Accounting Standards Board

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Dear Stig

EFRAG's Draft Comment Letter (DCL) on the IASB's Discussion Paper 'Leases Preliminary Views'

This letter sets out the UK Accounting Standards Board's (ASB) comments on the EFRAG DCL to the IASB on the above IASB Discussion Paper (DP). As the ASB is still in the process of finalising its response to the IASB's DP, this letter reflects tentative views only. The ASB does not plan to finalise its response until its 15 July Board meeting, and will forward EFRAG a copy of the response at that time.

Overall, we agree with the specific points raised in the DCL and expect that our response, when it is finalised, will be quite comparable. We also support the overall tone of the DCL – broad support for the proposals tempered by some practical concerns such as cost benefit and complexity.

We are particularly concerned, like EFRAG, that the effect of the DP's proposals will be moving the 'line in the sand' from a distinction between operating and financing to one between leases and other similar executory contracts. In this instance, we consider the overall benefits of the proposals will be less clear. As such, we support careful consideration of the scope of any new standard on lease accounting.

Like EFRAG, we are also concerned that, for more complex leases with optional terms and contingent rentals, the proposals result in the recognition of amounts that do not meet the definition of a liability. However, we have accepted this result as the most pragmatic solution, as explained in more detail in our answers to the DCL's 'questions for constituents' in the appendix to this letter.

Our initial view is that lessee accounting is currently sufficiently 'broken' to justify the 'lessee accounting first' approach adopted by the IASB. We do, however, agree with the comment in the DCL that some fundamental decisions could change as a result of a more comprehensive analysis of lease accounting that includes both lessee and lessor issues. As such, we agree that the 'lessee first' approach is not without risk.

Should you have any queries regarding our response please contact Melanie Kerr (+44 20 7492 2428, m.kerr@frc-asb.org.uk.) or me.

Yours sincerely

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Responses to EFRAG's Question to constituents

Paragraph 33 of the DCL

EFRAG members are divided on the issue of [the single asset versus the components approach]. Some believe that the approach the DP proposes is the only practical approach and is also the most useful (it focusing on the expected cash outflows from the lease); whilst others believe that that approach will result in amounts being recognised that are not understandable or comparable and misrepresents the flexibility the lessee has. We would therefore particularly welcome your views on the issue. Do you agree with the approach proposed in the DP? If not, what are your major concerns and why do you believe that the components approach is capable of practical implementation?

We agree with the DP that a lease can give rise to a range of separate rights and obligations and that these components could theoretically be recognised and measured individually in the financial statements. We also support the preliminary proposal that these components be recognised as a single asset and a single obligation as we consider this the only possible approach for practical reasons and, more importantly, we understand this provides sufficient information to users of financial statements.

Paragraph 61 of the DCL

EFRAG members are divided on the issue of [including optional lease terms in the measurement of the rental obligation using a 'most likely' approach]. We would therefore particularly welcome your views on the issue. Do you agree with the approach proposed in the DP? If not, what are your major concerns? And what approach would you favour instead?

As discussed in our response above, we agree with the preliminary view in the DP not to adopt a components approach to recognition of the rights and obligations arising under a lease. A necessary implication of supporting this proposal is the inclusion of optional lease terms in the measurement of the obligation to pay rentals even though we do not consider that these optional terms meet the definition of a liability under the framework. Our initial view is to support the approach on practical grounds, however, we consider that the DP should be more explicit that the measurement simplifications made on pragmatic grounds when adopting the single-asset/liability approach result in the recognition of amounts that do not meet the definition of a liability in the framework.

The 'most likely' lease term approach proposed in the DP is simply the lease term with the highest probability at a given point in time and therefore it is an inherently volatile basis for choosing the lease term. In our view 'most likely' works reasonably well when there is a particularly persuasive case for a particular lease term and less well when the balance of probabilities between lease terms is more evenly distributed.

We have assessed a number of approaches and have concluded that all approaches to including optional lease terms have significant disadvantages; however, we consider the 'most likely' approach is the best of the options we have considered.

Paragraph 81 of the DCL

Do you think the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable or should be on the basis of the most likely rental payment?

We agree with the DCL that the 'most likely' approach is too binary in nature to deal well with contingent rentals based on lessee performance measures such as sales. There is an infinite number of possible outcomes for rentals based on sales and selecting just one as 'most likely' when the probability of each outcome is actually very small, is unlikely to provide users of financial statements with much information of value.

We do agree with the DP, however, that using a probability-weighted approach that requires lessees to consider the probability of every conceivable outcome could be very complex to apply in practice and for other types of contingent rentals, could result in recognition of an amount that is not a possible outcome.

In our view, the margin of error in any estimate of contingent rentals is likely to be significant enough in practice to dwarf the difference between a 'most likely' or a 'probability weighted' approach. As such, we support the 'most likely' approach as it is less costly for lessees to apply and consistent with the approach applied for optional lease terms.

Paragraph 102 of the DCL

We would welcome your views as to whether describing a lease asset as an intangible asset is consistent with adopting a right-of-use approach.

We consider that the right-of-use asset is an intangible asset representing the lessee's right to use the asset during the lease term. One consequence of the right-of-use model for both lessee and lessor accounting is that it places perhaps undue emphasis on the concept of 'ownership'.