would recognize lease payments in the income statement over the lease term (paragraph 65).**

(See also paragraphs BC41–BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

We are generally not in favor of provisions that create a bright line between contracts of 12 months or less and contracts for more than 12 months. For the lessee, we agree with the proposed model as a practical expedient if the final standard does not address the issue of front-loading of expense due to the use of the effective interest method for all leases. For the lessor, we believe that short-term lease arrangements where the underlying asset is held to earn rentals are more in the nature of the provision of a service than a financing arrangement. We agree with the proposed accounting but believe that the lease receivable and performance

obligation would best be reflected net, as in the Revenue ED. If the approach in the Revenue ED is adopted for all leases, there would be no need for a separate accounting method for short-term leases.

Question 4

- a) **Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?**

We recommend that the Boards consider additional refinements to the proposed definition of a lease in order to create a robust and consistent model for accounting for transactions of similar economic substance and to exclude certain transactions that differ. As we noted in our response to the Revenue ED, the assets included within the scope of the definition should include intangible assets with finite lives. In addition, the proposed definition should exclude consumable items such as inventory and financial instruments. We believe that conveyance of the right-to-use asset for a period of time (a temporary transfer of control) is the defining characteristic of a lease and the criteria for distinguishing a sale (a nontemporary transfer of control).

- b) **Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?**

We believe that the criteria for recognition of a purchase or a sale are too narrow and would exclude sale or purchase recognition for many transactions that are in-substance sales or purchases of the underlying asset. Also, the definition of a sale in this ED is inconsistent with the proposed guidance in the Revenue ED. We believe that there should be a robust and consistent definition of control in the two final standards. In our view, a transaction that is a nontemporary transfer of control should be accounted for as a sale or purchase, and a transaction that is a temporary transfer of control should be accounted for as a lease.

- c) **Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?**

The guidance in B1-B4 is based on existing guidance in IFRIC 4, *Determining Whether an Arrangement Contains a Lease*, has often been difficult to apply in practice. However, the practical effect of applying this guidance has been limited to those situations where the lease element is a finance (capital) lease. Operating leases have not been an issue because the accounting for operating leases and executory contracts is similar. We are concerned that the provisions of paragraphs B1-B4 would not be operable in the proposed new environment where many contracts have the potential to contain an embedded lease, such as contracts where the service provider employs one or more asset in order to provide the service. We do not believe that it is cost effective or representationally faithful to separate the cash flows of the large majority of service contracts into lease elements and service

elements and to account for the elements differently, especially if the lease elements are not distinct from the service elements. We suggest that such contracts be excluded from the scope of the final standard instead of being subject to the provisions of paragraphs B1-B4. However, we note that the provisions in B1-B4 may still be useful for determining whether or not there has been a purchase of the underlying assets, an outcome that is closer to the original intent of the provisions of IFRIC 4.

Question 5: Scope exclusions

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

Do you agree with the proposed scope of the proposed guidance? Why or why not? If not, what alternative scope would you propose and why?

We believe that agreements that are transfers of identifiable intangible assets that meet the definition of a lease should be within the scope of a leasing standard unless the agreement is an in-substance sale, purchase, or service. We believe that current assets, such as inventory or supplies, should be excluded from the scope.

We also request that the Boards consider exempting service contracts that have nondistinct lease elements from the scope of the standard.

We also request that the Boards provide additional guidance for the accounting for lease contracts that will be accounted for as a purchase. We do not believe that it is sufficient to state that the lessor should account for the lease under the Revenue ED or that the lessee should account for the lease under IAS 16 or *FASB Accounting Standards Codification*TM (ASC) 360, *Property, Plant and Equipment*. We believe that purchases that are in the form of lease contracts would pose additional measurement, presentation, and disclosure issues that are not discussed in those other standards.

Question 6: Contracts that contain service components and lease components

This exposure draft proposes that lessees and lessors should apply the guidance in proposed Accounting Standards Update, Revenue Recognition (Topic 605): Revenue from Contracts with Customers, to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

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

b) The IASB proposes that:

- (i) A lessee should apply the lease accounting requirements to the combined contract.**
- (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.**
- (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the guidance in the exposure draft on revenue from contracts with customers.**

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

We believe that an ideal solution for the lessor would be a single model of accounting for leased assets and service elements that is consistent with the performance obligation model in the Revenue ED, thereby eliminating the need to bifurcate the cash flows under the contract into lease- and service-related elements.

Regarding the lessee, we believe that the proposal to recognize a right-of-use asset and a related obligation for nondistinct services could lead to undesirable consequences. For one, when the contract meets the criteria for recognition as a purchase, the recorded asset could easily exceed the fair value of the underlying asset. We believe that this result is counterintuitive. Recording a purchase in excess of the fair value of the underlying asset would also complicate impairment testing of assets purchased via a lease contract.

When the contract is recorded under the measurement provisions of the Leases ED, recording nondistinct services within the obligation would result in the payments for the services being accounted for as a financing arrangement. The lessee would recognize interest expense from commencement of the lease for future payments for future services, front-loading the recognition of the expense for nondistinct services over the lease term. We doubt that even those in favor of recording executory contracts for services on the statement of financial position would favor that pattern of revenue or expense recognition. A separate mechanism for recognizing services is necessary in order to preserve the representational faithfulness of expense recognition.

We believe that this is one of the items that requires further consideration and clarification in determining the nature and amount of the right-of-use asset and also should be included in a discussion of impairment testing should the Boards proceed with a requirement to test right-of-use assets for impairment

Question 7: Purchase options

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

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

We do not agree with these proposals. We believe they would result in too many options being ignored until exercised.

We agree that options to purchase an underlying asset at market value should be accounted for as a purchase when exercised. Options to purchase that are bargain options should be evaluated at inception to determine whether a sale has occurred. Options on land or real estate that may appreciate in value and options coupled with above-market rents might require separate accounting. We believe that separate accounting would be particularly appropriate when rents are above market.

Additional guidance in this area might necessary in view of the lack of current guidance in IFRS for options over nonfinancial items.

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

We do not agree with the provisions to include option periods in the determination of the lease term by the lessee. We do not believe that the rents during an option period meet the definition of a liability. Their inclusion in the right-of-use asset and lease obligation would not then be representationally faithful or relevant to users. The economic substance of a lease contract with renewal options is distinct from the economic substance of a lease contract with a fixed term, and we believe that the accounting should not obscure that difference. We also are concerned about the effects of recognizing interest expense on the portion of the lease obligation that is not a current liability. The inclusion of options periods also creates a potential bright line in that a small change in judgment could lead to significant changes in the accounting on the statement of financial position and in profit and loss.

We acknowledge that current U.S. GAAP and IFRS contain some anti-abuse provisions where option periods have been included for purposes of determining whether a lease is a finance (capital) lease or an operating lease and some of those provisions should carry forward. For example, the guidance should specify that option periods prior to a bargain purchase option or transfer of title should be included when determining whether the contract contains a purchase

or sale. The guidance should indicate that bargain renewal options or significant penalties for non-renewal may be relevant for determining whether the lease term covers the useful life of the asset and is in-substance a nontemporary transfer of control to the lessee that should be accounted for as a purchase or sale.

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be reliably measured? Why or why not?

We believe that the accounting for contingent rentals needs improvement. In general, the proposed accounting for contingent rentals would be complex, subjective, and imprecise and would provide only limited benefits to a small group of users who understand the measurement issues involved. Contingent rentals should meet the definition of an asset of the lessor and a liability of the lessee in order to be included in the lease receivable or obligation. For example, the amount recorded as an obligation should not include amounts for future services that have yet to be performed. If the Boards elect to include contingent rentals in the lease obligation, we believe it would be necessary to separate those contingent rents attributable to future services and to recognize those amounts when the services are performed. We believe that it is particularly inappropriate for the lessor to recognize interest income and the lessee to recognize interest expense for services to be delivered in future periods.

In addition, we believe that all contingent payments are not the same. Broadly speaking, some contingent rents are variable consideration for a fixed amount of usage of an underlying asset. The accounting for this type of variable consideration should be consistent in both the Revenue ED and the Leases ED. Other contingent payments are more in the nature of a payment for the potential additional use of the underlying asset in the future. Those contingent payments should not be recognized in the right-of-use asset or lease obligation unless the amounts meet the definition of an asset for the lessor and a liability for the lessee, such as contingent rentals that are readily determinable or contingent in form only.

We would not object to the disclosure of estimated future contingent payments that do not qualify as assets or liabilities as supplemental information in the notes of financial statements of publicly accountable entities.

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

We believe that the reassessment provisions may be unnecessary, or at least the need for reassessment may be less frequent, if the Boards improve the accounting for option periods and contingent rentals.

If the Boards proceed with those proposals, we think that the reassessment requirement would add considerably to the complexity and costs of implementing the standard. We recommend that a reassessment be performed only if the lease has been modified, the asset has been impaired, or there has been a change in management's assessment of the likelihood of exercising optional renewal periods. We also would request that the Boards consider clarifying the interaction of the reassessment requirements with the requirement for the lessee to test right-of-use assets for impairment, and the lessee's option to apply the revaluation model in IAS 16.

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

We do not agree with the proposed criteria for determining whether a contract is a sale or a lease in the ED and therefore do not agree with its use for determining whether there has been a sale of the underlying asset in a sale and leaseback transaction. We believe that the definition of a sale (or purchase) should be based on a robust and consistent definition of control in both the Revenue ED and this ED. We do not see any conceptual basis for using different conditions for recognizing a sale in future leasing and revenue recognition standards. Therefore, we suggest that the rules focus on whether there has been a nontemporary transfer of control to the buyer/lessor using criteria consistent with the proposed revenue recognition literature.

The proposal also includes several provisions in paragraph B31 similar to the continuing involvement provisions in existing U.S. GAAP even though continuing involvement is no longer a factor in recognizing sales of real estate in the proposed Revenue ED. We would rather see a principles-based approach to the accounting for sales and leaseback transactions rather than a list of possible situations where a nontemporary transfer of control has or has not occurred. We are concerned that the provisions in the Leases ED, as written, could replicate some of the issues with the current rules-based standards.

We would like to request that the Boards provide additional guidance on how to account for a transaction as a financing. We believe that financings would pose additional measurement, presentation, and disclosure issues that are not discussed in other standards. We understand that the existing guidance in U.S. GAAP would be superseded by the Revenue ED, and there is no comparable guidance within IFRS.

Question 12: Statement of financial position

- a) **Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?**

We believe that right-of-use assets differ from the underlying asset in several regards. Therefore, we believe it appropriate for lessees to present right-of-use assets separately from owned assets. It is not clear whether there would be any separate presentation requirements for contracts accounted for as a purchase under IAS 16 and ASC 360, but we do not believe that separate presentation is necessary for those assets.

- b) **Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totaling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?**

We do not agree with the proposed presentation. We believe that lessor accounting requires further development prior to issuance of a final standard. Ideally, the lessor should account for lease-related contract assets and performance obligations in a manner that is consistent with the Revenue ED: either as a sale with a financing or as a contract asset and related performance obligation.

- c) **Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?**

We believe that lessor accounting requires additional development before a final standard is issued. However, we agree that the right to receive lease payments, including guaranteed residual payments, should be presented separately from other financial assets.

- d) **Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?**

We believe that an intermediate lessor should account for a sublease of a leased asset that was accounted for as a purchase as a sale if the transfer of control is nontemporary and as a contract asset and performance obligation if the transfer of control is temporary in accordance with the approach in the Revenue ED.

If the original lease was accounted for as a lease, then the intermediate lessor should account for the sublease as a contract asset and performance obligation. If the intermediate lessor is released of all responsibility for the leased asset, then the contract should be accounted for as a termination, and the right-of-use asset and obligation should be derecognized.

Question 13: Income statement

- Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in the income statement (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?**

We believe that lease income and lease expense could be presented either on the face of the income statement or in the notes, depending on the relative importance of the amounts.

Question 14: Statement of cash flows

- Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?**

We believe that this information could be presented either on the face of the statement of cash flows or in the notes, depending on the relative importance of the amounts.

Question 15

- Do you agree that lessees and lessors should disclose quantitative and qualitative information that:**

- a) **identifies and explains the amounts recognized in the financial statements arising from leases; and**
- b) **describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows?**

(paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

We have a concern with the proposed disclosure objective. We think it is inconsistent with The Conceptual Framework for Financial Reporting 2010. That document (at paragraph OB3, for example) explains that the users of financial statements make an assessment of prospects for future net cash inflows to an entity. The proposed objective could be viewed as shifting responsibility to make this assessment to the reporting entity.

We suggest that the objective should be amended to be more consistent with the objective of financial reporting in the Conceptual Framework, in particular in relation to the respective roles of the entity and users in performing an analysis of future cash flows.

Question 16

- a) **This exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?**

We are concerned that the guidance might not be sufficient for all scenarios that lessors and lessees would / could face on transition. While there is an exception provided for plain vanilla finance leases in the transition, it is not clear how to account for sales-type leases that would no longer meet the criteria for sales recognition.

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

We believe that full retrospective application is necessary when the lease meets the criteria for classification as a sale or a purchase. We believe that full retrospective application is not feasible if the proposed accounting for options, contingent rentals, or impairment is included in the final standard. Full retrospective accounting may be possible if the option periods and contingent rentals are excluded from the performance obligation and right-of-use asset, and the right-of-use asset is not subject to impairment testing.

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

We believe that transition requirements should also include provisions for leases that would qualify as sales or purchases under the proposed guidance but not under existing guidance and those that qualify as sales under existing guidance but would not under the proposed guidance. The transition rules should also provide guidance for those situations where a sale and leaseback have deferred gains or losses that would not be deferred under the proposed guidance.

The transition guidance should also clarify whether any impairment loss on transition would be recognized in profit and loss or otherwise, and the treatment of provisions for onerous operating lease contracts recognized in accordance with existing U.S. GAAP or IFRS.

Question 17

Paragraphs BC200–BC205 set out the boards’ assessment of the costs and benefits of the proposed requirements. Do you agree with the boards’ assessment that the benefits of the proposals would outweigh the costs? Why or why not?

We believe that considerable work remains to be done on the lease accounting model, including the accounting by lessors, the distinction between a sale and a lease, and, especially, the measurement provisions of the standard. At the current time, we believe that the proposals are conceptually inconsistent with the proposed model in the Revenue ED, complex, and often tending toward rules instead of principles with bright lines where a small change in judgment could have a significant impact on the accounting results. Accordingly, we do not believe that, as proposed, the benefits of the proposed standard would outweigh the costs.

Question 18

Do you have any other comments on the proposals?

Impairment

The Boards have decided not to develop a new impairment approach for right-of-use assets. For a lease accounted for as a purchase, we assume that the fair value of the underlying asset would normally be used under the proposed guidance. However, for other leases the issue is less clear. As we have noted elsewhere in our comments, a right-of-use asset is a new type of asset. We do not believe that it is clear how a fair value would be determined for a right-of-use asset under either U.S. GAAP or IFRS. In the business combinations literature, leases are an exception to the fair value rules. The fair value of leases that are currently classified as operating leases is measured by looking at over- or under-market rentals and other factors, such as customer relationship intangibles.

It also is not clear how nondistinct services included within a right-of-use asset would affect the fair value. Those services are neither an intangible asset nor a tangible asset, but a discounted amount that represents future payments for payments to be performed in the future.

We believe that in many cases a right-of-use asset resulting from a lease that is not accounted for as a purchase could only be valued as part of an asset group. That implies that it is the asset group, and not the right-of-use asset, that should be subject to impairment testing. We question whether there would be a need for a separate impairment test for the right-of-use asset. If the Boards elect to include an impairment requirement, then we recommend that the standard include additional guidance on how to value the right-of-use asset, including consideration of nondistinct services.

Revaluation of the right-of-use asset

Our comments on impairment also apply to revaluation of the right-of-use asset in accordance with the IAS 16 revaluation model. As we have noted elsewhere, the right-of-use asset is a new type of asset and will present many different measurement issues. We recommend that the revaluation provisions be limited to underlying assets that are recognized when a lease is classified as a purchase. If the IASB elects to apply those provisions to right-of-use assets, we believe that that additional guidance is required to determine how those assets would be valued, including consideration of nondistinct services included within the right-of-use asset.

Onerous contract for service elements

As currently proposed, services would fall within the scope of the revenue recognition literature for lessors, which includes provisions for accounting for onerous contracts at the performance obligation level. Our comment on the Revenue ED suggested that those provisions should be applied at the level of the contract. We are concerned that there may be an interaction between the accounting for impairment of a lessor's receivable and accounting for service performance obligations as onerous contracts if the provisions in the ED are included in the final standard.

General comment on interest rates

Lessors are often willing to provide lease financing to lessees at rates that incorporate both tax advantages and reduced costs upon default by the lessee. We continue to believe that the use of the incremental borrowing rate could lead to overstatement of the interest element by the lessee, exacerbating the front-loading of expense.

For those leases that are not in-substance financing arrangements where rents are determined by market forces, it may not be possible to establish a rate charged by the lessor to the lessee. We believe that the final standard should consider permitting an alternative discount rate for such leases.

Investment property

The IASB has decided that revenue from investment property accounted for at fair value should be accounted for on a straight-line basis. We believe that the Boards should consider permitting similar accounting for other long-lived assets, such as rail cars, aircraft, or similar items.

Question 19

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

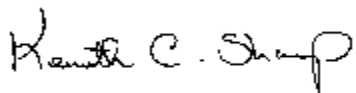
The question of the implementation date for private companies may depend in part on what the Boards decide in regards to other projects currently pending. We believe that there may be compelling reasons for a different implementation date for private companies in some scenarios. We are especially concerned that the large number of current projects could create resource constraints as large numbers of companies move to update their information technology, internal controls, and financial reporting processes. The more complex the requirements, the more severe those resource constraints could be. In general, we believe that

lessor accounting could readily coincide with changes in revenue recognition if the accounting methods align as we have suggested. If the models differ, it may be preferable to delay implementation of the lease accounting models until the revenue recognition guidance has been implemented simply from a resource-constraint and cost perspective.

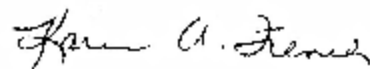
Another factor to consider is the relationship between private company accounting implementation dates and the adoption of IFRS by the United States. If the United States elects to adopt IFRS in the near future, we believe that it would make more sense for private companies to wait until the proposed changes have been incorporated into IFRS for SMEs. It would not be productive to have private companies in the United States implement the proposed standard as U.S. GAAP and then transition again to IFRS for SMEs. Therefore it would make sense to see whether the U.S. will be moving to adopt IFRS for SMEs or make other provisions for private company accounting standards before determining an implementation date for private companies. Similarly, it might be necessary to resolve the issue of future accounting standards for not-for-profit organizations before requiring those organizations to implement the final standard.

If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@uk.gt.com or + 44 207 391 9510), on behalf of Grant Thornton International Ltd or John Hepp, Partner, Accounting Principles Group (John.Hepp@us.gt.com or +1 312 602 8050), on behalf of Grant Thornton LLP.

Sincerely,



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