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Exposure Draft Leases (ED/2013/6), Proposed Accounting Standards Update (Revised) *Leases* (Topic 842)

Grant Thornton International Ltd and its US member firm, Grant Thornton LLP, appreciate the opportunity to jointly comment on the International Accounting Standards Board (IASB) Exposure Draft *Leases* and Financial Accounting Standards Board (FASB) Proposed Accounting Standards Update (Revised) *Leases (Topic 842), a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840)* (collectively, the ED).

Our main comments are set out below. Our responses to the questions included in the ED are set out in Appendix I. We have also commented on some other significant matters not addressed by those questions in Appendix II.

General comments

We welcome the Boards' decision to re-expose their lease proposals. We also commend the Boards for continuing to work jointly on this critical and high profile project. However, although we fully support the Boards' goal to improve lease accounting, we are not in favor of proceeding with finalization of the ED in its current form at this time. Although we appreciate the efforts that the Boards have expended in undertaking to address the issues raised with the 2010 Exposure Draft *Leases* (2010 ED), we believe the latest proposals would not improve financial reporting and would require substantial implementation costs.

Despite our concerns with the current ED, we encourage the Boards to continue to work together to improve lease accounting. We believe that it should be possible to develop an alternative model that would provide users with information that is more relevant and representationally faithful, more understandable, less complex, and conceptually consistent with the accounting for similar transactions with customers or acquisitions. We therefore encourage the Boards to further develop a model for classifying leases in a manner that would curtail current abuses and provide relevant and representationally faithful information to users of the financial statements.

We explain our main concerns with the ED, and our suggestions on the direction of future work on lease accounting, in the following paragraphs.

Main concerns with the ED

In our view, the comments on the 2010 ED indicated broader conceptual issues with using the right of use asset as the unit of account for lease accounting. For example, during the comment process it became apparent that the receivable and residual approach for lessors would not be practicable for all leasing arrangements. The current ED has not adequately addressed these concerns and has led us to conclude that the proposed unit of account is the root cause of many of the problems with the proposals.

By focusing mainly on the right to use tangible assets, the model creates a distinction between contractual rights to use tangible assets, intangible assets and service assets. This would create opportunities to structure transactions to obtain a particular accounting result. The focus on rights of use also requires preparers to separate lease arrangements into relevant (lease) and irrelevant (non-lease) elements for recognition purposes far more often than at present. This is a complex process that may actually reduce the relevance of the resulting information by not providing information to users that fully reflects the enforceable obligations within the arrangement.

Further, moving forward with a right of use model is supportable only if a lease can be defined in a manner that satisfactorily distinguishes leases from executory contracts (service contracts). We believe the ED's proposals and supporting examples fail to achieve this – quite possibly because in many instances such a distinction does not exist.

The Boards' efforts to address some of those concerns, while well intentioned, have introduced additional complexity into an already complex model. We do not believe that the end result in this ED is conceptually consistent with the accounting in the latest draft of the forthcoming revenue recognition standard or recent developments in the Boards' consolidations projects – both of which are founded on a control-based principle. Moreover, the concept of subdividing a tangible asset into individual bundles of rights is not well supported or developed in the Boards' current conceptual frameworks or the IASB's current Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the Conceptual Framework DP).

Various aspects of accounting for a right of use asset by the lessee are also problematic. For example, we are not convinced that the Boards' existing guidance on impairment, or the application of the revaluation model in IAS 16 *Property, Plant and Equipment*, are appropriate for a right of use asset.

We also identified other inconsistencies that could arise from application of the right of use asset as the unit of account for transactions to acquire groups of assets that meet the definition of a business. If control of the underlying assets passes to the lessee, the lease may be a business combination (we expand on this comment in Appendix II).

Overall we do not consider the right of use asset to be a practicable unit of account for accounting for lease transactions. The anomalies identified with the right of use model are so significant that development of an alternative approach seems warranted.

We also have significant concerns over:

- the ED's proposals on sale and leaseback transactions
- the potential for accounting arbitrage between accounting for an acquisition transaction as a lease or a business combination
- the accounting for intangible assets.

We explain these concerns in Appendix II.

Future work on lease accounting

Disclosures

In the short term we believe the Boards should focus on enhancing disclosures about lease arrangements. Our outreach efforts with users of financial statements have indicated overwhelming consensus on the need to improve the information on lease commitments provided in the financial statements. Users would derive significant benefits from comprehensive disclosure information about total rights and obligations and related income and cash flow effects inherent in lease contracts to which the entity is party – preferably in a single location (consistent with paragraph AV23 of Mr. Linsmeier's Alternative View).

As noted in our response to Question 8, we broadly support the direction of the ED's disclosure proposals but believe that the specific disclosures for both lessors and lessees may differ depending on the extent of leasing activity and the relative importance of leasing to the entity's business model or operations.

Investigate a model based on control and the underlying asset

We recognize that any significant reform of lease accounting is challenging and is likely to prove controversial (especially if reform leads to more leases being "on-balance sheet"). Nonetheless, as noted above we believe that improvements that would curtail current abuses and provide relevant and representationally faithful information are necessary and achievable.

We explain below our suggestion to redirect the Boards' future work on lease accounting towards investigating a model that focuses on whether a lease, in substance, transfers control of the underlying asset to the lessee. Such a model would maintain a distinction between leases that are sales (and financings) and leases that are executory arrangements (ie contracts for which the performance obligation is to provide access to an underlying asset that is discharged over time, or service contracts). This approach could be described as an update to IAS 17 *Leases*. However, more recent thinking in the Boards' projects on revenue recognition, consolidation, and a revised conceptual framework offer a starting point to update and improve the IAS 17 model in a manner that reduces structuring incentives. We would anticipate that the threshold would change under a control-based model, such that more leases would be classified as sales. Also, under sales-type accounting, the lessee would recognize its obligation to return the residual asset to the lessor (and the lessor would recognize the corresponding asset).

In more detail, we suggest that the Boards should investigate a model where:

- the underlying asset is normally the unit of account when control of the underlying asset has transferred to the lessee (there may be instances when a group of assets would be the unit of account)
- the rights and obligations under an enforceable contract would be the unit of account when control of an underlying asset has not transferred to the lessee.

This model should be, as far as possible, conceptually and operationally consistent with the accounting for contracts with customers in accordance with the forthcoming revenue recognition standard. The model would classify leases as either a sale of the underlying asset or an executory arrangement. Accordingly lessor accounting should be similar to the accounting for economically similar contracts with a customer, either a sale or an executory arrangement. Lessee accounting should be similar to the accounting for economically similar acquisitions, whether an asset purchase, a business combination, or an executory arrangement.

In suggesting a model that distinguishes between different types of lease we agree with the Boards' conclusions that there is more than one type of leasing arrangement. However, we do not agree with the proposed criteria for distinguishing between the different types of leases or with separate criteria for classifying property and other underlying assets. We believe instead that the recognition, measurement, and presentation of the assets, liabilities, expenses, and cash flows arising from a lease should differ based on whether control of the underlying asset has transferred from the lessor to the lessee. A control-based model also would provide a conceptual basis for accounting for short-term leases as executory contracts without a need for a practical expedient. It would also provide an opportunity to achieve more consistent accounting for leases of tangible and intangible assets.

A control-based model would necessitate developing specific guidance on assessing when a lease transfers control of the underlying asset. In that context we note that a control-based notion was described in paragraph 8 of the Discussion Paper *Leases*. In that document, the Boards proposed separate accounting for 'a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity'. To that end, we would not use the term 'trivial' in describing the risks and rewards and would also consider other indicators of control, such as the length of the lease term relative to the economic life of the asset, existence of options to renew a lease relative to the economic life of the underlying asset, purchase options, the ability to refinance, and perhaps other factors. We also note that the ED's proposals on sale and leaseback tacitly acknowledge that a lease sometimes transfers control of the underlying asset. As discussed in Appendix II to this letter, we consider that the control indicators in that part of the ED are a good start, but are incomplete.

In our view, the other key focus of future work should be on how best to portray executory contracts in the financial statements – that is, how the enforceable rights and obligations of the lessee should be measured and recognized when control of the underlying asset has not passed. As noted in the Conceptual Framework DP (paragraph 3.110), 'in principle, a net asset or a net liability arises under an executory contract if the contract is enforceable'. Consistent with the DP, we agree that it is enforceability that makes the information relevant to users, not whether the contractual asset represents a right of use of a tangible asset, intangible asset, or service asset. Therefore, we believe those contractual assets and liabilities should be accounted for when the contract is enforceable. When the control of the underlying asset has not transferred from the lessor to the lessee the contract is the unit of account and the rights and obligations are best represented by net assets and liabilities. How those assets and liabilities are measured and recognized should be a key focus of the Boards' future work on leasing. We suggest that accounting for the lessor's obligations to provide access to leased assets as performance obligations settled over time may best reflect the underlying economic substance of the transactions when control of the underlying asset has not passed to the lessee.

We acknowledge that much of this new model would need to be developed, and that its practical effects, operationality, and acceptance by constituents cannot be determined with certainty at this time. However, we believe that this 'direction of travel' has the best potential to deliver significant improvements to lease accounting while avoiding the problems that have beset the right of use model. In the long run, given developments in revenue recognition, consolidations, and the conceptual framework, we believe a control-based model, combined with a model for representing executory contracts in the financial statements, may well offer an appropriate long-term solution for lease accounting.

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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@gti.gt.com or + 44 207 391 9510), on behalf of Grant Thornton International Ltd or John Hepp, Partner - Accounting Principles Consulting Group (john.hepp@us.gt.com or +1 312 602 8050), on behalf of Grant Thornton LLP.

Sincerely,

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Responses to Invitation to Comment questions

Question 1: Identifying a Lease

Do you agree with the definition of a lease and the proposed requirements in paragraphs 842-10-15-2 through 15-16 for how an entity would determine whether a contract contains a lease? Why or why not? If not, how would you define a lease? Please supply specific fact patterns, if any, to which you think the proposed definition of a lease is difficult to apply or leads to a conclusion that does not reflect the economics of the transaction.

We do not agree with the proposed definition of a lease. Our main objections stem from concerns about whether the definition would be operational as a means of distinguishing between a lease contract and a service contract or between lease elements and non-lease elements within a contract. Specifically, we are concerned that the criteria for control of the right to use the asset and specified assets could lead to significantly different accounting outcomes for economically similar transactions. Potential ambiguity between what is a lease contract or element and what is an executory contract or element creates opportunities to structure transactions to achieve a particular accounting result. Even if structuring of transactions was not a concern, the degree of judgement required to distinguish whether an arrangement contains a lease could lead to diversity in practice.

We are also concerned that the proposed guidance on a specified asset and the separability of non-lease components will not result in financial statements that provide useful information. Examples 2 and 3 in the ED appear to offer criteria for determining separability, and therefore for whether the lessee controls an asset, that would not be met even by some owned assets. The determination relies heavily on whether consumables are available from third parties regardless of whether the lessee has the right to use those consumables. We believe that the relevant information for users centers on the timing and amount of non-cancellable future cash flows. Whether consumables are or are not available in the marketplace would not appear to be relevant. Also, the time and costs required to evaluate, document, and audit the judgements necessary to categorize leases does not in turn provide users of financial statements with better information regarding the transactions.

We are also concerned that in many cases distinguishing between lease elements and non-lease elements will not provide the most useful information to the users of the financial statements. Users of the financial statements are interested in information about the cash flows from all future commitments. The proposed definition of a lease will not provide that information. We believe that a user is more interested in the committed cash flows than whether the contract conveys the right to use a particular strand or a comparable amount of capacity. The requirement to identify a specified asset also creates opportunities for structuring a transaction to obtain a particular accounting result in other industries, including transportation and storage.

Therefore we prefer that the Boards develop a model for lessor accounting for a lease that is similar to the accounting for economically similar contracts with a customer, either a sale or an executory arrangement. We believe that lease arrangements should be evaluated using the guidance in the forthcoming revenue recognition standard to identify the distinct elements of an arrangement instead of developing a separate construct of a component of a lease. Also, the same guidance should be used to, for example, determine the circumstances in which an entity would allocate a contingent amount entirely to the lease element or other distinct goods or services promised in a contract. We also suggest the same practical expedient be available to account for two or more distinct goods or services promised in a contract as a single performance obligation if those goods or services have the same pattern of transfer to the customer.

Similarly, lessee accounting should be similar to the accounting for economically similar acquisitions, whether an asset purchase, a business combination, or an executory arrangement.

In the long run, given developments in revenue recognition, consolidations, and the conceptual framework, we believe a control-based model, combined with a model for representing executory contracts in the financial statements, may well offer an appropriate long-term solution for lease accounting.

Question 2: Lessee Accounting

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

We agree that the recognition, measurement, and presentation of expenses and cash flows arising from a lease should differ for different leases but do not agree with a model that differentiates leases based only on consumption of the underlying asset. Nor do we agree with the accounting model proposed for Type B leases.

As noted in the main body of this letter, we believe that the recognition, measurement, and presentation of the assets, liabilities, expenses, and cash flows arising from a lease should differ based on whether control of the underlying asset has transferred from the lessor to the lessee. Consumption may be one of the indicators of whether control of the underlying asset has been transferred to the lessee. We believe that a control-based model would be more consistent with the models for revenue recognition, consolidation, and the proposed change in the definition of an asset in the IASB's Conceptual Framework DP.

We note also that the Boards' 2009 Discussion Paper *Leases* made a distinction based on control of the underlying asset (as described in paragraph 8). In that document the Boards proposed separate accounting for 'a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity.' We encourage the Boards to further develop that distinction as a means of classifying leases in a manner that would curtail current abuses and provide relevant and representationally faithful information to the users of the financial statements. We believe that an updated definition of control that aligns with that in the revenue recognition standard would limit or curtail opportunities to achieve a particular accounting result through standards arbitrage. To that end, we would not use the term 'trivial' in describing the risks and rewards and would also consider other indicators of control, such as the existence of options to renew a lease for the economic life of the underlying asset, purchase options, and perhaps other factors.

We also do not agree with the accounting model proposed for Type B leases. At this time, we are not convinced that accounting for a right of use asset as tangible property is always representationally faithful. While amortization and impairment testing may be appropriate when control of the underlying asset has transferred to the lessee, we are not convinced that either is appropriate when it has not, nor would revaluation under IFRS be the appropriate model. When control of the underlying asset has not transferred to the lessee, we believe that the resulting assets and liabilities are better represented by a new accounting model that would reflect their nature as fully or partially executory contracts. The same is true of the related obligation.

Question 3: Lessor Accounting

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

We agree that consumption is one of the factors that could be considered for classification of leases, but not the only factor. Consumption is another way of describing the extent to which the benefits of the underlying property accrue to the lessee, and is one of the current criteria in IAS 17 and ASC 840 *Leases*. We believe that other factors would be relevant for determining whether control of the underlying asset has passed to the customer.

We believe that a better classification scheme would be to distinguish between those leases that are in substance a sale of the underlying asset (a Type A lease) and those that are not (in substance an executory contract that will be completed over time). Such a model, based on control of the underlying asset, was described in paragraph 8 of the 2009 Discussion Paper *Leases*. In that document, the Boards proposed separate accounting for 'a contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity'. A Type B lease would be a lease that does not transfer control of the underlying asset to the lessee and therefore is not a sale but a performance obligation that will be satisfied over time.

If the Boards elect to continue with the proposed model, we believe that the classification criteria should be applied uniformly to property and non-property. We do not agree with classifying leases from the perspective of the lessor based on transfer of more than an insignificant portion of the economic benefits to the lessee. We note that this is not consistent with the criteria in the forthcoming revenue recognition standard for transfer of the significant risks and rewards of ownership of the asset. The proposed model therefore creates the potential for different accounting treatments for economically similar transactions. Therefore, we would prefer that the criteria for classifying leases of property be used for classifying all leases in part because it is more consistent with developments in revenue recognition.

Question 4: Classification of Leases

Do you agree that the principle on the lessee's expected consumption of the economic benefits embedded in the underlying asset should be applied using the requirements set out in paragraphs 842-10-25-5 through 25-8, which differ depending on whether the

underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?

We agree that consumption of the underlying asset is one of the indicators of whether control of the underlying asset has transferred to the customer. We do not believe that it is the only factor that should be considered in making that determination. We would prefer that the Boards develop a model based on transfer of control of the underlying asset to distinguish between those contracts that should be accounted for as a sale and purchase and those contracts that do not and therefore are executory in nature.

Question 5: Lease Term

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

In general, we do not agree with reassessment of the lease term absent a modification of the lease. The proposed guidance on reassessment of the lease term is an element of the right of use asset approach that has not proved its ability to provide useful information to investors. In our view, optional renewal periods would be a factor in determining whether control of the underlying asset has passed to the customer and therefore in determining whether the transaction is a completed sale or an executory contract. Reassessments of whether the transaction has transferred control to the customer should be rare unless there has been a modification of the contract.

If control has transferred to the lessee, the lessee should account for the underlying asset with a corresponding obligation to pay or return the asset. On exercise, an obligation to return would be reclassified as an obligation to pay. This is not a reassessment of the lease term. A reassessment might occur when there is a change in the contract provisions such that the original determination as to whether control of the underlying asset has or has not transferred to the lessee could change.

Question 6: Variable Lease Payments

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

We do not agree with the current proposals. We are not convinced that the proposals would provide users with relevant information. The proposal considers some, but not all variable payments using procedures that differ from those in the forthcoming revenue recognition standard. Our preference is that the lessor would use the same measurement principle prescribed in the revenue recognition standard in accounting for variable lease payments. A similar model should be developed for lessees.

Variable payments are a broad group and include many payments that are very different in economic substance. For example, assuming that control of the underlying asset has passed to the lessee, the asset should be recorded at its selling price. A subsequent change in a variable payment that is due to a change in an inflation or interest rate index would affect the cost of financing the acquisition, but not the cost of the asset. Variable payments based on usage or sales may be an indicator as to whether control of the underlying asset has or has not transferred to the lessee. The payments may be executory in nature or may be a factor in determining the value of the residual asset of the lessor or obligation of the lessee at the end of the lease term. We believe that the accounting model should reflect those differences.

Question 7: Transition

Subparagraphs 842-10-65-1(b) through (h) and (k) through (y) state that a lessee and a lessor would recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach. Do you agree with those proposals? Why or why not? If not, what transition requirements do you propose and why?

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

We do not believe that the accounting approach in the proposal would provide relevant information for the users of the financial statements and therefore do not agree with transition to this model.

If the Boards elect to proceed with the proposed approach, the transition method for lessors should reflect the transition provisions in similar standards. For lessors, operating leases are another form of contract with customers and the transition provisions should align with those in revenue recognition, including retrospective application or the optional practical expedients.

We agree that finance leases should not be restated from the perspective of either the lessor or the lessee.

Question 8: Disclosure

Paragraphs 842-10-50-1, 842-20-50-1 through 50-10, and 842-30-50-1 through 50-13 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments, reconciliations of amounts recognized in the statement of financial position, and narrative disclosures about leases (including information about variable lease payments and options). Do you agree with those proposals? Why or why not? If not, what changes do you propose and why?

We agree with the overall disclosure objective proposed in the ED. However, we believe that the specific disclosures required to meet this objective for lessors and lessees may differ depending on the extent of leasing activity and the relative importance of leasing to the entity's business model. For example, we suggest that the Boards explore different disclosure requirements for the following situations because the information useful to an investor may vary:

- a lessor that is primarily a financing entity

- a lessor that is a manufacturer or reseller that offers leases as an alternative to sales and sells or transfers the related receivables
- a lessor that actively owns and manages assets to be rented for a return
- a lessor that is a special purpose entity that leases primarily or exclusively to related parties
- a lessee with incidental leases for low value items such as copiers, computers, vehicles, etc
- a lessee with individually significant leases, such as for manufacturing facilities, headquarters, etc
- a lessee with leases from special purpose entities that may or may not be a related party
- a lessee with leases from related parties.

Some entities may have more than one type of activity. Some of these distinctions may be captured in the current distinctions between Type A and Type B leases, but we suggest that it would be more informative if an entity described how it employs leasing arrangements in its operations and provides information useful for evaluating its performance and financial position. We generally support roll-forwards of amounts carried on the statement of financial position. However, the information may be redundant with other information in the notes when, for example, the reporting entity engages in leases that are sales of the underlying assets and does not retain the related lease receivable. Therefore, we suggest the Boards consider when the required disclosures may or may not be relevant to the user of the financial statements or redundant with other information provided in the notes.

Comments on other significant issues

Sale and leaseback

In accordance with the ED a sale and leaseback transaction would be evaluated to determine whether a sale has occurred, an approach more or less consistent with much of today's accounting. The major difference is that if a sale has occurred, many gains or losses are deferred, a tacit acknowledgement that a true sale has not occurred when the seller retains the use of the asset even though the accounting rules permit derecognition of the underlying asset.

The ED looks at a sale and leaseback as two separate transactions. We agree that control must pass to the buyer/lessor using the criteria in the forthcoming revenue recognition standard in order for a sale to be recognized. However, we do not agree with using a different set of criteria to determine whether control has passed back to the seller in the form of the leaseback. Those criteria are the same as those used for determining whether a lease of property is classified as a Type A lease or a Type B lease:

(a) the lease term is for the major part of the remaining economic life of the asset; or
(b) the present value of the lease payments accounts for substantially all of the fair value of the asset.

That leads us to two observations: first, a Type A leaseback of real estate would never qualify for sale and leaseback, a distinction we agree with but that will create a significant difference in accounting outcome based on what may be a minor change in the facts and circumstances or interpretation of the facts and circumstances, increasing the sensitivity of the classification analysis; second, we believe the proposal tacitly acknowledges that control of an underlying leased asset can be transferred by a lease arrangement and that if control passes back to the seller in the form of a lease a sale has not occurred.

This is inconsistent with other aspects of the right of use asset model because it uses the underlying asset as the unit of account, and therefore is another anomaly within the right of use approach. However, in terms of a possible control-based model this is a good start (but incomplete). It ignores other indicators of control, eg renewal options, purchase options, residual value guarantees, or other indicators that control has not transferred. We would use a lower threshold for evaluating transfer of control as the criteria in the proposal could perpetuate many of the current abuses in lease accounting, but we agree with the basic concept.

In relation to the ED's proposals on sale and leaseback, we have a concern as to the treatment of sales that are not priced at fair value. If control has transferred to the buyer and not transferred back to the seller, then any gain or a loss would be recognized on derecognition of the asset. This can lead to results that are not representationally faithful when the transaction is at an amount other than fair value. The ED's proposals aim to address those possibilities by making adjustments to the right of use asset and the gain or loss based on current market rates for lease payments for that asset. We do not agree with using market rates for rentals to determine the adjustment, nor do we agree with adjusting a right of use asset for the difference for the following reasons:

- the fair value of the asset, not the fair value of rentals, should be used to determine whether a sale is at fair value or not. The fair value of the underlying assets sold is generally available at the time of the transaction or determinable based on established valuation models for which market rents are not the only source of information. The market value of the asset therefore is a better indicator of whether the transaction price is at, above, or below market

- consistent with other GAAP, we believe that an impairment loss should be recognized for the excess of carrying value over fair value
- a sale at less than market is a form of prepaid rent. The excess of fair value over the sales price should be recognized as a separate asset (or as a net contract asset). Adding the unrecognized loss to a right of use asset could lead to immediate recognition at the next impairment test date
- a sale at more than market is a form of financing. The excess of the sales price over fair value should be recognized as a financing element in the transaction, if significant. Accounting for a financing element as a reduction of the right of use asset would not be representationally faithful for a Type B lease. If the Boards elect to issue a final standard based on the right of use asset, we may have similar concerns about the accounting for incentives.

Business combinations

In accordance with the ED's proposals there is potential for accounting arbitrage between accounting for an acquisition transaction as a lease or a purchase of a group of assets. Under ASC 810 *Consolidation* and IFRS 3 *Business Combinations* a purchase of a group of assets that constitutes a business would be accounted for as a business combination, including the recognition of unrecognized intangible assets and goodwill. However, if the transaction is structured as a lease, it would fall under the right of use asset model which produces a significantly different accounting result.

We acknowledge that this issue also exists today. However, we believe the ED's proposals could exacerbate the problem and that a leasing model should address this area.

We believe that transactions such as those described in Examples 1-3 of the ED should be evaluated under the consolidation literature first. If the group of assets does not meet the definition of a business, the acquisition should be accounted for as an asset purchase if the acquirer has control of the underlying assets or, if the acquirer does not obtain control of the assets, as a supply agreement. We do not believe that power supply arrangements and similar contracts should be included within the right of use asset model. While we would not object to accounting for a power supply arrangement as an operating lease, we believe it would be preferable to separately promulgate disclosure requirements for power supply agreements and similar non-cancellable contracts. We would include rights to use fiber optic cables (indefeasible rights of use) and other similar arrangements in that same category.

Intangible assets

The accounting for intangible assets will potentially differ between IFRS and US GAAP. The IASB's ED includes an option for lessees to apply the proposal to leases of intangible assets and excludes service concession arrangements. In our letter on the 2010 ED, we commented that the assets included within the scope of the definition should include intangible assets with finite lives. We also prefer that the Boards arrive at converged solutions whenever possible.

We are concerned that optionality will lead to a lack of comparability and suggest, at a minimum, that the IASB provides guidance on how to apply the option. For example, the standard should provide guidance on whether the option would be an accounting policy choice that would apply to all leases of intangible assets or can the option be applied to a class of assets or on a transaction by transaction basis. If the IASB retains the optionality, we suggest some guidance on classification and the accounting for variable payments based on royalties, milestones, or future developments.