Room 525, 5/F., Prince's Building, Central, Hong Kong
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035
Email: info@hkab.org.hk Web: www.hkab.org.hk

香港中環太子大廈5樓525室
電話：2521 1160, 2521 1169 圖文傳真：2868 5035
電郵：info@hkab.org.hk 網址：www.hkab.org.hk

12 September 2013 By post and email: commentletters@hkicpa.org.hk

Mr. Simon Riley
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East
Wanchai
Hong Kong

2013 SEP 17 PM 12:24
RECEIVED HKICPA

Dear Mr. Riley

**IASB's Exposure Draft of Leases**

We refer to your letter dated 22 May 2013 inviting our comments on the International Accounting Standards Board's Exposure Draft of Leases.

Our comments on the specific questions raised in the exposure draft are attached. Should you have any questions, please do not hesitate to contact our Assistant Manager, Mr. Timothy Tam, at 2526 6080.

Yours sincerely

Boey Wong
Secretary

Enc.

*Chairman* Standard Chartered Bank (Hong Kong) Ltd
*Vice Chairmen* Bank of China (Hong Kong) Ltd
The Hongkong and Shanghai Banking Corporation Ltd
*Secretary* Boey Wong

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**Appendix**

**Response of the Hong Kong Association of Banks to the Specific Questions in the International Accounting Standards Board's Exposure Draft: Leases**

**Scope:**

**Question 1: Identifying a Lease**

***This revised Exposure Draft defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". An entity would determine whether a contract contains a lease by assessing whether:***

***a) Fulfillment of the contract depends on the use of an identified asset; and***
***b) The contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.***

***A contract conveys the right to control the use of an asset if the customer has the ability to direct the use and receive the benefits from use of the identified asset.***

***Do you agree with the definition of a lease and the proposed requirements in paragraphs 6-19 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 conclusion that does not reflect the economics of the transaction.***

We generally agree with the definition of a lease and support that the definition should align more closely with the control principle in the revenue recognition project. In the 2013 Exposure Draft: Leases (the "2013 ED"), the IASB has made several changes to the definition of a lease from the definition in the 2010 Exposure Draft: Leases (the "2010 ED") that better distinguish when the transfer of an asset is a lease or a sale transaction. Specifically, the IASB has changed the application guidance for "the right to control the use of an asset" to be more consistent with the concept of control applied in the revenue recognition guidance and clarified that only the benefits arising from use of an asset, rather than the benefits arising from ownership of that asset, should be considered when assessing whether a customer has the ability to derive the benefits from use of an asset. We believe that these changes will result in a definition of a lease that is more clearly demarcated from a transaction that is a sale.

We note that the basis for conclusions states that the 2013 ED would not provide requirements for distinguishing a lease from the sale of an asset. The 2013 ED applies to any contract that conveys the right to use an underlying asset for a period of time and does not apply to transactions for which control of the underlying asset is transferred (i.e., sales transactions). Paragraph BC118 states that "distinguishing between a lease and the sale of an asset is less critical in light of the board's proposals on lessee and lessor accounting. Those decisions mean that the accounting for leases that are economically similar to the sale of the underlying asset would be accounted for in a similar way to the

sale of that asset." While there may be similarities in accounting, there are still significant presentation and disclosure differences between lease accounting and revenue recognition. The IASB should ensure that the final lease standard provides the guidance necessary to distinguish between sales transactions and leases. It would be helpful if the IASB provided an example of a transaction purporting to be a lease that is classified as a sale for accounting purposes. In addition, given the importance of distinguishing a lease from a service contract, we believe that the IASB should also provide a definition of a service contract in addition to the examples included in the 2013 ED.

The definition of lease in paragraph 6 of the 2013 ED should be clarified to encompass the concepts in paragraph 7, which serve to provide additional criteria for identifying a lease. Paragraph 6 states that a lease is "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration." Paragraph 7 requires that a lease have an identified asset and that the lessee have the right to control the use of the identified asset. We suggest that the definition of lease be changed to state: "a lease is a contract that conveys the right to control the use of an identified asset for a period of time in exchange for consideration."

Paragraph 20 provides the criteria for separating lease components of a contract. Paragraph 20 states that for a right to use an asset to be a separate lease component the lessee must (a) be able to benefit from use of the asset either on its own or together with other resources that are readily available to the lessee and (b) the underlying asset is not dependent on another underlying asset in the contract. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events). The requirements in paragraph 20(a) do not appear necessary in light of the requirements in paragraph 19, which defines when a customer has the ability to derive benefits from use of an asset – one of the requirements for identifying a lease. We do not understand why the requirement for lease separation need encompass the concept of readily available resources, which is similar to the criteria in paragraph 19. Once a lease component has been identified in a contract, it should be accounted for as a separate lease component as long as the use of the underlying asset is not dependent on the use of an underlying asset from another lease component within a contract.

**The Accounting Model:**

**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 consumer more than an insignificant portion of economic benefits embedded in the underlying asset? Why or why not? If not, what alternative approach would you propose and why?***

We generally agree with the lessee accounting model which results in both Type A and Type B leases being recognized on balance sheet, which is consistent with the IASB's

overriding objective to bring most leases on balance sheet. In addition, we support the dual measurement models for Type A and Type B leases. Presenting a single lease expense better reflects the economics of Type B leases. For financial services entities, the proposed measurement model for Type B leases is preferable to presenting interest expense related to leases as this would distort the net interest margin, particularly for institutions that are heavily dependent on property leases for their operations.

The IASB should address certain issues arising out of the inconsistent balance sheet treatment between lessees and lessors for Type B leases. Under the proposals, a lessee of Type B property that subleases that property would continue to recognize the right-of-use asset rather than derecognizing that asset and recognizing a lease receivable. (In contrast, under a Type A lease, the lessee/sub-lessor would recognize a lease receivable and a corresponding obligation to make lease payments.) The inconsistency between a lessee recording a liability for lease payments and a lessor not recording the receivable that relates to the right to receive those payments will create complexity for inter company leases. In addition, while we agree that the presentation of a single lease expense better reflects the economics of Type B leases, the amortization of the right-of-use asset under the proposal is a balancing figure as opposed to a reflection of the expected pattern of consumption embodied in the asset, which could have implications when the asset is tested for impairment. We suggest that the IASB specifically address these and similar situations in the final standard.

Additional clarification should be provided for (i) the term "insignificant" when evaluating whether a lease term is for an insignificant part of the total economic life of the underlying asset or when the present value of the lease payments is insignificant to the fair value of the underlying asset and (ii) the term "major part" when evaluating whether a lease term is for the major part of the remaining economic life of the underlying asset.

In addition, the IASB should explicitly clarify the nature of the right-of-use asset as either a tangible or intangible asset. The distinction is important for regulatory capital reporting. In our view, the right-of-use asset should be considered a tangible asset given the characteristics of the asset underlying a lease.

## 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 do not support changing the existing accounting model under IAS 17 for lessors. The primary issue that has driven the need to revise accounting for leases is the off-balance sheet treatment currently afforded lessees under operating leases. The IAS 17 requirement for lessors currently requires balance sheet recognition for either the underlying asset (in the case of an operating lease) or the lease receivable (in the case of a

finance lease). The proposed changes to lessor accounting would continue to result in recognition of either the underlying asset (Type B leases) or a lease receivable (Type A leases). The primary difference for lessors between the existing requirements under IAS 17 and the 2013 ED are the criteria for determining whether a lease results in de-recognition of the underlying asset (and recognition of any gain or loss) and recognition of a lease receivable. The current requirements under IAS 17 result in many leases being classified as operating leases, which does not result in any upfront profit recognition. The proposed standard would result in most non-property leases (which would include many leases currently classified as operating leases under IAS 17) being classified as Type A leases, resulting in the upfront recognition of profit or loss.

We do not support moving to an accounting model that results in upfront recognition of profit or loss for most non-property leases, particularly when the lessor has retained significant credit risk of the lessee. With the exception of recognizing a residual asset, if any, there is not a significant difference between the proposed lease accounting for lessor Type A leases and the proposed revenue recognition standards, both of which result in the upfront recognition of profit or loss. Therefore, we do not see a compelling conceptual basis for the proposed lessor accounting. If a transaction does not meet the standard for revenue recognition, it is unclear why it would effectively result in revenue recognition under the leasing standard. In addition, significant judgment will be necessary in determining the residual values, which will largely drive profit or loss recognition.

We do not believe that creating symmetry between lessor and lessee accounting is necessarily desirable. The current lessor accounting under IAS 17 is not a broken model, is well understood and generally provides useful information to users of financial statements. We support retaining the IAS 17 accounting model for lessors and incorporating that model into the final standard on leases with appropriate changes (e.g., definition of a lease, lease payments, etc.) to ensure that the criteria for identification of leases and the unit of account are similar for lessees and lessors. Lessors would continue to classify leases as either operating or financing based on the current criteria in IAS 17, while lessees would classify leases as either Type A or Type B based on the criteria in the ED. In addition, we would support additional note disclosures regarding residual values, which would address a particular area of concern regarding current lessor accounting standards.

In addition, paragraph 70 of the 2013 ED states that the measurement of the lease payments by the lessor incudes the exercise price of a purchase option if the lessee has a significant economic incentive to exercise the option. Paragraph B5 lists factors to be considered in making the assessment. Those factors are entity specific and may only be known to the lessee. We suggest that the IASB provide further guidance on how the lessor should make such an assessment.

**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 paragraph 28-34, which differ depending on whether the underlying asset is property? Why or why not? If not, what alternative approach would you propose and why?***

Generally, we see merit in the proposed lease classification principle based on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset, and we believe that the nature of the underlying asset provides a simplified approach to applying the principle. We believe that the requirements proposed are a reasonable approach to distinguishing leases that do and do not consume an insignificant amount of the economic benefits of the underlying asset. We agree that most property leases will not result in the consumption of more than an insignificant amount of the economic benefits of the underlying asset.

We found the drafting of paragraphs 28-32 of the proposals addressing classification between Type A and Type B leases very difficult to interpret and only understandable by fully reading the relevant basis for conclusions. While we acknowledge that the presumption based on the nature of the underlying asset may not always result in conclusions that are consistent with the classification principle and there is a need to add in exceptions, we believe that the current structure of these paragraphs, which uses double negatives and refers to different threshold levels, is very confusing. We encourage the IASB to improve the clarity of these paragraphs and provide a clear description of the classification indicators.

Paragraph 33 of the 2013 ED states that if a lease component contains both land and a building, an entity shall regard the economic life of the building to be the economic life of the underlying asset when applying the classification criteria. We are uncertain whether this requirement will properly reflect the underlying economics since the majority of the lease payments should in theory relate to the use of the land. In addition this does not consider that in some legal jurisdictions land use rights are limited and could be for a period less than the remaining economic life of the building. We suggest that paragraph 33 be revised to reflect such situations.

**Measurement:**

**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 principle, we agree with the proposals on lease term whereby the lessee and lessor reflect options that exist in leases if the lessee has a significant economic incentive to

exercise the option. We noted from paragraph BC 140 that the concept of 'significant economic incentive' should provide a threshold that is similar to the concept of 'reasonably certain' in the existing IAS 17. Given that the IASB intends for the new terminology to functionally have the same meaning as the existing criteria, we recommend that the IASB continue to use the term 'reasonably certain' as it is already well adopted under the current practice and widely understood by users. We acknowledge that the IASB wants to emphasize the need for the presence of a significant economic incentive by the lessee to exercise the option and that intention alone is not sufficient. We suggest that the IASB could retain the term 'reasonably certain' but incorporate the concept of significant economic incentive in the application guidance.

We generally agree with the reassessment criteria; however, paragraph B5 of the 2013 ED states that "a change in market-based factors (such as market rates to lease a comparable asset) shall not, in isolation, trigger reassessment of the lease term". However, there could be situations where a change in market rates would on its own be the determining factor as to whether an option is exercised. It is unclear what the IASB intends when it refers to "in isolation". If the intent is that the criteria are entity specific then the IASB should state this or otherwise clarify its intent.

## 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?***

The 2013 ED introduces the term "in-substance fixed payments" that is undefined. The application guidance provides an example of a minimum payment that is concluded to represent an in-substance fixed payment. In our view, this is clearly a fixed payment. If the IASB is contemplating other arrangements that represent in-substance fixed payments, it should provide further guidance in this respect. The IASB clearly rejected (which we concur with) the approach in the 2010 ED, which would have required probability-weighted estimates of future variable lease payments. However, by not defining in-substance fixed payments, it is not clear whether highly probable payments should be included in the calculation of lease payments. The basis for conclusions states that the intent of the IASB is to capture "unavoidable" lease payments. We suggest that standard be revised to use the word "unavoidable".

Example 17C (an example of variable lease payments that are in-substance fixed lease payments) provides a scenario where the lessee has a purchase option at CU375,000 if annual sales exceed CU1 million and is required to purchase the property for CU375,000 if sales do not reach CU1 million in any year. Lease payments are based on a fixed amount plus 3% of sales. The example concludes that the lessee may measure the lease liability at either (i) fixed payment plus CU30,000 per year assuming sales are CU1,000,000 or (ii) fixed payment plus CU375,000 option purchase price. We do not understand the basis for the lessee having a choice. It is not clear whether the IASB views

this as an accounting policy choice or a choice based on the most likely outcome. Given that the principle in the 2013 ED is that only unavoidable amounts should be included in lease payments, we believe that the lease liability in the example should be based on fixed payments plus CU30,000, which is the lowest possible amount (and therefore unavoidable) that the lessee will have to pay in variable lease payments. The option purchase price should only be included in the lease payments if it meets the criteria in the standard for being reasonably certain.

The 2013 ED proposes that lease payments should be reassessed if there is a change in any of the following: (a) the lease term, (b) relevant factors that change the conclusion as to whether there is a significant economic incentive to exercise an option, (c) amounts expected to be payable under residual value guarantees, and (d) an index or rate used to determine lease payments during the reporting period. We agree that these are all factors that would logically lead to a need to revise the expected lease payments inherent in the lease asset and lease liability. In the context of an index or rate that changes on a regular basis, this may require a recalculation of the lease asset and liability at each reporting period, which could present systems challenges.

Further clarification could be provided around variable lease payments that depend on an historical index or rate such as the Consumer Price Index ("CPI"). The 2013 ED requires that the lease payments initially be measured using the index or rate as at the commencement date. The IASB should consider clarifying within the body of the standard that forward rates should not be used and that the assumption is that future lease payments incorporate the spot rate based on the index or rate at the commencement date or at any date of reassessment.

**Transition:**

**<u>Question 7: Transition</u>**

***Paragraphs C2-C22 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 transition issues the boards should consider? If yes, what are they and why?***

We support the proposed transitional arrangements and appreciate the practical reliefs the IASB has provided. We agree with retrospective application where information is readily available. A full retrospective approach will be difficult for many entities to prepare without undue cost and effort particularly when historical leases are of long duration. However, we are concerned with the need to restate comparatives to the earliest prior period, which could mean that some entities, such as foreign private issuers with SEC filing requirements, would need to restate five years of comparative information. In fact, we question the benefit of this if transition occurs at the same time as the transition to IFRS 9 'Financial Instruments', which does not require restated comparatives.

The proposals in the 2013 ED, while significantly addressing many of the concerns in the 2010 ED, remain complex and apply to all leases regardless of amount or whether they pertain to the core business of an entity. Adoption of these proposals will take considerable time and effort (particularly where there are a number of smaller leases that may be material in the aggregate) and will, in many cases, necessitate system changes. For banks, the proposed accounting would have a significant consequential impact on regulatory capital and risk-weighted assets. Therefore, we would appreciate the IASB to provide sufficient lead time when setting the effective date of the proposed standard to allow banks to have the opportunities to engage with the relevant regulatory authorities. We believe that the effective date should be no earlier than three years from the issuance of the final standard.

**Disclosure:**

**Question 8: Disclosure**

***Paragraphs 58 – 67 and 98 – 100 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliation 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 welcome the clarifications the IASB has made in paragraph 71 to allow preparers to determine the level of emphasis to place on each disclosure requirements and to aggregate information as necessary for disclosures. We also welcome the disclosure exemptions provided for short-term leases. However, we would urge the IASB to assess more carefully the practical implication of the proposed disclosure requirements. The proposed disclosures are extensive and comprehensive and will likely require significant resources to prepare at each reporting period. In particular, we question the benefit of the extensive disclosures for Type B leases given that the economic benefits of the underlying assets have not been transferred. The gathering of the disclosure data required for a large number of property leases could be an onerous process for preparers. In addition, the IASB should also ensure there is no duplication in the disclosure requirements with those under IFRS 7.

The 2013 ED proposes to require a roll-forward of the lease liability. We are aware of other stakeholders that believe the disclosure requirements do not provide sufficient information to provide an understanding of the impact on profit or loss of the proposed lease accounting standard. We believe that the information included in both the lease asset and lease liability roll-forwards provide sufficient information so that users will have the information necessary to understand the impact on profit or loss from leases.

Paragraph 67 and 106 of the 2013 ED require disclosure of maturity analyses of the undiscounted cash flows of the lease liability and lease receivable, respectively. Those paragraphs also require a reconciliation between the undiscounted cash flows to the

discounted amounts recognized in the balance sheet. Given that the discount rate is already required to be disclosed, we do not believe that the reconciliation requirements are necessary.

Paragraph 66 states that a lessee shall disclose information about the acquisition of right-of-use assets in exchange for lease liabilities as a supplemental non-cash transaction disclosure. The sentence would be clearer if the reference to exchange for lease liabilities referred to the assumption or novation of lease liabilities.

**IAS 40 Investment Property:**

**Question 9: Consequential Amendments to IAS 40**

***The IASB is proposing amendments to other IFRSs as a result of the proposals in this revised Exposure Draft, including amendments to IAS 40 Investment Property. The amendments to IAS 40 propose that a right-of-use asset arising from a lease of property would be within the scope of IAS 40 if the leased property meets the definition of investment property. This would represent a change from the current scope of IAS 40, which permits, but does not require, property held under an operating lease to be accounted for as investment property using the fair value model in IAS 40 if it meets the definition of investment property.***
***Do you agree that a right-of-use asset should be within the scope of IAS 40 if the leased property meets the definition of investment property? If not, what alternative would you propose and why?***

Given that operating lease classification is eliminated under the proposals in the 2013 ED, we agree that it is necessary to amend IAS 40 to eliminate such references. All leases are accounted for on balance sheet by lessees under the proposals in the 2013 ED and should be within the scope of IAS 40 if such lease meets the definition of investment property. Leases that would currently be classified as operating leases under IAS 17 (and optionally within the scope of IAS 40) would be within the scope of IAS 40 under the 2013 ED. However, the proposed amendments to IAS 40 would provide an option to account for right-of-use assets arising from leases as either at fair value or amortized cost as determined under the proposed lease accounting model. Effectively, the proposals in the 2013 ED do not change the existing accounting policy choice between fair value and amortized cost for an investment property lease.

As the unit of account for fair value measurement would be the right-of-use asset as opposed to the underlying asset, there would be added complexities from a valuation perspective and we recommend the IASB provide additional application guidance in this area.

**Other Comments:**

**Short-term Leases**

We appreciate the practical relief that is available for short-term leases whereby a lessee or a lessor may elect to recognize lease payments in the income statement on a straight-line basis over the lease term without balance sheet recognition. The proposals specify a short-term lease as one with a maximum possible term, including options to extend, of twelve months or less. However, we believe that a short-term lease should be defined as a lease with a lease term of twelve months or less, where 'lease term' should be consistent with what is currently defined in the proposals, that is, the non-cancellable period together with the periods covered by any renewal or termination options that the lessee has a significant economic incentive to exercise. By considering options that will clearly not be realized, the proposals will scope in a large number of leases that are in substance short-term in nature, which will defeat the objective of the expedient.

**Re-assessment of Lease Receivable and Lease Liability**

Paragraphs 46 and 81 of the 2013 ED require that the discount rate be revised at the date of re-assessment as the rate the lessor would charge the lessee at that date on the basis of the remaining lease term. (If that rate was not readily determinable for the lessee, then the lessee would use its incremental borrowing rate at that date). It may be practically difficult to determine the rate that the lessor would charge the lessee given that the underlying asset will not be a new asset with a readily determinable fair value and there may not be comparable lease terms on other transactions to reference. For most new leases, the interest rate inherent in a lease would be used to determine the rate the lessor charges the lessee. To arrive at that rate, the fair value of the property and the lease terms must be known. At a re-assessment date, it may be difficult to determine the fair value of the property and the remaining lease payments would have been determined at the inception of the lease based on the factors that existed at that date. Therefore, there would not be an interest rate inherent in an existing lease for its remaining term as of a re-assessment date. We question the usefulness of re-assessing the discount rate because of a change in lease payments resulting from a change in lease term or whether an option is expected to be exercised. The right-of-use model is not a fair value model, which would necessitate the periodic revision to the discount rate. Revisions to the discount rate would be more appropriate when a contract is modified in a way that results in a substantively new lease. (See comment below regarding contract modification.)

**Contract Modifications**

Paragraph 36 of the 2013 ED states that if contractual terms and conditions of a lease are modified, resulting in a substantive change to the existing lease, an entity shall account for the modified contract as a new lease. Examples of substantive changes include changes to the contractual lease term or the amount of the contractual lease payments. However, changes to lease term and lease payments are also the basis for the reassessment of the lease liability by the lessee and the lease receivable by the lessor. It is not clear when a change to a contract results in a reassessment or a new lease. In addition,

it is not clear whether the resulting accounting between a reassessment and a new lease would be substantively different other than for the potential reclassification of the lease as a Type A or Type B. We suggest that the IASB provide clarification as to what changes result in a new lease versus a reassessment of the lease asset and liability and highlight how the resulting accounting differs.

**Definition of Economic Life and Useful Life**

The definitions of economic life and useful life refer to the number of production or similar units expected to be obtained from an asset. We suggest that the definition should be qualified to refer only to economically useful units.

**Short-term Leases Expense Recognition**

Paragraph 118 of the 2013 ED states that a lessee that elects not to account for short-term leases on the balance sheet, should recognize the lease payments in profit or loss on a straight-line basis over the lease term. We suggest that the expense recognition criteria be modified to allow for another systematic basis if it is more representative of the pattern in which the lessee expects to consume the right to use the underlying asset.

**Residual Value Guarantees**

Paragraph 70(d) states that lease payments include those payments structured as residual value guarantees (as described in paragraphs B17-B18). However, B17-B18 does not describe a guarantee but a fixed payment mechanism. Paragraph 70(d) should be revised to state "lease payments structured as residual value guarantees (including those arrangements described in paragraphs B17-B18)."