26 November 2010

Francoise Flores
Chairman
EFRAG

Dear Francoise,

Exposure draft leases - EFRAG's draft comment letter to the IASB

This letter sets out Alliance Boots' comments on EFRAG's draft comment letter in response to the IASB Exposure Draft ED/2010/9 – Leases ("ED").

Alliance Boots is a leading international pharmacy-led health and beauty group. Our two core business activities are pharmacy-led health and beauty retailing and pharmaceutical wholesaling. Alliance Boots is privately-owned and, including associate and joint ventures interests, employs over 115,000 people in more than 20 countries. In our most recently published annual results to March 2010, we reported revenue of £18.7 billion and trading profit of £940 million. Our annual operating lease rental expense is around £350 million and approximately 90% of this charge relates to property leases, of which the Group has around 3,000.

We share EFRAG's concerns that the IASB's proposals do not offer an effective improvement on existing lease accounting rules and indeed we are concerned that the usefulness of financial statements may be reduced. Whilst we will be submitting a full response to the IASB in due course, we would like to share our current position on those areas which we consider particularly important that the IASB address so that EFRAG can consider these in its own final response.

Transition

We disagree with the transition proposals in the ED. We believe that a methodology that recognises the actual start date of the lease, but permits the use of a current discount rate and rental amount would be more appropriate.

We believe that the standard, when issued in its final form, must allow preparers of financial statements to apply an approach that does not distort the income statement on initial application. In particular, the ED would artificially understate the profits of many businesses in the early years of adoption, to the detriment of users of financial statements.

The ED proposes that lessees and lessors recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach. This approach requires preparers, on adoption of the standard, to effectively treat the first day of the comparative period as the date of inception for all outstanding operating leases.

Whilst we can understand that the board wants to make initial application simple and less time consuming for preparers, we do not agree that this simplified approach should be mandated. Applying the proposed simplified retrospective approach will result in a distortion in the income statement in the early years of adoption which could be significant. This is because under the ED's proposals, the total income statement charge is higher in the early years of a lease than the later years, and so a simplified retrospective approach will lead to a higher income statement charge for businesses who are lessees than would be the case under a fully retrospective approach.

In retail businesses such as ours, leasehold property portfolios are typically managed so that lease renewals and rent reviews are spread over many years to minimise risk. The transitional arrangements of the ED do not reflect this reality.

We propose therefore that the board consider other simplified retrospective approaches that reflect the true economic position and do not artificially reduce profits immediately on initial application. At the very least, entities must be allowed to fully retrospectively apply the standard.

Lease term – contractual options

We do not believe that the standard, when issued in its final form, should require lessees and lessors to take into account and consider either lease terms beyond contractual break points, or contractual options to extend a lease, when determining the lease term over which future cash flows are discounted.

We believe that the ED does not reflect economic reality, (as it would overstate liabilities). As drafted, it completely fails to distinguish between businesses who manage risk by leasing property with break points and those who do not and sacrifice flexibility for lower rents.

We believe the lease term should therefore be the minimum contractual term.

We do not believe the possible future payment of lease rentals during a renewal period or past a breakpoint meets the definition of a liability, as it takes account of payments that are still at the discretion of the entity and will only occur under conditions that are favourable to the entity (i.e. the entity will not exercise an option to extend a lease under conditions that are potentially unfavourable). We believe the only exception to this should be where the option is not at "market terms".

Options to extend or break a lease provide the lessee with the flexibility to react to changing business circumstances and consequently these features reduce risks. If these options are required to be included in the measurement of the lease liability, then, for example, a 10-year lease would be accounted for in the same way as a 5-year lease with a 5-year extension period (assuming the lessee is more likely than not to extend the lease). In our view, this is not logical as it fails to reflect the different economics for the lessee.

Lease term – statutory options

Consistent with our view on contractual options, we do not believe that statutory options should be taken into account when determining the lease term as it makes no sense to account for these as a liability on a balance sheet.

Were however the standard to be issued in its current form, then we believe further practical guidance must be given for statutory options.

In certain countries, such as England and Wales, unless it is explicitly excluded, a tenant has a statutory right allowing them to renew a property lease at the end of its contractual term. It is not clear to us how a lease term is determined in such circumstances. One view could be that where a lessee has no intention to leave a property and a statutory right of tenure applies, then the lease term is the estimated asset life. An alternative view could be that whilst a statutory right exists, this is a right to negotiate a new lease rather than extend the existing lease term.

In our informal discussions with a number of the major accounting firms we have not been able to establish a consistent view of how this statutory right of tenure should be treated when determining the lease term. This demonstrates that there is uncertainty and some confusion in this area, and we urge the board to provide further, specific guidance on this aspect.

Contingent rentals payable

We do not agree that contingent rentals should be included within the estimate of lease payments when measuring the lease liability and right-of-use asset at inception as it would not reflect economic reality and will lead to costs not being matched with income.

Additionally, the inclusion of contingent rentals would require highly judgemental forward looking assumptions which will be difficult to audit. This would undoubtedly lead to less comparability across businesses to the resulting detriment of users of financial statements.

In our business, it is not uncommon for retail outlet lease terms to be up to 25 years in length. Where the rental is contingent on future sales of the outlet, in its current form, the ED could require us to estimate sales 15 or 20 years hence. Given that the success of such outlets can be, to a large extent, dependent on the wider location's success (e.g. if a landlord develops and promotes a shopping complex, this is likely to increase sales in our individual leased outlet), such estimates can be complicated by factors beyond the lessee's control. Such an estimation exercise will be a complex, time consuming process and by definition, judgemental. Furthermore, the determination of the lease payment will involve applying an estimated probability weighting to an amount which is already estimated.

It is also common for upward-only rental reviews to be in place, and similar judgement would need to be applied in relation to unknown future events.

We believe that the change in lease rental payments under a contingent rental arrangement should be accounted for in the period in which it arises and applies, as this will ensure it matches the conditions or results which give rise to the change.

Another downside to the proposed treatment of contingent rentals is that an entity which is relatively prudent and/or pessimistic regarding future sales (where the rental is contingent on such sales) will end up with a lower initial total income statement charge than a more optimistic entity.

Whilst we do appreciate that ultimately the total income statement charge over the lease term will be equal to the total rental payments, we believe that the requirement under the current proposals to consider contingent rentals in the determination of the liability and right-of-use asset at the inception of the lease is not correct and will be open to too much estimation and therefore potentially open to abuse and manipulation.

Conclusion

In conclusion, our main concerns with the proposals contained within the ED are as follows:

- The transitional requirements will lead to significant distortion of income statements for a number of years.
- Liabilities will appear on balance sheets which do not reflect economic reality.
- Costs are not matched to the relevant income in an accounting period.
- The application requires too many judgements which will render the proposals open to abuse and manipulation, as well as very difficult to audit.

We strongly believe that financial statements should meet the demands of users. We do not believe that the proposed standard meets this key objective.

We would be pleased and would welcome the opportunity to discuss any aspects of the matter raised in this letter. If you wish to do so, please do not hesitate to contact me.

Yours sincerely,

George Fairweather
Group Finance Director