The Institute of
Chartered Accountants
of Pakistan

HEAD OFFICE

International Accounting Standards Board,
30 Cannon Street, London EC4M6XH,
United Kingdom

December 13, 2010

Subject: **COMMENTS ON EXPOSURE DRAFT 'LEASES'**

Sir,

The Institute of Chartered Accountants of Pakistan welcomes the opportunity to offer comments on the above mentioned exposure draft.

Please find enclosed the comments of the relevant Committee of the Institute for your perusal.

If you require any further clarification, please do not hesitate to contact us.

Yours faithfully

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COMMENTS ON EXPOSURE DRAFT 'LEASES'

Question 1: Lessees

(a) Do you agree that a lessee should recognize a right-of-use asset and a liability to make lease payments?

(b) Do you agree that a lessee should recognize amortization of the right-of-use asset and interest on the liability to make lease payments?

Answer:

We agree that a lessee should recognize a right-of-use asset and a liability to make payments and recognize amortization and interest on the liability to make payments. However, currently there is one option to amortize right-of use asset in ED which is straight-line method. Our suggestion is other methods of amortization should also be allowed which should properly reflect pattern of use of the right-of-use asset over the lease period. This will allow fair presentation of the asset and its usage in each reporting period.

Question 2: Lessors

(a) Do you agree that a lessor should apply (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and (ii) the derecognition approach otherwise? Why or why not? If not, what alternative approach would you propose and why?

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting? Why or why not? If not, what alternative model would you propose and why?

Answer:

Factors stated in ED for determining either a lease contract falls in the performance obligation approach or the derecognition approach are complex and performing such exercise for each lease contract will be very lengthy process for each entity in the country. We understand that providing two approaches are based on premise whether or not a lessor retains exposure related to risks or benefits associated with the underlying asset. If risk or benefits are retained, a lessor will follow the performance obligation approach; otherwise derecognition approach. In our view, it would have been better, had one approach been allowed as it has been done in case of the lessee accounting. Under the performance obligation approach, two assets are recognized by the lessor during the lease term, one being the leased item and other a receivable representing the lessor's right to receive payment during the lease term. Accordingly, the lessor's statement of financial position will be significantly inflated by this approach. Hence, we recommend that only the derecognition approach should be allowed. However, if the performance obligation approach is also considered as an allowable option, then we believe the unamortized performance obligation should be stated net of the underlying asset to present a clear picture of the financial position of the lessor.

Question 3: Short-term leases

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

Answer:

Although it is another version of accounting treatment of lease for both lessee and lessor in ED, we agree with the Board's proposal for recognizing the right of use asset and liability to make payments of short-term leases at undiscounted amounts in books of lessee and recognizing only the underlying asset in books of lessor. Given the short term duration of such leases, the cost of arriving at the full requirement proposed in the exposure draft may be significant and outweigh the benefit of full disclosure.

Question 4:

(a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?

(b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?

(c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

Answer:

(a) The definition of lease should be modified to clarify that only lease of a depreciable tangible assets and land (i.e property, plant and equipment) is considered to be within the scope of the definition. Further, the definition should be inclusive and not exclusive i.e. it should define what a lease is instead of specifying what it is not.

(b) Significant change which has been brought in ED is exclusion of those lease contracts which contain bargain purchase option or where title to underlying asset is automatically transferred to lessee at the end of lease period. Now, such contracts have been treated as sale/purchase contracts and will be accounted for as per guidance given in other IFRS.

We do not support a distinction for in-substance purchases/sales. Determining which lease are in-substance purchases/sales is the underlying premise of lease classification (finance vs operating) under current accounting requirements for lease accounting and the Boards decided to abandon this approach. Any approach to distinguish these types of lease arrangements would create another arbitrary bright line in lease accounting. Further, in our view, such contracts should not be treated as sale/purchase contracts unless all requirements for sale of goods as stated in IAS 18 or are met.

(c) Appears to be sufficient.

Question 5: Scope exclusions:

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

Answer:

We agree with the proposed scope exclusion except the rationale behind the exclusion of lease of intangible assets (refer BC36). Further, we would like to highlight the fact that certain contracts may include both tangible and intangible components as in case of IT industry where many lease solutions include both equipment and software. In such cases, management has to apply different requirements in different IASs which create additional complexity and are not beneficial for the user.
Further, exposure draft proposes that lease investment property measured by the lessor at fair value be scoped out and lease investment property measured at cost be scoped in without explaining the conceptual reason for the preferred treatment. This approach dilutes the objective of the standard that all the lease related issues are comprehensively dealt with in this standard.

Question 6: Contracts that contain service components and lease components:

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

Answer:

We believe that when a contract includes both leases and non-distinct services, a lessee should identify the predominant component and treat the whole contract accordingly. Consideration should be given to the substance of the transaction.

We believe that the lessor should always be required to account for the services and lease components of a contract separately.

Question 7: Purchase options:

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

Answer:

We do not agree that the lessee or a lessor should account for purchase options only when they are exercised. We believe that purchase option should be accounted for in the same manner as option to extend or terminate the lease. Purchase option provides the lessee with a contractual ability to acquire additional rights associated with the leased assets and therefore should be considered as extension of the lease term on a basis similar to renewal option.

Question 8: Lease term:

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

Answer:

We strongly disagree to determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of options to extend or terminate the lease.

First, this will add unnecessary complications. Although including in the contract the option to extend obviously indicates the original intention of the two parties, as circumstances can change since the initial date of the contract which makes the option to extend unfavorable for lessee. And predicting the likelihood of lease option renewals is therefore significantly more difficult on the lessor's side.

Secondly, this estimation is too subjective and hence will open the proposed standard to inconsistency in application.

We believe that lease term should only include optional lease period that is reasonably certain to be exercised. Under this approach, only optional lease period for which lessee is likely to exercise the option should be considered due to the existence of significant economic incentive to renew.

Question 9: Lease payments:

(a) Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

(b) Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

Answer:

No.

We believe that lease payments should only include payments for the recognized lease term that represent a present obligation of the lessee. That is, only payments that a lessee has a present obligation to pay should be recognized in the liability to make lease payments recognized by the lessee and the right to receive lease payments recognized by the lessor.
Below we separately discuss our view specific to contingent rent, residual value guarantees and term option penalties.

Contingent rent
Only contingent rent that represents current obligation of lessee rather than a probability estimate on all possible outcomes should be considered.

Guaranteed Residual value
It should be included in present obligation of the lessee based on the best estimate approach of the liability.

Term option penalties
It should not be included in present obligation of lessee and accounted for at the termination of lease rather than applying weighted average probability approach to account for the present obligation of lessee.

Question 10: Reassessment:

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not? If not, what other basis would you propose for reassessment and why?

Answer:

We agree with the Board's proposal for the reassessment of assets and liabilities under the lease in view of significant change in the circumstances. However, we believe that any subsequent change in the circumstances should be recognized in the profit and loss account rather than adjusting against assets and liabilities.

However, it is important to note that it will pose a practical problem to the entities to reassess the relevant assets and liabilities which outweighs the benefits to be received from such a change.

Question 11: Sale and leaseback

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?

Answer:

In ED, new criteria (appears to be stringent) have been outlined which is required to be met before any transaction is accounted for as a sale and leaseback transaction. When criteria are not met, transaction will be recognized as a financing transaction due to which there is a possibility that many transactions may not be considered as sale and leaseback. In our view, reconsideration should be given to the criteria to reduce the requirements for sale and leaseback transactions.

Question 12: Statement of financial position:

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)? Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

(b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totaling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?

(d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

Answer:

(a) Presentation appears to be appropriate as it will give clear view to users about leased assets and liabilities.
(b) See our comments in answer to Question 2 above.
(c) We will agree with the presentation, if the Board continues with its proposal instead of our suggestion as given Question 2 above.
(d) Yes.

In our view, clarification should be provided whether the information should be presented on face or in the notes.

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

Answer:

We agree with the proposal.

Question 14: Statement of cash flows:

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Answer:

We agree with the proposal.

Question 15: Disclosure

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

(a) identifies and explains the amounts recognized in the financial statements arising from leases; and
(b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows

(paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

Answer:

We welcome the requirement in paragraph 71 of the exposure draft that an entity should consider the level of disclosures appropriate to satisfy the objectives in paragraph 70. The list of disclosure requirements is rather extensive and we believe that the IASB should state even more clearly that they should not be regarded as mandatory in all situations.

Question 16: Transition

a) The exposure draft proposes that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186– BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?

(b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?

(c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

Answer:

This seems to be appropriate.

Question 17: Benefits and costs

Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

Answer:

In the local environment, it appears that cost of implementing requirements of the proposal will outweigh its benefits as it will require expertise and changes in existing systems. Many entities especially lessors have to appoint consultants to prepare models which capture data and prepare reports in such way that meet requirements of the proposal as the existing systems may not be such robust. Hence, this may not be cost-effective. Further, carrying out reassessments of lease terms and uncertain payments like contingent rents at later intervals will be a complex job due to which entities will have to either employ persons with the required skills or train their existing staff. This again will result in an increase in cost. Currently, in Pakistan, the leasing sector is going through a crisis situation due to shortage of liquidity and it is not clear when this sector will revive so imposition of the requirements of this ED will be onerous for them at this stage. In our view, the Board should reconsider the proposal and lessen requirements related to uncertainties/probabilities where use of estimates is high.

<u>Question 18:</u> Other comments

Do you have any other comments on the proposals?

<u>Answer 18</u>

Accounting for changes between the date of inception and commencement of the lease
In some leases a significant lag between lease inception and the commencement date may occur. We believe the Boards should address the accounting for any transaction prior to the commencement date or the effect of changes that could occur between the inception and commencement date or explicitly state that no intervening accounting occurs.

Multiple leased assets
Companies enter into agreements involving numerous pieces of equipment or properties either simultaneously or through a master lease arrangement. We believe the Board should address whether to segregate the multiple assets in the right-of-use model as the level of disaggregation and methodology to allocate the payments will impact the measurement of the arrangement (e.g., the amortization period if the economic life of the asset is shorter than the lease term).

Impairment assessment for right-of-use assets
Although the ED references other standards (IAS 36 and ASC 350) for impairment of recognized right-of-use assets, we believe that it would be beneficial to include application guidance within the leases standard or as consequential amendments to the other applicable standards on whether or not (and if so how) the liability to make lease payments should be considered in the impairment assessments for right-of-use assets.