

THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND



Response from
The Institute of Chartered Accountants of Scotland
to the International Accounting Standards Board

Exposure Draft 2010/9: Leases

1 December 2010

INTRODUCTION AND KEY COMMENTS

The Institute's Accounting Standards Committee has considered the above exposure draft and I am pleased to forward its comments to the IASB.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires the Accounting Standards Committee to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

We strongly support the development of a new standard on lease accounting as this has been a widely criticised area of financial reporting for some time. We agree with the overall approach proposed by the IASB for lessee and lessor accounting which we believe will result in more useful and accurate information about leasing transactions being reported in financial statements. We do have concerns about certain aspects of the proposals, in particular:

- The distinction between a lease and a service contract: we believe that more guidance is required to assist in distinguishing between a lease and a service contract. We believe that the overall focus should be on the business purpose of a transaction rather than the current narrow focus on the provision of a specified asset.
- The treatment of options to extend or terminate a lease: we were unable to reach a consensus on this area amongst our members. Some members disagree with the recognition of the longest likely lease term as they believe a likely extension of a lease does not meet the definition of an asset or liability under the conceptual framework. Other members believe it would be appropriate to recognise certain changes to the lease term but believe that further work is required in setting a threshold of likelihood at which such changes should be recognised.

Any enquiries should be addressed to Amy Hutchinson, Assistant Director, Accounting and Auditing and Secretary to the Accounting Standards Committee.

Question 1: Lessees

(a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

(b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Response:

We agree that a lessee should recognise a right-of-use asset and a liability to make lease payments, and should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments. We believe this is an appropriate model to use since it reflects the fact that a lessee has an asset in respect of the right to use the leased asset for a specified period, and a liability in respect of the obligation to make lease payments for the same period. This is in accordance with the IASB conceptual framework and is undoubtedly an improvement on the current model of accounting by lessees. The right-of-use model will provide more useful information about all of an entity's leasing activities and will address many of the criticisms of the current accounting model such as the structuring opportunities created by the current split between operating and finance leases.

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?

Response:

Conceptually we are less comfortable with the proposals for lessor accounting than we are with those for lessee accounting. We feel that if a single approach is possible for lessee accounting, the same should be true for lessor accounting and we are concerned that the hybrid approach proposed here will provide opportunities for leasing transactions to be structured so as to achieve a desired accounting outcome. However we have been unable to identify a single approach capable of being applied to all types of leases from a lessor perspective. We recognise that a hybrid model may in fact be necessary in order to reflect the different ways in which a lessor may manage its business. Therefore on balance we support the IASB's proposals for the performance obligation approach and derecognition approach for lessors.

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

(a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (i) the liability to make lease payments at the undiscounted amount of the lease payments and (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognise lease payments in profit or loss over the lease term (paragraph 64).

(b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognise assets and liabilities arising from a short-term lease in the statement of financial position, nor derecognise any portion of the underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognise lease payments in profit or loss over the lease term (paragraph 65).

(See also paragraphs BC41–BC46.)

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?

Response:

In general we are happy with the proposed treatment for short-term leases. It is appropriate that short-term leases are recognised, as the assets and liabilities involved could be material, but it is also appropriate to offer some relief in relation to such leases. We are happy with the approach proposed for lessees. However, we are concerned that paragraph 65 states that a lessor may elect to use the short-term lease method on a ‘lease-by-lease basis.’ This gives the impression that the lessor will simply select whichever short-term leases it wishes to apply the simplified method to. This does not seem to tally with the wording in paragraph BC46 which states that the short lease period ‘may make the assets and liabilities arising from those leases insignificant.’ Therefore the lessor’s assessment of which leases the simplified method should be applied to should be based on the significance of the assets and liabilities arising from each lease. The wording in paragraph 65 should be changed to reflect this.

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?

Response:

Overall we agree that a lease is defined appropriately although we are concerned that the distinction between leases and service contracts will be difficult to apply in practice. We doubt if the guidance in B2 to B4 will be sufficient - we believe that more guidance is required on consideration of the business purpose of a transaction, rather than the current narrow focus on the provision of a specified asset.

In general, we are happy with the criteria for distinguishing a lease from a contract that represents a purchase or a sale, although as indicated in our response to Question 11 below we believe that the information in B31 is also relevant, and therefore it may be more appropriate to supplement the criteria in B9 and B10 with that in B31. We agree that a contract is a sale or purchase if, at the end of the contract, control of the asset is transferred along with all but a trivial amount of the risks and rewards related to the asset.

Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

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?

Response:

The IASB has not advanced a convincing argument for the scope exclusions for intangible assets. There is no conceptual basis for a blanket exclusion for all such assets, and this represents a backward step from the IAS 17 position, which includes some intangibles in its scope. We believe the IASB should give further consideration to the treatment of intangible assets prior to the finalisation of this standard.

Question 6: Contracts that contain service components and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

(a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.

(b) the IASB proposes that: (i) a lessee should apply the lease accounting requirements to the combined contract.

(ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract. (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.

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?

Response:

We agree that where service components are distinct these should be separated out and accounted for under the revenue proposals. Where there are non-distinct service components we believe that both lessors and lessees should identify the predominant component and treat the whole contract accordingly. This would be a practical approach that depends on the entity's perception of the overall economic substance of a contract, and minimises complexity by allowing lessors and lessees to avoid attempting to separately ascribe values to 'non-distinct' services.

Question 7: Purchase options

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64). 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?

Response:

We agree with the view that a purchase option is a means of terminating the lease therefore such options should only be accounted for when they are exercised. We agree that the exercise price of a purchase option is not a lease payment and should not be included in the measurement of the lease.

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?

Response:

We believe that this is a difficult area and we are unable to reach a consensus amongst our members on the approach that should be taken on options to extend or terminate a lease. Some of our members agree with the alternative view expressed by Stephen Cooper. They agree that rentals payable or receivable under extension periods do not meet the definitions of a liability or an asset under the conceptual framework. They believe that recognising the longest likely lease term will result in dissimilar leases being accounted for in the same way (e.g. a 10 year lease would be accounted for the same as a 5 year lease with an option to extend for another 5 years). Where a lease includes an option to extend, this is likely to be reflected in the price of the lease contract therefore the option is recognised in the financial statements in this way. Recognising the longest likely lease term is particularly difficult to justify conceptually from the lessor's point of view, since they do not have any control over whether the lease is going to be extended.

On the other hand, some of our members are concerned that ignoring the existence of options to extend the lease in the measurement of the lease liability for a lessee relies on a sometimes overly legalistic definition of a liability which may not reflect the economic reality of the lessee's business. For example, there may be compelling business reasons that would make it almost certain that a lessee will exercise the option to extend a lease, although there is no legal obligation. In such a case it would appear that recognition of the extension to the lease term is appropriate. It could be that further work on defining the threshold at which the likelihood of an option being exercised is such that the extension is recognised.

In either case – recognising the longest likely lease term, or not recognising options to extend or terminate the lease, we believe that there are significant opportunities for entities to structure transactions in order to achieve a desired accounting outcome. Since this is one of the major criticisms to be levelled at existing lease accounting, this should be avoided at all costs. We believe that further work is required in this area.

Question 9: Lease payments

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? 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?

Response:

We agree that contingent rentals and expected payments under term option penalties and residual value guarantees should be included in the measurement of assets and liabilities arising under a lease. We believe this issue differs from the treatment of options to extend or terminate a lease because it relates purely to the measurement, and not the recognition, of the lease asset or liability. We agree with the boards' view that the liability to pay contingent rentals and the right to receive lease payments exist at the inception of the lease, and it is only the amount that is uncertain. Therefore we are comfortable that such options should be measured using an expected outcome technique.

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?

Response:

We agree that lessees and lessors should remeasure assets and liabilities when there is an indication that there is a significant change since the previous reporting period. This is necessary to ensure that the measurement of lease assets and liabilities remains accurate over the term of the lease. Requiring remeasurement only where there is an indication of a significant change is appropriate as it is less burdensome than requiring a periodic reassessment of all lease contracts. However, consideration should be given to providing guidance as to what might constitute a 'significant' change.

Question 11

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?

Response:

We agree with the criteria for classification as a sale and leaseback transaction. We believe that the information in B31 is also relevant to distinguishing between a lease and a purchase or sale and therefore it may be more appropriate to include this within this section at B9 and B10.

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, totalling 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?

Response:

- (a) We agree with the proposed presentation in the statement of financial position for lessees. We believe this will result in a transparent depiction of the impact of lease contracts on the lessee's financial position.
- (b) At first glance, we find it odd for lessors applying the performance obligation approach to present a net lease asset or liability but we think that this presentation will help to alleviate the perception that under this approach the underlying asset is somehow double-counted, therefore we support this approach.
- (c) We agree with the proposed presentation in the statement of financial position for lessors applying the derecognition approach.
- (d) We agree that lessors should distinguish assets and liabilities relating to a sublease in the statement of financial position if these balances are material.

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?

Response:

We agree that lessees and lessors should present lease income and expense separately from other income and expense in profit or loss. We believe it is useful for the impact of leasing transactions to be clearly depicted on the face of the statement of comprehensive income.

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?

Response:

We agree that leasing cash flows should be presented separately in the statement of cash flows. This means that leasing information is consistently presented across the primary statements.

Question 15

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

- (a) identifies and explains the amounts recognised 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?*

Response:

We agree with the general principle for disclosure set out in paragraph 70. However the list of disclosure requirements in paragraphs 73 to 86 is very extensive and we believe the IASB should clarify that it is not mandatory to disclose all of these items. The current wording in paragraph 71 – 'an entity shall consider the level of detail necessary to satisfy the disclosure requirements in paragraphs 73-86' gives the impression that all of these requirements are mandatory. We do not think that this should be the case – preparers should exercise judgement in determining which of these disclosures are required to meet the overall principle for disclosure.

Question 16

(a) The exposure draft proposes that lessees and lessors should recognise 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?

Response:

We understand that full retrospective application could be onerous and therefore a simplified approach is reasonable. However we believe that full retrospective application should be permitted as we understand that some preparers are concerned that applying the transitional provisions could have a misleading impact on their profit figures.

Question 17

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?

Response:

We believe that further work is required by the IASB to ensure that all costs related to the implementation of the proposed standard are identified. We are not convinced that the IASB’s current analysis of the costs is conclusive.

Question 18

Do you have any other comments on the proposals?

Response:

We have no other comments.