

International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

7 December 2010

Dear Sirs

## **Feedback to Consultation on IASB Exposure Draft ED / 2010 / 9 Leases**

### **About the Responder**

Oxfam GB is an International Non-Governmental Organisation, registered as a charity. Oxfam GB prepares financial statements under the UK Companies Act, Scottish Regulations relating to Charities and UK GAAP including specifically the Charities Statement of Recommended Practice.

As explained in our response to Q18 below, we recognise that charities in the UK are not currently subject to IFRS, however there is a parallel consultation process which aims to bring charities within the scope of the IFRS for SMEs, hence our interest in participating in the consultation process.

Oxfam GB has a substantial portfolio of real estate properties occupied for a variety of purposes. In the UK, these include c. 670 leasehold shops, c. 70 freehold shops, a number of trading depots, online sales and logistics warehouses, small offices for regionally located retail and/or property management and campaign teams as well as the main office and a regional accounting services facility. Oxfam has a number of partially sublet properties in place in its retail portfolio, primarily residential in nature, and subcontracts the administration of these to an external party due to the volume and nature of work involved in the residential sublet market. Internationally, Oxfam has offices in over 60 countries worldwide and the rental contracts for the majority of these also take the form of leasehold contracts for 1-5 years.

Additionally, Oxfam GB has approximately 100 vehicle lease rental contracts primarily related to the retail division.

Oxfam's lease commitments (Statutory Accounts to 31 March 2010 note 20 c) total £13.8 million of which £13.4 million relates to Land & Buildings (calculated on the basis of the period to the next break) and the rest (less than 3% of the total) relates to vehicle leases.

### **Answers to Consultation**

#### **Question 1: Lessees**

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

The intent of the Exposure Draft is to provide users of accounts with a complete and understandable picture of an entity's leasing activities remarking that leasing is an important source of finance.

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The majority of our organisation's operating leases relate to the land and buildings in which our retail operations are conducted. In the UK property may be occupied primarily as freehold or leasehold and the choice between these two is usually made on the basis of the occupier's core business model. The opportunity to lease rather than buy property is not seen so much as a matter of financial engineering as a practical choice that maintains operational flexibility.

This aim of operational flexibility is underlined by the fact that in the UK most retail leases have break clauses before the expiry of the lease and will also have rent review clauses during the term of the lease. Both of these factors dictate that certainty of the fundamental aspects of a lease namely the term and the rent for the duration of the contract are not known until the end of the contract.

The Exposure Draft indicates that readily available forward indices should be used to determine rental payments and that in the absence of these prevailing indices should be used. The results of future rent reviews in the UK market depend very much on the evidence on Zone rates in the area in the immediate proximity of the property. Whilst commercial organisations do sell information about retail market rental indices these relate to primary retail locations and wide geographic areas. There are no reliable indices for secondary and tertiary retail locations such as those often occupied by charity retailers like Oxfam.

As a result of these factors relating to the likely term of a lease and the value of future rentals, the application of the requirements of the Exposure Draft would lead to a range of interpretations by organisations operating a network of leasehold properties and this degree of subjectivity would not aid comparability of performance for users.

The current model requiring the disclosure of lease liabilities according to when the liability falls due appears to us to provide as much relevant information for users of accounts as they may need, in order to form an understanding of the financial obligations of a reporting entity. We consider that adopting the 'right-of-use' model will introduce a significant additional administrative burden on organisations such as ours, as well as much more subjectivity, in terms of decisions over discount rates, lease periods and future rent increases, for no identifiable benefit.

Conceptually we would also argue that a typical 15 year property lease does not actually represent a transfer of a significant proportion of the risks and rewards of ownership from the lessor's standpoint, where the bulk of the value is represented by the residual value at the end of the lease.

We note that the Exposure Draft recognises a different conceptual model for accounting by Lessors, ie the Performance Obligation Approach, where the lessor retains significant risks or benefits in the underlying asset. The ED also recognises that short leases (ie less than 12 months) may be treated as period costs.

In our view a model of accounting by lessees and lessors, similar to the current operating lease accounting, should be maintained, and available based either on lease length as a proportion of the asset useful life or the minimum lease payments as a proportion of total value. However we recognise that the current threshold for

operating lease accounting (often taken as 90% of the asset value for example) is set too high, and should be reduced.

Incidentally, it does appear to us that the performance obligation approach is fundamentally flawed, in that it results in the recognition of two separate assets in the accounts of the lessor company, which cannot possibly represent the same underlying physical asset simultaneously.

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**Question 1: Lessees**

**(b) Do you agree that a lessee should recognise amortisation 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 use and why?**

As stated above, we believe that, where it can be demonstrated that the right of use does not represent a significant proportion of the value of the asset, it is more appropriate to continue to regard the lease as a period cost, in line with the contractual terms, including the lessee's obligations to pay rent, service charges etc.

Having said that, if the right-of-use model is adopted, then there clearly needs to be a mechanism for removing the respective asset and liability from the accounts, and so some form of amortisation is inevitable.

However, adopting the requirement in the ED on assessing lease periods under the right-of-use model introduces a high degree of subjectivity, and notional amounts into the financial statements, some of which, for example the discount rate, are particularly problematic for charities.

**Question 4: Definition of a Lease**

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

We would not disagree with the definition of a lease in the exposure draft. Our disagreement is with the failure to distinguish between a lease that is fundamentally a financing transaction and one which is a rental transaction.

It is our view that leases which do not transfer a significant proportion of the risks and benefits of ownership (including most short leasehold property contracts of say, less than 25 years) should continue to be accounted for as operating leases for the reasons outlined in our answer to Question 1 (a) above.

**Question 5: Scope Exclusions**

**Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you use and why?**

See above.

**Question 8: Lease term**

**Do you agree that a lessee or 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 lessor should determine the lease term and why?**

It is our view that requiring the longest possible lease term to be used will create a distorted picture which will not represent the choices most likely to be made by an organisation. Determining the most likely exit to a lease is only feasible over the short term. Decisions to continue trading in a property can generally be made on a 12-18 month timeframe prior to potential exit dates. While the preference would be to continue trading subject to a favourable rent review, in many cases deteriorating shop performance will result in a decision to discontinue the lease at the next available break point (or even prior to it), unless a rent reduction can be negotiated.

Trading strategy can also change in a dynamic retail environment where trade is shifting increasingly to the internet and the high street presence may change or relocate substantially.

As mentioned above, in cases where trading losses are being incurred, it will be preferable to an operator to consider breaking the lease before the next contractual opportunity where a relatively low penalty will ensue.

These considerations indicate how subjective a decision on the most probable exit may be. In this situation it is our view that the best and least subjective criterion available is the end of the lease, or the next contractual break point if earlier. This will aid users in providing comparability between organisations. Phasing information about liabilities over time (<1 year, 2-5 years, 5 years plus) can further supplement this.

Applying the longest probable lease term would increase the liability two or three fold and would also increase the degree of inaccuracy in the calculation due to the uncertainty over future rental payments which will be unknown at the time the calculations are made. In the case of a longer lease there will be multiple rent review dates as these will increase with the length of lease term that is brought into the scope of the calculation. Note: In the UK rent reviews typically occur each 5 years and are not subject to prevailing national published indices.

We note that the IFRS' representatives at the Lease Outreach event in London on 5th November indicated that they are sympathetic to changing the proposals, such that the lease period could be taken as the shortest guaranteed period, unless it was 'highly probable' that it would be extended. We would encourage the IASB to adopt this in the proposals for change.

#### **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?***

Reassessment would be a detailed and arduous annual exercise as there will be substantial change in the leasehold contracts in our portfolio over that time with on average a 20% rate of change aside from additions to and exits from the portfolio. The evaluation of the trading prospects of the retail environment would also change and potentially the financial performance of individual outlets.

However provided that the interpretation of "significant change" is sufficiently broad, such that only real exceptions would be in scope, the burden would be reduced accordingly.

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**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 or investment property as appropriate, 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?***

If the right-to-use model is adopted then it would be essential to separate the resulting assets and liabilities from other categories in the Statement of Financial Position. Oxfam's donors and supporters use our Financial Statements to understand the choices we have made to use resources they provide and their primary interest would be to see funds directed to programme work. We are concerned that it would be confusing and misleading to the users of our accounts to see notional values appearing as a result of these changes, as it would incorrectly suggest that we had 'acquired' a large balance of fixed assets, which would be contrary to the best use of charitable funds.

Confining the presentation of this information to the notes to the accounts might lead to this detail being overlooked by some users of Financial Statements.

**Question 13: Statement of comprehensive Income**

***Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (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?***

It is not clear how separate statement of lease expense would be accomplished within the relatively prescriptive requirements related to income and expense that are set down in the Charities SORP. To the extent that the resulting expense to be disclosed is materially higher than the true cost of rental and related costs actually incurred under leasehold contracts it would be important to indicate what the true costs are and the degree of distortion arising from the application of the exposure Draft's requirements. Demonstrating cost effectiveness to our supporters is a key requirement for Oxfam.

**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?***

If the right-to-use model is implemented then it would be essential to separate the related cash flows in the Statement of Cash Flows.

Confining the presentation of this information to the notes to the accounts might lead to this detail being overlooked by some users of Financial Statements.

**Question 15: Disclosure**

***Do you agree that lessees and lessors should disclose quantitative and qualitative information that: (a) identifies and explains the amounts recognised in the financial statements arising from leases; and (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?***

It is not clear how the disclosure of quantitative and qualitative information would be achieved in a practical and meaningful manner for a portfolio of 700 or so leasehold contracts on anything other than a very high level basis. This would be best achieved by disclosure of amounts related to right-of-use-assets and related liabilities in the Financial Statements as an explicit category with an explanatory note explaining the nature of the underlying asset ie. leasehold property.

**Question 16: Transition**

***The exposure draft proposes that lessees and lessors should recognise 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? Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not? Are there any additional transitional issues the boards need to consider? If yes, which ones and why?***

The simplified retrospective approach is appropriate for practicality and ease of implementation. However we are concerned at the suggestion at the recent consultation event that the impact of the proposed changes will lead to a reduction in our reserves, which would potentially result in our organisation falling outside its committed reserves range as approved by the trustees. We would prefer to achieve a 'nil impact' transition on our balance sheet.

**Question 17: Benefits and Costs**

***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?***

Meeting the requirements of the Exposure Draft would result in a significant amount of work to change the current basis of calculations undertaken to state lease liabilities and to add to the reporting of fixed assets and liabilities throughout the financial statements. On an ongoing basis, the incremental work to document the judgements made on a case by case basis concerning the lease term of each leasehold contract would be material. It would probably necessitate additional portfolio reviews or a change in timing of current portfolio reviews to facilitate the production of statutory accounts at the year-end. This would represent additional work across retail line management and property services as well as for financial staff compiling accounts.

Meeting the requirements would result in differences between management and statutory reporting as retail reporting includes lease rental in shop costs. It is undesirable to replace rental costs related to a current lease contract with which shop teams are familiar with a charge for amortisation of the present value of the right of

use assets represented by a shop lease that may have a maximum legal term of 10 to 20 years. Rental costs are a material element of the cost base in charity retail outlets, which are highly reliant on a shop team comprised of volunteers usually led by a paid shop manager. This team comprises the principal users of individual shop financial accounts. Maintaining parallel accounting for the cost of lease properties would also add workload and complexity.

The complexity of collecting information on office leases from over 60 countries worldwide with their own distinct leasehold contracts would add a further layer of complexity and burdensome work for no apparent benefit.

We have no evidence that users of our Financial Statements would benefit from the change in reporting.

The extension of the Exposure Draft's requirements to sublet contracts within our portfolio would add a further workload. It would dictate a change in administration of our sublet contracts and/or a change in the subcontracted arrangements in place. Both would add workload with cost implications.

## **Question 18: Other Comments**

### **Charity Reserves**

The Exposure Draft clearly intends that these right of use assets be reported under tangible assets with all other property, plant and equipment. Charities create designated reserves for all fixed assets equal to the amount of unamortized net book value as a result of the requirement in the Charities SORP to classify general reserves to exclude any part of unrestricted funds not readily available for spending, specifically, income funds which could only be realised by disposing of fixed assets held for charity use. If right of use assets were to be deemed as tangible fixed assets under the SORP or the new Public Benefit Entity standard, then a potentially enormous transfer from general reserves to designated reserves may be required, which would leave many charities with negative reserves.

The Exposure Draft is silent on this aspect of fixed asset accounting for charities and we recommend that clarification on the need to establish designated reserves should be explicitly included in the Public Benefit Entity standard. Charities with a substantial volume and value of property leases (care providers, charity shops chains etc.) would be materially impacted.

### **Comparability**

There are a number of points where we think that the aim to ensure comparability of statement of property assets between organisations will be compromised and we outline these briefly below in the interests of indicating that this document should exclude property leases from its scope:

#### **(1) Holding Over**

In the current rental market it may be more typical that tenants are holding over on negotiations where the landlord has taken no action. They will be looking for rental evidence on zone A rates in the market to be more favourable before negotiations commence. As a result no liability to pay future rentals will be reported in this case although the property is occupied and used for business. This represents a major lack of comparability for users of the accounts comparing one organisation to

another. This is not addressed in the standard. We have no proposals to make but we think it further weakens the accounting treatment and supports our recommendation to not change from current disclosure in the note to the accounts.

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(2) Other Cost Provisions relevant to ownership status

The presumption of ownership set down in the standard indicates that a more extensive evaluation of other costs may be required than may currently be the case relating to:

- a) Dilapidations;
- b) repairs status on leases with specific lessee repairing clauses ;
- c) back rent risk on open negotiations;

(3) Comparability with Freehold:

Freehold properties are held on the books at cost less depreciation which represents the revenue charge. Leasehold charges would be based on flow of rental payments discounted which may bear no relation to depreciation on historic cost for freeholds. As a result, comparability between organisations with say 30% freehold/70% leasehold portfolios and 50%:50% would not be aided by the recommendations of the discussion paper.

Retailers Objections & Cost Benefit

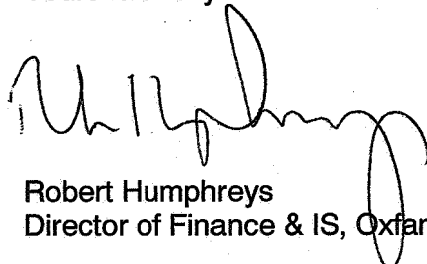
Paragraph 203 in the Basis for Conclusions lists the concerns of Retailers who are concerned that the administrative burden outweighs any benefits provided to users of accounts. These focus on the difficulty of determining an appropriate discount rate, the burden of assessing lease options on a shop by shop basis and the significant costs to implement the changes to reporting.

The Board goes on to disregard these concerns, using the rationale that "the majority of users of financial statements think that the proposed model is an improvement". In our view this approach gives insufficient consideration and weight to the cost aspects of implementing the standard and has not considered the very real operational complexities of implementation and the consequent cost for retailers with extensive leasehold portfolios. Having attended the London consultation event, it is not clear which users of accounts the Board has in mind – none of the attendees who were not associated with the Board's proposals in some way were in favour of them.

Applicability to UK SME's

Oxfam, as a charity, is not yet formally subject to IFRS's, until they become part of UK GAAP. However, we assume that charities will be brought into their ambit in the next couple of years. There is a parallel ongoing consultation over how to implement IFRS for SMEs and one of the proposals is that charities should adopt the IFRS for SMEs, which currently retains the current model of accounting for leases. The IASB should clarify whether they intend to allow SMEs to continue to use the current model of lease accounting in this case.

Yours faithfully



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