

9 September 2013

International Accounting Standards Board 1st Floor 30 Cannon Street London EC4M 6XH

Dear Sirs

Comment Letter: ED 2013/6 Leases

We are pleased to respond to your request for comment on the revised exposure draft on accounting for leases. We have answered the questions on which specific comment has been requested in turn below, but also have some overall observations.

In our view, the revised draft Standard is a vast improvement on the previous exposure draft, on which we also provided comment. However, there are still a number of areas which we believe will cause difficulties for companies in practice, including the time and costs involved in applying the effective interest rate method for the unwinding of the lease liability. We would suggest that instead the interest charge should be spread over the period of the lease, using a suitable method such as the actuarial or sum of digits method as is done at present.

We would also agree with the comments made by the ICAEW that the use of the terms 'Type A' and 'Type B' leases is not meaningful. Whilst acknowledging that the Board wishes to avoid the use of the terms 'Finance Lease' and 'Operating Lease' because of the significant conceptual differences between IAS 17 and the exposure draft, we would agree that without using meaningful terminology for the two types of leases divergence is likely to occur in practice. The terms proposed by the ICAEW of 'Financing Leases' and 'Rental Leases' are sensible and reflect reality, and we would support the inclusion of these or similar terms in the final Standard.

Finally, although we agree with the exemption in the exposure draft for short term leases (defined as those with a term of 12 months or less) as noted in our previous comment letter we believe that, on the grounds of practicality and to reduce the burden on preparers, particularly SMEs, this exemption could be extended to include leases with a term of less than three years, and indeed for leases that are immaterial (assuming that they are not material in aggregate).

We still do not understand why leases of intangibles have been specifically scoped out of the Standard. There would not appear to be any particular conceptual reason for this, although we would recognise that such leases are relatively rare in practice.

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1. Do you agree with the definition of a lease and the proposed requirements in paragraph 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 a conclusion that does not reflect the economics of the transaction.

Overall we agree that the definition of a lease, and guidance for how an entity should determine whether a contract contains a lease, are reasonable. We would agree that if a right of substitution exists which is substantive, then the contract should be treated as a service contract, rather than a lease; this should make it easier for entities to account for short term rental agreements where a right of substitution genuinely exists and is frequently exercised, for instance rental of office equipment such as photocopiers.

However, we would share the ICAEW's concern that the proposals as drafted might lead to structuring opportunities, which could lead to some contracts being treated as service contracts when they are in substance leases. Similar structuring opportunities arose in the United Kingdom as a result of the '90% test' for determining whether a lease was an operating lease or a finance lease, and whilst this presumption could be rebutted, it did lead to more leases being kept off balance sheet than might otherwise have been the case. The substance of the lease should determine the accounting in all cases. We agree with the ICAEW that more examples of, or guidance on, operational barriers to substitution would be helpful.

2. 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 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?

Yes, we agree that the recognition and measurement requirements should be different for different leases. However, basing the distinction on the consumption of all but an insignificant portion of the economic benefits embedded in the underlying asset is not entirely equivalent to the transfer of the risks and rewards of ownership under the old model, even though the lease being for the major part of the asset's useful economic life is an integral part of determining whether the risks and rewards have been transferred. We have commented further below on how the line between the different types of leases is drawn.

Also, as noted in our introductory remarks, the terminology used for the different types of leases is in our view not meaningful and we strongly believe that alternative terms for the different types of leases need to be determined. In addition, the accounting that results for 'type B' leases is, in our view, somewhat forced – in particular the requirement that the amortisation of the right to use asset is a balancing figure such that the resulting charge to profit or loss is on a straight line basis.

We recognise that conceptually under the current lease model lease liabilities are not recognised on operating leases when an obligation to transfer economic benefits nonetheless exists over the lease term, and clearly for a liability to be recognised for the entire lease rentals, a matching asset has to be recognised as well. The current lease model has the benefit of simplicity in that there is no need for a balancing figure to be calculated, the rentals are simply spread on a straight line basis over the term of the lease.

However, given that the Board appears to have decided that recognition of a right to use asset for all leases is required, with the liability measured at amortised cost, it is difficult to see how else the



lease expense could be recognised on a straight line basis, and for that reason use of the balancing figure has the benefit of practicality.

We have commented in our introductory remarks on our concerns about how the amortised cost approach to accounting for lease liabilities would be applied in practice and that it could be onerous to apply. As noted above, in our opinion it would be more practical for the interest charge to be determined on an actuarial or sum of digits basis as is done at present for finance leases.

3. 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 agree with this approach on the grounds of consistency with the approach proposed for lessees. We are pleased that the overly complex proposals for lessor accounting in the previous exposure draft (and specifically the performance obligation approach) have been dropped.

4. 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 paragraphs 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?

Whilst as noted above we can see that the consumption principle is a logical way of determining which type of lease a particular arrangement is, we do have some concerns. In particular, whilst property leases usually will be 'type B' leases (and under the current model, are treated as operating leases) and most other leases will tend to be 'type A' or finance leases, this is not always the case. For example, a lease of an aircraft may be for a term significantly less than the useful life of the aircraft itself and therefore a relatively small proportion of the economic benefits embedded in the asset may be consumed over a lease term when the term is relatively short – but this would not necessarily be categorised under the draft Standard as an 'insignificant' portion.

The principle in IAS 17 that classification of a lease depends on whether the risks and rewards incidental to ownership are transferred to the lessee is well understood and is not, in our view, incompatible with the right to use asset model used in the draft Standard. It would also have the benefit that leases classified as finance leases under the old standard would be classified as 'Type A' under the new standard and operating leases as 'Type B' without the need for major reassessment and subsequent reclassification. This would ease the transition process for both lessors and lessees.

5. 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?

We generally agree with the proposals (which are a significant improvement on the proposal in the previous exposure draft to define the lease term as the longest possible term that is more likely than not to occur) but are concerned that under the draft Standard, reassessment will be required more frequently than ideal, which could be onerous to apply in practice. We would support the ICAEW's suggestion that the lease term should only be reassessed if the change in relevant factors is 'significant' – as currently drafted paragraph 27 appears to require reassessment if there is any change in relevant factors. We agree that optional renewal periods should only be included in the



lease term if there is a significant economic incentive for the lessee to exercise the option, as this should equate to it being highly probable that the option will be exercised.

6. 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?

Generally we agree with the proposals for measurement of variable lease payments i.e. that they should only be included when they are either index or rate linked or are in substance fixed. However, as with changes in factors affecting the lease term, we believe that variable lease payments should only be reassessed when the change is significant.

7. Paragraphs C2-C22 state that a lessee and a lessor would recognise 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 these proposals? Why or why not? If not, what transition requirements do you propose and why? Are there any additional transition issues the Boards should consider – if yes, what are they and why?

We agree that full retrospective restatement would be overly harsh particularly if the requirements for determining the appropriate classification of leases are changed as envisaged in the draft Standard. As noted above we believe that retention of the classification requirements in IAS 17 would help with the transition to the new Standard.

We agree with the proposed treatment for 'Type B' leases that the right to use asset and lease liability should be recognised at the same amount at the date of transition. However, we would propose that in the event the classification model in the draft Standard is unaltered for the final version, this transitional exemption is also extended to any leases that were previously treated as operating leases and where no liability or asset were therefore recognised. Of course, if the Board were to adopt the suggestion proposed by the ICAEW (and supported by ourselves) that the criteria for classification in IAS 17 are retained, then there would not be any operating leases that were required to be treated as 'Type A' leases on transition to the new Standard.

The use of average remaining lease payments to determine the right of use asset for 'Type A' leases assumes that lease payments are made evenly which may not be the case. It is quite common with some leases (for instance finance leases on cars) to have large up front deposits and 'balloon' payments at the end of the lease rather than being spread evenly over the life of the lease.

8. Paragraphs 58-67 and 98-109 set out the disclosure requirements for a lessee and a lessor. Those proposals include maturity analyses of undiscounted lease payments; reconciliations of amounts recognised 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?

Overall we believe that the disclosure requirements, whilst conceptually sound, are likely to result in rather lengthy disclosures and are therefore likely to be onerous for companies to apply in practice. Whilst we would accept that the Standard allows some flexibility over how much detail is disclosed (and indeed note that IFRS permits non disclosure on grounds of immateriality as a general principle) we would encourage the Board to include an explicit statement that disclosure is not



required if it is not material to the financial statements, perhaps with the caveat that information may be material by nature even if it is not necessarily material by amount.

12. 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*. 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?

Yes, we agree with this proposal which essentially revises the current treatment in IAS 40 of property under operating leases which otherwise meets the definition of investment property, for the new requirements.

We hope that our comments are useful to you. If you have any questions, then please contact either Tessa Park or Tim Gonzaga.

Yours faithfully

Kingston Smith LLP

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