

Exposure Draft ED/2010/09
Leases

response to exposure draft

21 December 2010

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Our ref: Responses/101221 SC0152

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
Submitted electronically to www.ifrs.org

21 December 2010

Dear IASB Secretariat

IASB Exposure Draft ED/2010/09 Leases

CIPFA welcomes the opportunity to comment on this exposure draft, which has been reviewed by CIPFA's Accounting and Auditing Standards Panel, in consultation with other CIPFA expert panels and stakeholders with an interest in financial reporting.

CIPFA supports the general direction of travel of this and previous IASB papers, which propose that certain arrangements which are currently off balance sheet should be recorded as assets and liabilities. However, in our view, further explanation and some changes to the content of the proposals will be required before moving to a final IFRS.

Having seen the detailed proposals in the ED, CIPFA is less clear on the benefits of essentially all leases being capitalised. We can see that relaxing the capitalisation requirement would potentially introduce 'bright lines' and opportunities for structuring. If the IASB proceeds along the lines proposed it is crucial that the new IFRS should not impose onerous additional requirements. If inclusion on balance sheet is mandated, CIPFA would hope that the IFRS would provide opportunities for reducing the lease disclosures for routine and less significant leasing, while recognising that further information may be required in cases where lessee or lessor issues are significant to reporting entity objectives.

We also have some new reservations on the extension of the expected outcome approach to lease terms and lease payments.

In addition, we have some significant concerns that the hybrid approach for lessor accounting is not sufficiently explained, and the apparent mismatch between this and the single approach for lessee accounting may flag up a disconnect between the proposed IFRS and the developing conceptual framework. We accept that conceptual issues do arise during the development of standards and there are dangers in delaying standards development until the framework is revised. However, given the other issues raised by the exposure draft, more clarity is needed before going forward to a final IFRS.

Our comments on the questions in the ED are set out in the attached annex.

I hope this is a helpful contribution to the Board's development of revised standards.

Yours faithfully

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IASB Exposure Draft ED/2010/09 Leases

Responses to questions in the Invitation to Comment

The accounting model

The exposure draft proposes a new accounting model for leases in which:

(a) a lessee would recognise an asset (the right-of-use asset) representing its right to use an underlying asset during the lease term, and a liability to make lease payments (paragraphs 10 and BC5–BC12). The lessee would amortise the right-of-use asset over the expected lease term or the useful life of the underlying asset if shorter. The lessee would incur interest expense on the liability to make lease payments.

(b) a lessor would apply either a performance obligation approach or a derecognition approach to account for the assets and liabilities arising from a lease depending on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the lease (paragraphs 28, 29 and BC23–BC27).

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?

As noted in our 2009 response, CIPFA agrees that recognising a right-of-use asset and a corresponding liability to pay rentals seems to better capture the economic substance of lease arrangements than current reporting. In that response we also noted that the benefits of improved reporting would be greater for high value leases, and also where the combined value of leases is high. The benefit of more detailed reporting on less significant leases is much less clear.

We would also note that the ED proposals fit better with the working definitions of asset and liability adopted by the IASB and FASB and set out in FASB summaries of decisions made as at September 2008, but that formal discussion and consultation on these in a revised Elements chapter of the conceptual framework has not yet been undertaken.

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?

The proposals for lessor accounting are less well explained and we are less clear about their conceptual fit. Intuitively we consider that the approach for lessee accounting should broadly mirror that for lessor accounting.

We note that the performance obligation approach is consistent with other IASB development, for example in revenue recognition, but that in our responses to other consultations we have indicated that further development is required. The lack of a fully developed approach to performance obligations may be the reason why it is necessary to bring in the derecognition approach.

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?

Short-term leases are not inherently different from other leases and in principle should be subject to the same reporting requirements. However, this would impose a heavy burden on some reporting entities and we accept that a simplified approach is appropriate.

However, the proposed simplifications seem to offer little relief in practice, particularly for entities with large numbers of short-term leases for whom the burden of identifying and tracking these leases may still be onerous. We are wary of introducing another bright line or structuring opportunity, but we consider that it would be helpful if the Board could investigate other ways of reducing the reporting requirement.

Definition of a lease

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

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?

CIPFA is generally content with the definition of a lease which follows that in IAS 17. While the criteria in B9 and B10 are broadly satisfactory, some care will be necessary to ensure that the combined package of IFRIC 4, IFRIC 12 and the leasing IFRS are consistent, and this may require clarifying changes or improvements to be made to the interpretations.

Scope

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?

BC37 notes that the ED proposes to exclude from its scope leases of most intangible assets to be consistent with most existing IFRS practice and US GAAP, while noting that the boards have identified no conceptual reason why a lease accounting standard should exclude intangible assets. It explains that the boards decided not to include leases of intangible assets within the scope of the proposed IFRS until they had considered the accounting for intangible assets more broadly.

This wholly pragmatic justification seems to have the effect of applying or condoning an operating lease approach for intangibles until such time as the boards review the accounting for intangible assets. We note that this project is not on the active agenda for the IASB.

In the light of the above we consider that this aspect of the ED will have the effect of reducing the quality of IFRS standards albeit with possibly less of an effect on IFRS practice. We suggest that 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?

We support this approach, which has regard to the fact that lessees may more often have difficulties in distinguishing service and lease components.

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?

CIPFA supports this approach.

Measurement

The exposure draft proposes that a lessee or a lessor should measure assets and liabilities arising from a lease on a basis that:

(a) assumes 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 (paragraphs 13, 34, 51, B16–B20 and BC114–BC120).

(b) includes in the lease payments contingent rentals and expected payments under term option penalties and residual value guarantees specified by the lease by using an expected outcome technique (paragraphs 14, 35, 36, 52, 53, B21 and BC121–BC131). Lessors should only include those contingent rentals and expected payments under term option penalties and residual value guarantees that can be measured reliably.

(c) is updated 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 (paragraphs 17, 39, 56 and BC132–BC135).

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?

CIPFA agrees that in measuring the assets and liabilities relating to a lease, consideration should be given to the likely lease term, and that it would not be appropriate to ignore the effect of options to extend or terminate the lease.

CIPFA supported a 'more likely than not' approach to lease term as opposed to probability-weighted approach in our response to the 2009 Discussion Paper. Having seen the proposals in more fully worked out form, we are not as convinced that the same treatment should be applied to optional components of the lease term, and we consider that more work should be carried out before a standard using this approach is issued.

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?

CIPFA supported an 'expected' outcome to contingent rentals and other expected payments in our response to the 2009 Discussion Paper.

Consideration of contingent rentals may be necessary to avoid certain types of restructuring. It may also be necessary to capture the economic substance of lease arrangements, particularly where additional payment obligations arise through external factors.

However, while we still consider that contingent payments are relevant information for users of financial statements, having seen the proposals in more fully worked out form, we are not as convinced that the same treatment should be applied to all contingent payments. In particular, we see a difference where the circumstances giving rise to higher levels of payments are within or outside the control of the 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?

CIPFA agrees with the 'significant change' trigger for remeasurement.

Sale and leaseback

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

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?

CIPFA has no observations to make on the criteria.

Presentation

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

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?

CIPFA considers that separate disclosure of information on right-of-use assets and lease payment liabilities somewhere is appropriate. However, it is not clear that these disclosures should always be made in the Statement of Financial Position, rather than 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?

The need for 'flow' disclosures will reduce if there is a clear and consistent basis for asset and liability disclosures, as long as these are properly understood.

It might be helpful for the new IFRS to draw attention to the IAS 1 requirement to explain the assumptions underlying the financial statements, particularly in connection with lease terms or contingent rentals relating to particular assets.

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?

See response to Question 13 above.

**Disclosure
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?

See response to Question 13 above. Proportionate explanation in cases where leasing matters are significant would be helpful. CIPFA would hope that the IFRS would not require a large volume of automatic disclosures for routine items which would increase the complexity and clutter in financial statements.

Transition
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?

CIPFA agrees that the ED proposals are appropriate. We have no comments to make on questions (b) and (c).

Benefits and costs

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?

As noted in our response to Question 1, CIPFA agrees that recognising a right-of-use asset and a corresponding liability to pay rentals seems to better capture the economic substance of lease arrangements than current reporting. The benefits of improved reporting will be greater for those entities which are very significant users of lease arrangements.

The cost of implementation will depend on the detail of the IFRS and how this would be operationalised, but we are concerned that the proposals may result in significant and possibly onerous costs for many entities in the 'middle ground' of entities where leasing is neither mission critical nor immaterial.

Other comments

Question 18

Do you have any other comments on the proposals?

Although CIPFA and others have been waiting for improvements to lease accounting for several years, notwithstanding the proposed transitional arrangements, implementation of any major changes will need to be carefully managed in order to allow time to set up systems. A reasonable lead time will allow lease registers and associated financial reporting to be developed in a more orderly fashion.