Accounting Standards Board

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Dear Rachel

Discussion Paper 'Leases Preliminary Views'

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the above IASB Discussion Paper (DP).

The ASB welcomes the publication of this DP. On balance, we are supportive of the new approach to lease accounting outlined in the DP, on the basis that it will correct a major flaw in the requirements for lease accounting by recording operating lease obligations on-balance sheet. While we believe the benefits of the proposed change exceed the costs, we do believe that that the costs of changing the lease accounting model are considerable.

While the ASB supports the proposed right-of-use model, we do not necessarily agree that it will reduce the complexity of lease accounting by removing the distinction between operating and financing leases. Rather we think this source of complexity is less significant than that of accounting for complex leases using the right-of-use model or the added burden of right-of-use accounting instead of cash accounting for former operating leases.

We also consider that if the scope of any new standard is not carefully defined, the new proposals will not succeed in removing arbitrary bright-lines from lease accounting, rather they will move 'the line in the sand' from operating/financing to lease/other similar contract. We accept that this issue will be difficult to overcome, and are still supportive of moving to the right-of-use model despite this drawback.

The DP makes some significant compromises in order to apply the single asset/liability approach as opposed to the components approach. This results in the need to consider optional terms and contingent rentals in the measurement of the obligation, and in our view, these may not meet the existing definitions of a liability. We accept this compromise as the best approach but feel that the DP should be more explicit in highlighting any cases when there is a departure from the existing definition of a liability made on pragmatic grounds.

Also on the issue of optional terms and contingent rentals, the ASB does not agree with the proposals to adopt the most likely lease term and/or rental payment. The ASB takes the view that an approach using the longest term/largest payment that is more likely than not to occur would be more appropriate, as outlined in our response to question 13 in the Appendix.

If you would like to discuss these comments, please contact Melanie Kerr (020 7492 2428, m.kerr@frc-asb.org.uk) or me.

Yours sincerely

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Appendix

Response to the Invitation to Comment

<u>Chapter 2: Scope of lease accounting standard</u>

Question 1

The boards tentatively decided to base the scope of the proposed new lease accounting standard on the scope of the existing lease accounting standards. Do you agree with this proposed approach? If you disagree with the proposed approach, please describe how you would define the scope of the proposed new standard.

1. We are concerned that retaining the existing scope could result in moving 'the line in the sand' from distinguishing between operating leases and financing leases to distinguishing between leases and other similar (executory) contracts. While we agree that scope is not the main source of complaint with regards to the existing lease accounting requirements, it is likely that scope will become more important as the proposals will create fundamentally different accounting (that did not previously exist) between former operating leases and other similar executory contracts.

2. We believe that the IFRIC 4 *Determining whether an Arrangement contains a Lease* concept of a lease being the 'right to use a specific asset' may be useful in distinguishing leases from service contracts. A lease conveys the right to use a specific asset while a similar contract for services would specify the services to be provided but not require a specific asset provide them. An advantage of this approach is that it could result in fewer short-term, non-core leases being accounted for using the right-of-use model. For example, photocopiers and other low value assets are more readily substitutable by the lessor. The lease of high-ticket items such as aircraft is more likely to be for use of a specific asset.

3. We would also like the IASB to consider whether the current scope exemptions from IAS 17 are still appropriate. It seems a shame to us to have a fundamental rethink of the lease accounting standard without careful analysis of the existing arbitrary scope exemptions that have been in place for some time.

4. Finally, we note that when converging the definition of a lease between IAS 17 and SFAS 13, using the IASB approach that starts with 'assets' as opposed to the FASB approach that starts with 'property, plant and equipment' is preferable.

Question 2

Should the proposed new standard exclude non-core asset leases or short-term leases? Please explain why. Please explain how you would define those leases to be excluded from the scope of the proposed new standard.

5. We consider the burden of a new lease accounting standard on preparers is best managed through a 'material leases only' approach to application of the standard. However, we note there is much difficulty in practice in applying the concept of materiality, with many preparers applying standards to immaterial items just to be safe. As such, the standard is likely to be onerous in practice for short-term leases even if it is not intended to be. Given this likely and unintended consequence of a new standard, we encourage the IASB to consider how it might discourage application of a new standard on leases to immaterial items.

6. We do not support excluding non-core leases from the scope of a new standard as, in our view, a material liability is a material liability regardless of whether or not it is core. In our response to question 1 we note that if a lease is the 'right to use a specific asset' it may reduce the instance of contracts relating to use of short-term, non-core assets being considered within the scope of a new standard on leases.

Chapter 3: Approach to lessee accounting

Question 3

Do you agree with the boards' analysis of the rights and obligations, and assets and liabilities arising in a simple lease contract? If you disagree, please explain why.

7. We agree with the analysis of the assets and liabilities arising in a simple lease contract.

8. However, we do struggle with the analysis of the asset in relation to the ***control*** element of the definition of an asset as it is interpreted by Exposure Draft (ED) (2009/03) *Derecognition Proposed amendments to IAS 39 and IFRS 7.* The criterion in paragraph 17A (c) of the ED implies that the lessor has control of the right-of-use asset unless the lessee is able to transfer (sublet) the right-of-use asset unilaterally, which may or may not be possible in the simple lease described in the DP.

Question 4

The boards tentatively decided to adopt an approach to lessee accounting that would require the lessee to recognise:

(a) an asset representing its right to use the leased item for the lease term
(the right-of-use asset)

(b) a liability for its obligation to pay rentals.

Appendix C describes some possible accounting approaches that were rejected by the boards. Do you support the proposed approach? If you support an alternative approach, please describe the approach and explain why you support it.

9. On balance, we support the right-of-use model advocated in the discussion paper. However, we do not consider that this model is without flaw and have some reservations that the leasing project may be replacing one imperfect model with another.

10. We support the right-of-use model on the basis that we consider the lessee obligation to pay rentals meets the definition of a liability and should therefore be recorded in balance sheet of the lessee. We support recording the intangible right-of-use asset as the only possible asset to record as part of this transaction. However, splitting tangible assets into bundles of intangible rights could make the financial statements more difficult to understand.

11. Although we support the right-of-use model, it has the potential flaw that similar transactions could be accounted for differently. For example, the lease of a car for three years with a residual value guarantee is not very different from the debt-financed purchase of a car that is intended for sale in three years, yet the accounting could be quite different under the proposed right-of-use model. This will require users of financial statements to continue to adjust the financial statements in order to adequately compare companies who choose lease financing with those who choose debt financing.

12. Equally, when leases contain optional terms and contingent rentals, the accounting model may be unable to capture the differences between leases, with the result that the accounting for very different contracts is similar.

Question 5

The boards tentatively decided not to adopt a components approach to lease contracts. Instead, the boards tentatively decided to adopt an approach whereby the lessee recognises:

(a) a single right-of-use asset that includes rights acquired under options

(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.

Do you support this proposed approach? If not, why?

13. 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.

Chapter 4: Initial measurement

Question 6
Do you agree with the boards' tentative decision to measure the lessee's obligation to pay rentals at the present value of the lease payments discounted using the lessee's incremental borrowing rate? If you disagree, please explain why and describe how you would initially measure the lessee's obligation to pay rentals.

14. We agree with the proposed approach.

Question 7
Do you agree with the boards' tentative decision to initially measure the lessee's right-of-use asset at cost? If you disagree, please explain why and describe how you would initially measure the lessee's right-of-use asset.

15. We agree with the proposed approach.

Chapter 5: Subsequent measurement

Question 8
The boards tentatively decided to adopt an amortised cost-based approach to subsequent measurement of both the obligation to pay rentals and the right-of-use asset. Do you agree with this proposed approach? If you disagree with the boards' proposed approach, please describe the approach to subsequent measurement you would favour and why.

16. We support an amortised cost-based approach to measurement of the lease obligation and right-of-use asset on the basis that this is consistent with the accounting for many other non-derivative financial liabilities (IAS 39) and non-financial assets (IAS 16).

Question 9
Should a new lease accounting standard permit a lessee to elect to measure its obligation to pay rentals at fair value? Please explain your reasons.

17. We consider that that the measurement of the obligation to pay rentals should be aligned with the measurement of other similar financial liabilities. However, we also understand that users of financial statements find that 'choices' in accounting standards make it very difficult to compare between entities. For this reason, we do not support a fair value election for the obligation to pay rentals.

Question 10
Should the lessee be required to revise its obligation to pay rentals to reflect changes in its incremental borrowing rate? Please explain your reasons. If the boards decide to require the obligation to pay rentals to be revised for changes in the incremental borrowing rate, should revision be made at each reporting date or only when there is a change in the estimated cash flows? Please explain your reasons.

18. On balance, we agree with paragraph 5.23 that the obligation to pay rentals should *not* be revised for changes in the incremental borrowing rate. We consider that revising the rate for lease liabilities will reduce the comparably between lease finance and other sources of finance.

Question 11

In developing their preliminary views the boards decided to specify the required accounting for the obligation to pay rentals. An alternative approach would have been for the boards to require lessees to account for the obligation to pay rentals in accordance with existing guidance for financial liabilities. Do you agree with the proposed approach taken by the boards? If you disagree, please explain why.

19. We agree with the approach proposed in the DP, with the stipulation that the accounting treatment should remain aligned with the treatment for other similar financial liabilities.

20. To us, specifying the treatment is sensible because it makes it makes the requirements for measurement of the obligation to pay rentals more clear. Because the lease obligations contain characteristics of financial liabilities under IAS 39 (for the simple lease described in chapter 3 of the DP) and contingent liabilities under IAS 37 (for the more complex leases described in chapters 6 and 7 of the DP) referring lessees to existing standards for subsequent measurement of the obligation could cause considerable confusion in practice.

Question 12

Some board members think that for some leases the decrease in value of the right-of-use asset should be described as rental expense rather than amortisation or depreciation in the income statement. Would you support this approach? If so, for which leases? Please explain your reasons.

21. We do not dispute that for some leases, a rental expense charge in the profit and loss that is tied to cash flow may result in more useful information to users of financial statements than interest and amortisation charges. For example, for very short-term leases and leases of land and other assets that would not be depreciated if owned. However, the classification of leases into objective categories is problematic and we therefore do not support taking this approach further. Also, the linked approach described in the DP results in accounting for the financial liability in a way that is inconsistent with the accounting for other financial liabilities.

Chapter 6: Leases with options

Question 13

The boards tentatively decided that the lessee should recognise an obligation to pay rentals for a specified lease term, ie in a 10-year lease with an option to extend for five years, the lessee must decide whether its liability is an obligation to pay 10 or 15 years of rentals. The boards tentatively decided that the lease term should be the most likely lease term. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.

22. As discussed in our response to question 5 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 consider that these optional terms may not meet the definition of a liability under the framework. While we are happy with the approach on practical grounds, we consider that the DP should be more explicit in instances when 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.

23. 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 persuasive case for a particular lease term and less well when the balance of probabilities between lease terms is more evenly distributed.

24. For example, if you have a lease with possible terms of one year (30% probability); five years (30% probability) and ten years (40% probability) the DP requires a ten-year term, as the individually most likely. However, it seems more sensible, if we are seeking a more stable lease model, to use a five year term in this example, as cumulatively it is 70% likely that the lease will last at least five years. In our view, the case for a five-year term is much more compelling than the case for a ten-year term.

25. Our preference therefore is for a model based on the longest lease term that is 'more likely than not' to occur. In the example above, this would result in accounting for a five-year term, on the basis that the ten-year term is not more likely than not to occur. In practice, we do not think this approach necessarily requires assigning probabilities to all possible outcomes.

Question 14

The boards tentatively decided to require reassessment of the lease term at each reporting date on the basis of any new facts or circumstances. Changes in the obligation to pay rentals arising from a reassessment of the lease term should be recognised as an adjustment to the carrying amount of the right-of-use asset. Do you support the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why. Would requiring reassessment of the lease term provide users of financial statements with more relevant information? Please explain why.

26. We believe that reassessment of the lease term will provide users of financial statements with more relevant information and support reassessment on the same basis that we support adjustment of other assets and liabilities when there is a change in estimate. We also support the proposal to adjust the right-of-use asset on the basis that the lessee is adjusting the amount of its purchase of the right-of-use asset to the amount that would have been recorded had the

estimate of the lease term been made correctly at the time of initial recognition of the lease.

27. We do not support systematic reassessment of all lease terms at each reporting date; we prefer an approach based on indicators of a change in lease term.

Question 15
The boards tentatively concluded that purchase options should be accounted for in the same way as options to extend or terminate the lease. Do you agree with the proposed approach? If you disagree with the proposed approach, please describe what alternative approach you would support and why.

28. We agree that the accounting for purchase options should match the accounting for optional terms.

Chapter 7: Contingent rentals and residual value guarantees

Contingent rentals

Question 16
The boards propose that the lessee's obligation to pay rentals should include amounts payable under contingent rental arrangements. Do you support the proposed approach? If you disagree with the proposed approach, what alternative approach would you recommend and why?

29. The DP discusses a number of different types of contingent rentals and in principal, we consider that it may not be ideal to account for each of these different types of rentals the same way. However, given the added complexity of dividing contingent rentals into categories and defining each category, we consider that the costs of using a different accounting treatment for different categories likely outweighs the benefits and that a single model should be used for all contingent rentals.

Question 17
The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payment. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. Which of these approaches to measuring the lessee's obligation to pay rentals do you support? Please explain your reasons.

30. 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.

31. We also consider that the 'most likely' approach has the disadvantage of being 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.

32. As such, we support the same approach for measuring contingent rentals as we supported for optional lease terms – that is, measuring the largest contingent rental amount that is more likely than not to occur.

Question 18
The FASB tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee should measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Do you support the proposed approach? Please explain your reasons.

33. The FASB's tentative approach only works well for contingent rentals based on an index or rate and we would prefer to see a single accounting treatment for all contingent rentals, primarily on pragmatic grounds. As such, we consider that rentals based on an index should be calculated on the same basis as all other contingent rentals.

34. We note that in practice this will frequently result in using the index value at the inception of the lease, due to the impossibility of trying to 'predict the future' for many indices. However, in some cases a measure other than the current index value could provide better information to users of financial statements and reduce the instance of re-measurements in the future.

Question 19
The boards tentatively decided to require re-measurement of the lessee's obligation to pay rentals for changes in estimated contingent rental payments. Do you support the proposed approach? If not, please explain why.

35. We believe that re-measurement of contingent rentals will provide users of financial statements with more relevant information and support reassessment on the same basis that we support adjustment of other assets and liabilities when there is a change in estimate.

Question 20
The boards discussed two possible approaches to recognising all changes in the lessee's obligation to pay rentals arising from changes in estimated contingent rental payments:
(a) recognise any change in the liability in profit or loss
(b) recognise any change in the liability as an adjustment to the carrying amount of the right-of-use asset.
Which of these two approaches do you support? Please explain your reasons. If you support neither approach, please describe any alternative approach you would prefer and why.

36. For some contingent rentals, such as a rental based on usage, it is easier to support an argument for adjusting the asset on re-measurement, as the lessee is effectively purchasing more or less of the right-of-use asset. However, for other contingent rentals, such as a rental indexed to interest rates, the link is much less clear. The theoretically correct treatment would probably adjust the asset or the profit and loss, depending on the nature of the contingent rental. However,

we consider that on pragmatic grounds, there should be a single treatment for all adjustments to contingent rentals. As such, we support adjustment to the right of use asset for all changes in contingent rentals.

Residual value guarantees

Question 21
The boards tentatively decided that the recognition and measurement requirements for contingent rentals and residual value guarantees should be the same. In particular, the boards tentatively decided not to require residual value guarantees to be separated from the lease contract and accounted for as derivatives. Do you agree with the proposed approach? If not, what alternative approach would you recommend and why?

37. As the IASB has adopted the single asset/liability approach as opposed to the components approach, we consider that this approach should be applied consistently to all elements of the lease. As such, we support the preliminary view not to require the residual value guarantee to be separated from the lease contract and accounted for as a derivative. We agree that the recognition and measurement for contingent rentals and residual value guarantees should be the same but note that different disclosure requirements may be appropriate.

Chapter 8: Presentation

Question 22
Should the lessee's obligation to pay rentals be presented separately in the statement of financial position? Please explain your reasons. What additional information would separate presentation provide?

38. There is no need to require the lessee's obligation to pay rentals to be presented separately in the statement of financial position, provided this information is presented in the notes to the financial statements. We consider that in many instances the obligation may not be material enough to warrant separate presentation on the face of the statement of financial position, and in this instance - to avoid cluttering the primary statement - note presentation is more appropriate.

39. Looking forward to potential changes from the IASB's project on financial statement presentation, we consider that the obligation to pay rentals is best presented in the financing section as opposed to operating section of the statement of financial position.

Question 23
This chapter describes three approaches to presentation of the right-of-use asset in the statement of financial position. How should the right-of-use asset be presented in the statement of financial position? Please explain your reasons. What additional disclosures (if any) do you think are necessary under each of the approaches?

40. We consider that, if material, information regarding the nature of leased items should be presented somewhere in the financial statements separate from the information on owned assets – potentially in a separate right-of-use asset section. However, we do not consider it appropriate in all instances for this information to appear on the face of the statement of financial position.

Chapter 9: Other lessee issues

Question 24
Are there any lessee issues not described in this discussion paper that should be addressed in this project? Please describe those issues.

41. We consider that the DP identifies the issues that need to be addressed in this project. However, as the DP does not provide any detailed analysis of any of the issues outlined in Chapter 9, we may have detailed comments on these issues at the Exposure Draft stage of the project.

42. Given the potential that lessee and lessor accounting models will differ for a period of time, there is a need to address the sublease issues outlined in chapter 10 of the DP as a matter of priority.

Chapter 10: Lessor accounting

Question 25
Do you think that a lessor's right to receive rentals under a lease meets the definition of an asset? Please explain your reasons.

43. Yes. We consider the lessor's right to receive rentals meets the definition of an asset under the Framework.

Question 26
This chapter describes two possible approaches to lessor accounting under a right-of-use model: (a) derecognition of the leased item by the lessor or (b) recognition of a performance obligation by the lessor. Which of these two approaches do you support? Please explain your reasons.

44. We would prefer to respond to specific questions on lessor accounting after reading a more thorough analysis of the issues in a detailed lessor accounting discussion paper. As such, we make only very preliminary remarks below.

45. We consider that both of the approaches for lessor accounting discussed in the DP have some very significant disadvantages. Approach (a) is inconsistent with the IASB's latest thinking in its derecognition ED while approach (b) inflates the balance sheet and does not, in our view, well represent the economics of a leasing transaction. This is particularly true for banks or other lessors who will be required to show in their financial statements assets they purchased specifically for a lease contract that they never have had, nor ever will have, any involvement with outside the lease contract.

46. We also consider that given these disadvantages and the difficulty overcoming them, that it could be quite a long period before a new lessor accounting model can be developed. Assuming a new lessor accounting model is 'on the way' we are prepared to wait and accept the discrepancies between lessor and lessee accounting in the meantime. However, we do have concerns that achieving a satisfactory lessor accounting solution using a right-of-use model may be difficult. We consider that developing a lessee accounting solution in advance of the lessor model has risks associated with it.

Question 27
Should the boards explore when it would be appropriate for a lessor to recognise income at the inception of the lease? Please explain your reasons.

47. Yes. The boards should explore this issue and ensure the conclusions are consistent with the revenue recognition project. Of course, the answer to this question is heavily dependent on whether approach (a) or (b) in Question 26 is selected as the lessor accounting model.

Question 28
Should accounting for investment properties be included within the scope of any proposed new standard on lessor accounting? Please explain your reasons.

48. We consider that this issue should be investigated as part of the IASB's work on lessor accounting. There are important differences between letting investment property and other equipment that may warrant different accounting treatments. For example, users of financial statements may find it more useful if the lessor's financial statements show investment property at fair value as opposed to a receivable and a residual value asset. Approach (b) above could possibly work well with an investment property model based on fair value, while approach (a) above clearly would not.

Question 29
Are there any lessor accounting issues not described in this discussion paper that the boards should consider? Please describe those issues.

49. We have not identified any additional issues but expect that additional issues will arise as a more detailed lessor accounting debate takes place.